SUBMISSION TO THE
FINANCIAL SYSTEM INQUIRY

by the

AUSTRALIAN ASSOCIATION OF
PERMANENT BUILDING SOCIETIES

Canberra
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GLOSSARY

ACCC	Australian Competition and Consumer Commission
ADFs	Approved Deposit Funds
AFIC	Australian Financial Institutions Commission
APCA	Australian Payments Clearing Association
ASC	Australian Securities Commission
ATMs	Automatic Teller Machines
BAD	Bank Account Debits Tax
CMTs	Cash Management Trusts
CFS	Council of Financial Supervisors
DTI(s)	Deposit Taking Institution(s)
EC	Electronic Commerce
EFT	Electronic Funds Transfer
EFTPOS	Electronic Funds Transfer at Point of Sale
FI Scheme	Financial Institutions Scheme
FID	Financial Institutions Duty
ISC	Insurance and Superannuation Commission
MF(s)	Managed Fund(s)
NCDs	Non Callable Deposits
PLA	Primary Liquid Assets
RSA(s)	Retirement Savings Account(s)
SG	Superannuation Guarantee
SIS Act	Superannuation Industry Supervision Act
SRDs	Statutory Reserve Deposits
SSA	State Supervisory Authority

Executive Summary

The Need for Reform

◊ There are a number of developments that mean the current regulatory arrangements governing the operation of Australia's financial system are inadequate to take Australia into the next century.

◊ The pursuit of economies of scope by financial institutions operating in a highly competitive environment is leading to the breakdown of traditional institutional boundaries through the emergence of financial conglomerates. This trend is evident both in Australia and in other countries competing in the international marketplace for financial services.

◊ The current institutional-based systems of prudential and consumer regulation are ill-equipped to cope with this development. Forcing institutions into categories for regulatory purposes risks interfering with the processes of evolution and structural change in one of Australia's most dynamic industries.

◊ Technological change is occurring at a rapid pace based on decreasing costs of communications and data processing. Because it is difficult to predict the nature of future technological change, it is important that Australia's regulatory system be able to adapt to change. Regulatory arrangements based on definitions of institutions are ill-suited to accommodate change.

◊ Market pressures are changing the forms of delivery of financial products, with new competitors able to enter the markets with particular financial services for selected market segments. This is placing great pressure on traditional DTIs that rely on a branch network to service their broadly based public customer base. Similarly, the traditional distinctions between deposits and other investments are being blurred through innovative products that are being released onto the market.

◊ The intensification of competitive pressures and the associated narrowing of margins puts a premium on regulatory arrangements that enable financial institutions to compete on an equal footing. It is vital that the new regulatory arrangements implement, rather than pay lip service to, the principle of competitive neutrality.

◊ Building societies and credit unions suffered initially in the post-Campbell era because they were subjected to prudential arrangements that were fragmented, poorly supervised, more prescriptive and more intrusive than those applied to banks. In addition, societies were excluded from many activities including direct participation in the payments system.

◊ These defects were partially addressed through the establishment in 1992 of the FI Scheme, although the current State-based system is expensive, cumbersome, overly prescriptive and does not provide the same safeguards as apply to banks.

Proposed Regulatory Arrangements

◊ All these considerations point to the need for a shift in the basis of regulation from institutional to functional, administered on a consistent basis at the national level. It should be what an institution does, not what it is categorised as, that determines the regulatory obligations of the institution. Thus, functional regulation is competitively neutral and does not inhibit the process of conglomeration or technological innovation.

◊ Australia will have a vibrant and competitive financial system, which observes appropriate prudential standards, if any institution that meets the prudential standards that apply to a particular function, such as taking deposits or offering a superannuation product, is allowed to undertake that function, providing the institution meets the prudential standards that apply to that function. This approach should also apply to the payments system. That is, if an institution meets the requirements that apply to participants in the payments system, then that institution should be allowed to participate. That said, the prudential supervisors must have an eye to the overall health of each financial institution.

◊ A regulatory structure based on regulatory function is likely to achieve the most efficient outcomes for Australia. There are three regulatory functions that should be performed:

- competition regulation;
- prudential regulation; and
- consumer regulation.

Co-ordination and resolution of conflicts between the three regulators would be facilitated by virtue of the fact that each regulator ultimately is responsible to the Federal Treasurer.

◊ These regulatory functions are sufficiently distinct that a separate regulator is required for each function:

- Competition regulation should continue to be performed by the ACCC. This avoids overlap or inconsistencies that would be likely to arise if a special competition regulator for financial institutions were established.
- A single consumer regulator should assume many of the responsibilities currently performed by the ISC and ASC, and under the Consumer Credit Code and State privacy and data protection legislation. All State consumer regulation of the financial system should be transferred to the national arena and overhauled prior to implementation.
- Prudential regulation should be performed by a single prudential regulator that assumes responsibility for the prudential regulatory functions currently performed by the Reserve Bank, AFIC, and the ISC. The basis of regulation should be by function, with an institutional overlay. A single prudential regulator would avoid problems due to

gaps and overlaps. This would most likely achieve the appropriate balance between functional and institutional regulation.

Prudential Regulation

◊ These arrangements assume that the States are willing to cede prudential regulatory responsibility to the single national prudential regulator. Building societies and credit unions would continue to be incorporated under State legislation or, if the States agreed, under Corporations Law.

◊ The single prudential regulator should most appropriately be the Reserve Bank. The institutional overlay for building societies could be facilitated through the establishment of "AFIC within the Reserve Bank" as an Office of Regional and Community Financial Institutions, which would have responsibility for the overall prudential standing and supervision of community banks, building societies and credit unions.

The Evolution of Building Societies

◊ Looking to the future, building societies do not believe that it is necessary for financial institutions to be large in order to survive. There is little evidence of economies of scale and large and small financial institutions compete both in Australia and in most other countries. To date, technological change has not imparted an efficiency advantage to large vis-a-vis small financial institutions.

◊ Building societies see a continuing role for small community based financial institutions in Australia whose main strength is their powerful affinity with the local communities that form their customer and investor base.

◊ The regulatory arrangements proposed in this Submission would facilitate the evolution of the building society industry and all other sectors of the financial services industry in the light of changing market and technological developments. This flexibility is vital to the future of the industry.

◊ The building society of the future may evolve in various ways. Societies want the freedom to retain the building society name and focus, including mutuality, while also allowing for the evolution into broader based community banking activities.

◊ Whichever directions the industry takes in the future, it is committed to preserve its reputation for the core values of service, innovation, fairness and reasonableness in lending and pricing in its dealings with its customer base in local communities in regional and rural Australia.

SUMMARY OF MAIN RECOMMENDATIONS

Prudential

Building societies (and credit unions) should be included in the mainstream of prudential supervision at the national level.

The system of prudential regulation recommended by the Inquiry should allow for an environment where building societies could evolve into community based financial institutions providing a broad range of services.

There should be a single prudential regulator for financial institutions, with prudential regulation organised along functional lines. The prudential regulator would assume all the prudential supervisory responsibilities currently exercised by the Reserve Bank, AFIC and the ISC. The industry has a preference for the prudential regulator being the Reserve Bank because it is the major existing prudential regulator and has the expertise and standing to assume responsibility for prudential oversight of all financial institutions.

The establishment of AFIC and the administration of the FI Code has developed considerable expertise in prudential supervision of building societies among SSAs. It therefore could be helpful for appropriately skilled persons engaged by AFIC and the SSAs to transfer to the national prudential regulator, whether it is the Reserve Bank or its successor. This would help ensure continuity and conservation of essential expertise, including in the inspection of regional financial institutions.

That building societies should no longer be subject to prescribed lending purposes to avoid limitation on the scope of their lending activities in the future.

The issue of whether the current depositor protection measures that apply to banks[1] *are still appropriate and whether they should continue to be restricted to banks should be reviewed by the Inquiry. Building societies consider that there is such a widespread expectation in the community that bank deposits are safe, that it would not be possible to alter the depositor protection provisions that apply to banks. To ensure competitive neutrality, stability and public confidence, these provisions should be extended to all DTIs.*

The notion of the spectrum of risk should be a reflection of the mix of business of a financial institution, rather than the classification of the institution.

The user pays principle should apply to the funding of the new prudential regulator, with deposit taking institutions contributing to the cost of supervision in proportion to their assets. Substantial cost savings and ongoing economies would be possible in a truly national scheme.

The building society industry considers that there are a number of policy issues raised by the process of securitisation the Inquiry ought to examine, including the attainment of

1 Depositors rank ahead of all other creditors and the Reserve Bank can take over the running of a bank that it considers to be under threat.

competitive neutrality, the implications for the regulation of DTIs, compliance with the Credit Code and the impact on the integrity of the provision of housing finance.

Consumer and Disclosure

A national approach to consumer credit legislation, State transactions taxes, privacy and data protection is highly desirable.

All consumer regulation pertaining to the retail financial services industry should be consolidated into a single new regulator at the national level. The national consumer regulator would assume the regulatory functions currently performed by the ISC and ASC, and States under the Consumer Credit Code and State privacy and data protection legislation. All State consumer regulation should be transferred to the national arena and overhauled prior to implementation. In order to ensure that the Credit Code is interpreted consistently and uniformly, a national jurisdiction should be established, including a national secretariat to develop and administer policy, compliance and administrative factors on a national basis.

Competition Policy

The approach most likely to produce consistency of treatment across industries, is to leave responsibility for competition regulation with the ACCC. This has the advantage of avoiding the creation of a new regulator.

The proposed ACCC 1997 review of the impact of globalisation on competition in domestic markets and on the opportunities for domestic industry to penetrate overseas markets should be integrated into the work of the Inquiry insofar as it relates to financial services.

The building society industry endorses the approach of APCA and recommends that the Wallis Inquiry accept the role of APCA in determining eligibility to participate in the payments system and as a requirement for settlement, finality of payment requires a settlement account operated at the Central Bank by an institution of high prudential standing.

Specifically, we recommend that, given the importance of economically viable access to networks by small institutions, such networks should be regarded as essential facilities in terms of the national Competition Principles Agreement.

Saving Policy

The Commission of Audit recommended that the government undertake a comprehensive review of options for improving the contribution of household saving to national saving, including a full review of tax and social security arrangements in terms of how they affect incentives to save. The building society industry strongly supports this recommendation of the Commission and favours policy initiatives designed to level the tax playing field for saving

Building societies should have broader access to the retirement savings market by being able to offer superannuation and other managed fund products.

1. THE POST-CAMPBELL SEARCH FOR A REGULATORY HOME FOR BUILDING SOCIETIES

1.1. The Campbell Inquiry Outcome for Building Societies: Ten Years in No Man's Land

"*Deregulation principally concerns* ***banks*****"** (emphasis in the original)
Grenville (1991), p 4[2].

The Campbell Inquiry both validated the freeing up of the Australian financial system that was occurring naturally in the 1970s and was itself the impetus for further, similar changes that were implemented in the 1980s. The main focus of the Campbell Inquiry was on improving the efficiency of the financial system. Like later microeconomic reforms in other sectors of the economy, increased efficiency was largely achieved through the removal of regulations that hindered competition, in this case, among banks, and between banks and other financial services providers.

Prior to the deregulation of the Australian financial system, the system of controls over the operation of banking served both as the mechanism for conducting monetary policy and the means of applying prudential standards on banks. While they now seem archaic, less than two decades ago banks were subject to a raft of detailed regulations, including ceilings on interest rates banks could offer on deposits, minimum maturity periods on bank borrowings, saving banks were not allowed to offer fixed deposits, the growth in bank lending had to conform with pre-determined limits set by the Reserve Bank and savings banks were required to hold a majority of their deposits in the form of prescribed assets (mainly government securities). In place of open market operations, SRDs were used to vary the amount of liquidity available to banks and, in conjunction with the LGS ratio, they were the means of controlling the size of banks' balance sheets.

The need for the removal of these prescriptive regulations on banks caused the Campbell Committee to devote much intellectual effort to consideration of how monetary policy would operate in the deregulated environment and, in particular, the implementation of market-based monetary policy.

While the main focus of the Campbell Inquiry was on these broad efficiency and monetary policy issues, the dismantling of the old regulatory structures inevitably led the Committee into consideration of prudential regulatory issues. In particular, the Campbell Committee made recommendations about the prudential arrangements that ought to replace those that had existed until the early 1980s.

Consistent with the prevailing free market orthodoxy at the time, the Campbell Committee's recommendations involved a looser set of regulatory arrangements than those that evolved in

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2 Stephen Grenville, *The Evolution of Financial Deregulation,* in Ian Macfarlane (editor) *The Deregulation of Financial Intermediaries,* Reserve Bank, June 1991, p4.

response to the excesses in financial markets in the late 1980s. From the viewpoint of building societies, *the crucial feature of the Campbell Committee's recommendations was that they related only to banks.* The Committee formed the view that "*Basic supervision of non-bank DTIs would remain essentially a state responsibility*" (para 19.29).

This set the scene for the emergence of the current multi-regulator structure, with two regulators responsible for DTIs (the Reserve Bank responsible only for banks and the States for non-bank DTIs), a third regulator responsible for insurance and superannuation and a fourth regulator responsible for companies.

The Campbell Inquiry's preference for the States to retain responsibility for non-bank DTIs sits uneasily alongside a number of the arguments advanced by the Committee itself in its report. For example, after noting the *"diversity in methods of control and application both between groups of institutions and as between the States"* (para 19.3), the Committee expressed its belief that:

> "*the present fragmented approach to regulation makes it difficult to achieve competitive neutrality, inhibits the development of nationally oriented DTIs, and may discourage desirable longer term rationalisation. Moreover, the perpetuation of past distinctions between different groups of institutions, each subject to different supervisory authorities, may well constrain the natural, flexible evolution of deposit-taking intermediaries in the changing competitive environment of the future. In short, continuation of the existing approach to regulation can be expected to entail major efficiency costs*" (para 19.16).

Despite holding those views, the Campbell Committee came to the conclusion that:

> "*banks would remain in a special category for prudential policy and continue to be regulated under the Banking Act; but, in the view of the Committee, the basic approach to their regulation should be the same as for other DTIs"* (para 19.18).

The Committee went so far as to recommend:

> *"that a national framework for the prudential regulation of non-bank institutions which accept deposits primarily from households without issuing prospectuses should be developed, possibly along the lines of the co-operative approach to national regulation of companies and the securities industry*" (para 19.24).

This recommendation of the Campbell Committee proved to be nothing more than an expression of good intentions. The reality of the situation was that this was a recommendation of a Committee reporting to the Commonwealth Government. The Federal Government either was too preoccupied with other priorities including managing the overall process of financial deregulation or was not able to obtain the approval of the States, which was a prerequisite for the establishment of a co-operative approach for the regulation of non-bank DTIs on a national basis.

It took the banking crises of the late 1980s and the collapse of the Farrow Corporation in 1989 to generate the national will - on the part of both the States and the Commonwealth - necessary to establish the current co-operative approach to national regulation envisaged by the Campbell Committee in 1981. In the interim, the building society and credit union industries were subjected to prescriptive regulations that were fragmented, poorly supervised, and were different from those that applied to banks, in total contradiction to the Campbell Committee recommendations.

The Campbell Committee's recommendations for the prudential supervision of non-bank DTIs were not translated into anything close to reality until the establishment of AFIC in 1992. This delay was a major factor for the post-Campbell transfer of major building societies to banks.

This view of the shortcomings of the Campbell Committee processes is not simply that of the building society industry. It is shared by an influential adviser to the Campbell Committee, who commented in 1991 on the failings of the Campbell Committee, as follows:

> *"...the Committee failed to come to terms with some of the problems which arise in attempting to achieve competitive neutrality. First, the fact that many financial institutions are under State control makes it unlikely that they will be subject to the same controls as those under the supervision of the Reserve Bank. Secondly, the Committee could produce no solution to the departure from competitive neutrality created by the advantages possessed by banks - an implicit government guarantee and control of the payments system."*[3]

Despite these shortcomings and their implications for the building society industry, the then Governor of the Reserve Bank in 1985 was able to claim that "*We now have a virtually fully-deregulated financial system.*"[4] This statement was true for banks, but not for building societies. In 1985, the process of financial deregulation had by-passed building societies and left societies unable to compete on equal terms with banks. For example, in 1985:

- each State and Territory had its own legislation of varying quality governing the operation and regulation of building societies;
- those regulations differed among the States and were more prescriptive and onerous than those adopted by the Reserve Bank;
- building societies were not permitted to expand their activities beyond the borders of their State of incorporation;
- most States failed to establish a competent prudential supervisory capacity to cope with deregulation; and
- many State governments set controls over interest rates and the structure of building societies' assets.

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3 Tom Valentine, *What the Campbell Committee Expected*, in Ian Macfarlane (editor) *The Deregulation of Financial Intermediaries*, Reserve Bank, June 1991, p40.

4 Robert Johnston, *Monetary Policy - The Changing Environment*, T. A. Coghlan Memorial Lecture, University of New South Wales, 1985.

In particular, building societies, as housing finance specialists, should have benefited from the Campbell Committee's recommendation to remove all interest rate controls and limitations on the deposit base of housing finance institutions. Given the political sensitivity of housing interest rates in a period of high interest rates generally, this proved to be an area where the recommendations of the Campbell Committee took some time to be implemented, initially to the detriment of both banks and building societies. Savings banks were obliged to hold rates at 13.5% for new and existing housing loans for a long period after Campbell, whilst suasion and control by other means in a number of States had the same effect for building societies. These controls adversely affected building societies' financial performance and, perversely, reduced the supply and raised the cost of finance to housing and sowed the seeds of future instability.

By April 1986 these distortions had reached such proportions that the Federal Government actually subsidised bank loans (including State banks and foreign banks) to the extent of $150 million and was compelled to remove the interest ceiling for new housing loan rates in order to avert a collapse in bank home loan lending volumes. The distinction between banks and others was again highlighted when no similar subsidies were made available to building societies, even though significant suasion was being exerted by State governments on interest rates charged by building societies for new and existing home loans.

In the event it was not until 1992 that the power of State governments to interfere with mortgage interest rates was formally abandoned by all States.

In addition to being subject to more burdensome regulation by the States in the post-Campbell era, building societies were excluded from direct participation in the payments system. The provision of payment services is a key area of building society operations and the building society industry had hoped that the Campbell Committee would empower societies to provide those services directly to their customers without dependence on their main competitors, the banks, in respect of paper-based payments and provide building societies and credit unions with full access to the then rapidly emerging electronic payments mechanisms. Instead, the Campbell Committee expressed a preference for cheque agency arrangements, and recommended the establishment of the Australian Payments System Council to oversee the Australian payments system and to analyse issues of public policy and foster interconnectivity between payments systems.

Given the very unfavourable deregulatory outcome for the building society industry from the Campbell Committee processes, it is little wonder that some two thirds of building societies accounting for three-quarters of building society assets in 1985 have opted to become banks.

1.2. The Present State-based FI Code

The present system of prudential regulation for banks evolved over the course of the post-Campbell era in response to local pressures and developments in thinking about appropriate arrangements at the Bank for International Settlements (the Basle accords). Initially the Reserve Bank relied on its depositor protection powers to establish the prudential system for banks.

Starting in January 1985, the Reserve Bank issued a series of prudential statements (22 over the next five years) which involved the gradual construction of the present prudential framework[5].

In constructing the prudential framework, it was the intention of the Reserve Bank to *"minimise the likelihood that a bank would get into such difficulties that the 'rescue' powers of the Banking Act would be required or that the stability of the financial system would come into question."*[6]

The prudential statements involved the establishment of the first formal requirement for minimum capital standards for banks in Australia, liquidity management, including the prime assets ratio, limits on large credit and foreign exchange exposures, guidelines on associations with non-bank financial institutions and restrictions on ownership of banks. Australia was one of the first countries to implement the 1988 Basle Supervisors' Committee proposals for minimum capital adequacy standards.

In its submission to the 1991 Parliamentary Inquiry, the Reserve Bank stated that for banks *"Arrangements are required that bolster community confidence and support the reliability and viability of the banking system and the payments system"*. Even though the prudential arrangements established in 1992 for Australian non-bank DTIs were largely in line with Reserve Bank standards, AFIC status is less than the Reserve Bank and non-bank DTIs do not enjoy the level of public confidence that goes with supervision by the Reserve Bank.

Against the background that most of the major non-bank DTIs already had voted with their feet and converted to banks, the collapse of the Farrow Corporation in 1989 led to sufficient acceptance among State governments of the view (long-obvious to astute observers) that the largely separate supervisory arrangements for non-bank DTIs were inadequate and threatened to undermine public confidence in all non-bank DTIs. There was a realisation among State Treasurers and those responsible for the regulation of non-bank DTIs that financial contagion paid little attention to State borders. The Pyramid collapse demonstrated that non-bank DTIs operated in a national market for financial services and that weakness in an institution in one State undermined confidence in similar non-bank DTIs in other States.

In effect, what followed the Pyramid collapse was implementation of the recommendation by the Campbell Committee ten years earlier for the establishment of a national framework for the prudential regulation of non-bank DTIs along the lines of the co-operative approach to national regulation of companies. With the support of the Prime Minister and State Premiers, State Ministerial meetings were held culminating in the decision in May 1991 to implement the FI Code. Fourteen months later, on 1 July 1992, AFIC was established.

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5 It was not until the 1989 amendments to the Banking Act that the Reserve Bank was specifically empowered to carry out the prudential supervision of banks.

6 Graeme Thompson, *Prudential Supervision,* in Ian Macfarlane (editor) *The Deregulation of Financial Intermediaries,* Reserve Bank, June 1991, p118.

1.3. Gains Made Under the FI Scheme

The structure of the State based FI Code reflects the old NCSC model without Federal Government involvement. A Council of State Ministers is responsible for the Code and for AFIC. *"The basic functions of AFIC are to promote on a national basis the financial integrity and efficiency of a State-based financial institutions system and secure effective and efficient implementation of uniform prudential and other standards for financial institutions."*[7] A Minister in each State is responsible for each State Supervisory Authority. AFIC sets the prudential standards for building societies and credit unions and the State SSAs have responsibility to ensure that these standards apply in their jurisdictions.

The post-AFIC arrangements represent a major improvement over the regulatory no man's land that building societies were obliged to occupy over the previous decade. These improvements include:

- high prudential standards laid down by AFIC for building societies and credit unions, including minimum capital adequacy requirements, the adoption of sound risk management practices and adequate liquidity standards;

- the prudential standards set by AFIC are uniform across all States;

- these developments have assisted building societies to become direct participants in the payments system, freeing them from reliance on banks for these services. Arguably, these developments also have assisted in the gradual removal of barriers in major States (except Victoria) to building society participation in deposits of government, semi-government and statutory funds;

- the AFIC system has seen the development of a well regarded and professional group of regulators with policy formulation and supervisory skills; and

- the AFIC and State Commissions and their Chairmen comprise experienced, and independent directors at arms length from industry.

In combination, these developments have redressed the worst features of the arrangements for non-bank DTIs during the first post-Campbell decade. The new arrangements have uniformly strengthened industry balance sheets and had a very favourable effect on the standing and credibility of building societies and credit unions. The significance of AFIC's role was recognised in 1992 by the inclusion of AFIC as a founding member of the Council of Financial Supervisors, alongside the Reserve Bank, the ISC and the ASC.

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[7] Richard Beetham, *A Review of the Structure, Efficiency and Effectiveness of the Financial Institutions Scheme*, Access Economics, 1993, p3.

1.4. Shortcomings of the FI Scheme

> *"The objective in establishing the Scheme was to establish a co-operative supervisory structure but in so doing it inevitably involved an overlapping of functions and created significant potential for differential regulation and other tensions."*
>
> Beetham (1993), p 3

The standards set under the FI Code are equal to and in some areas more stringent than those applying to banks, which does raise questions about competitive neutrality objectives. The perpetuation of differences will inhibit the ability of building societies to compete and, therefore, is incompatible with the objective of facilitating vigorous competition between building societies and banks in the longer-term.

Notwithstanding the greater stringency of the prudential arrangements for non-bank DTIs compared with banks, the status of AFIC is less than that of the Reserve Bank in the eyes of many in retail financial markets. With more stringent prudential arrangements and less recognition of that, it is as though the banks are calling at the toss of the coin: "Heads I win and tails you lose". Judging by revealed preference, larger building societies have regarded the benefits that accompany supervision by the Reserve Bank as an advantage and a major factor in converting from building society to bank status.

The status of banks essentially derives from the powerful depositor protection provisions of the Banking Act. While these provisions do not amount to a formal guarantee by the RBA to repay deposits, the Act:

> *"places a duty on the RBA to use its powers for the protection of depositors of authorised banks...To this end, where a bank considers that it is likely to become unable to meet its obligations, or is about to suspend payment, it is required to inform the RBA. In these circumstances, or where the RBA forms its own opinion to this effect, it may appoint a person to investigate the affairs of the bank concerned. The RBA may, with the interests of depositors in mind, assume control of and carry on the business of that bank until such time as the deposits with the bank have been repaid, or the RBA is of the opinion that it is no longer necessary for it to remain in control of the business of the bank. In addition, the Act provides that the assets of the bank in Australia shall be available to meet its deposit liabilities in Australia ahead of all its other liabilities."* [Council of Financial Supervisors, Annual Report, (1995), p40]

There are no such equivalent provisions for building societies. Depositors of building societies do not rank ahead of other creditors in the event of a winding up of a building society.

The nearest provision to this in the FI Code is the Emergency Liquidity Support Scheme which requires building societies, if so directed by AFIC, to provide liquidity support to another society (or societies) of an amount equal to a maximum of 50% of its prime liquid asset requirement. Any such calls by AFIC for liquidity support are shared among societies in proportion to each society's share of the total assets of all eligible societies. Similar industry-based arrangements apply for credit unions. Clearly, these industry-based liquidity support arrangements are very different from the *de facto* lender of last resort facility which is available to banks.

The FI Code in several key areas remains prescriptive, in particular, through the retention of the prime purpose clauses, which require building societies to direct a minimum of 50% of their loans to housing finance. This clause owes its origins to the view that it represented the *raison d'etre* of a building society. In a financial system that rewards those institutions best able to satisfy customer requirements and aggressive new entrants, the prime purpose requirement is not only a throw-back to pre-Campbell Committee regulations governing the structure of banks' balance sheets but now restricts the expected future development of societies.

Not only do various legislative requirements for building societies differ significantly from those required of banks, but the Federalist structure of supervision for building societies does not deliver uniform supervision of all building societies. Different priorities and styles among SSAs leads to comparisons and perceptions that one State is more vigorous and exacting in its audit and inspection activities than another State, which tends to undermine confidence in the whole structure.

Market pressures have led an increasing number of building societies and credit unions to operate beyond their State of incorporation. Society numbers trading interstate are: Queensland (8), New South Wales (10), Victoria (7), South Australia (6), Western Australia (4), Tasmania (5), ACT (7) and Northern Territory (4). A number of societies are offering services via the Internet and are potentially trading across national boundaries. While this trend to broader participation in national financial markets by non-bank DTIs is an important element of their business strategies, the pursuit of markets in other jurisdictions is more complex and more expensive because of the State based system.

Finally, virtually all commentators agree that the pace of change in the market for financial services will continue or even accelerate in the foreseeable future. While the full impact of technological change is difficult to predict, it is important that financial institutions recognise the skills and attitudes that will be necessary for them to be a part of the new order. In offering suggestions to building societies on the skills and attitude crucial to their survival, one authoritative commentator said: *"First, never, stand still. Flexibility will be the key to coping with change."*[8]

A major problem for building societies, however, is that the federalist FI Scheme is, by its very nature, inflexible. There are simply too many layers of government for the FI Scheme to be fully effective in the long term. The processes associated with legislative change to the FI Scheme have proven to be cumbersome and tortuously slow. The many layers of officials in each of the States, each layer with different and diverse responsibilities and Ministers, means that the system is unable to deliver legislative change within a reasonable timeframe. This is a design flaw in the arrangements for building societies, as the rapidity and the unpredictable nature of change in the financial system demands a regulatory system that is able to adapt promptly.

This design flaw in the current arrangements concerns the building society industry greatly in terms of its likely adverse consequences for the future development of the industry. *A national regulatory framework for building societies is essential for the future of the industry.*

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8 Jeffrey Carmichael, *Developments in the Finance Industry: Messages for Building Societies*, Address to QAPBS Seminar, Royal Pines, 31 August 1995, p11.

Building societies (and credit unions) should be included in the mainstream of prudential supervision at the national level.

1.5. Costs and Duplication in the FI Code

AFIC and the SSAs are financed by levies on subject institutions. The scale of levies varies according to the size of each institution's assets.

The total estimated cost of the FI Scheme, responsible for supervising institutions (including friendly societies) with an asset base of about $35 billion, was $11.5 million in 1994-95 (for building societies and credit unions only it was $9 million in 1992-93 and some $9.1 million in 1993-94). This compares with the estimated cost of Reserve Bank supervision of banks, which is responsible for supervising institutions with an asset base of about $478 billion, of about $17 million in 1994-95.

There are differences between States and institutions in the costs of supervision and, in Queensland, the Building Societies' Fund is used to pay the levies due to the Queensland Office of Financial Supervision and AFIC. These differences have contributed to a situation where there are substantial differences in the burden of financing the FI Scheme between States, as shown in Table 1.1.

Table 1.1:Financial Institutions Scheme Levies for Building Societies, 1995-96 and 1996-97[1]

Supervisory Body Levy	Estimated Building Societies' Supervision Gross Levies 1996-97	% of Building Societies' Assets 1996-97	Actual Building Societies' Supervision Gross Levies 1995-96
	($)	**($)**	**($)**
Queensland Office of Financial Supervision[3]	461,700	0.0073%	580,540
NSW Financial Institutions Commission	433,575	0.0105%	355,971
Victorian Financial Institutions Commission	464,584	0.0372%	360,315
Western Australian Financial Institutions Authority	74,393	0.0116%	68,330
South Australia Office of Financial Supervision	12,000	0.0250%	12,732
Tasmanian Office of Financial Supervision	66,002	0.0380%	63,740
NT Registrar of Financial Institutions	8,800	0.0240%	7,284
Sub-Total SSAs' Levies	**1,521,054**	**0.012%**[2]	**1,448,912**
Australian Financial Institutions Commission	821,308	0.0065%[2]	708,700
TOTAL LEVIES	**2,342,362**	**0.0184%**[2]	**2,157,612 (0.0189%)**

Notes:

1. Source: AFIC, SSA's budgets and advice from building societies.
2. Sub-Total SSAs' Levies, AFIC Levies and Total Levies (1996/97) as a % of Building Societies' Assets are based on total assets at 31 March 1996 = $12,725,100,000 (AFIC statistics May 1996). and levies for 1995/96 are based on total assets at 31 March 1995 = $11,393,900 (AFIC statistics May 1996).
3. Queensland Office of Financial Supervision levies (and Queensland building societies' share of AFIC levies) are paid out of the Building Societies Fund under the *Building Societies Fund Act 1993 (Qld).*

   Banks are required to hold 1% of their liabilities in Australia (excluding capital) in *Non-Callable Deposits* (NCDs) with the RBA. The RBA pays to banks an interest rate on NCDs equivalent to 5 percentage points below the 13 week Treasury Note yield. This *5% of 1% of liabilities* is effectively a "bank levy". This "Bank Levy" totals to about $195,900,000 pa, that is about 0.0433% of assets based on:

   - banks' total $A residents' assets in June 1996 = $452,270 million (RBA Bulletin August 1996 Table B.1)
   - banks' non-callable deposits June 1996 = $3,918 million (RBA Bulletin August 1996 Table B.1)

   Although the "bank levy" is a cost of being a bank, it does not necessarily equate to the cost of supervision, which is estimated to be about $17 million in 1994-95.

Substantial studies commissioned by building societies in 1993 (the Beetham Report) and credit unions in 1994 (the Waterhouse Report) concluded that the cost of the FI Scheme was a major factor undermining the competitiveness of building societies and credit unions.

The ISC's supervisory activities are funded by levies on subject institutions, which are flat amounts irrespective of size in the case of life and general insurance companies. In 1995-96 the levies were set at $70,000 for each life office and $16,300 for each general insurer.

The Superannuation Levy on each fund ranges from $200 to a cap of $14,000, with a rate of $200 per $0.5 million of fund assets.

Beetham identified three factors that unnecessarily increase the costs of the FI Scheme, as follows:

- the multitude of Boards that results from the allocation of supervisory responsibilities between AFIC and the SSAs;
- the duplication of specialist and executive staff, particularly in the area of policy and legal services, between AFIC and the SSAs; and
- the administrative and operations functions carried out by SSA, especially the registry functions.

Because of the relatively small asset base of DTIs subject to the FI Scheme, the practicality of maintaining a fully separate and independent superstructure into the future is questioned by the building society industry. Despite the clarity of the arguments for rationalisation in these areas and the cogency of those arguments, little has been done to address the structural problems of duplication and superstructure identified by Beetham and Waterhouse three years ago. Since the commencement of the FI Scheme, substantial building society assets have been converted to banking and the number of credit unions have been reducing, thus reducing the base on which supervision levies are raised. Future exits and conversions will exacerbate the problem of funding on a reducing asset base and raise ongoing difficulties for the remaining societies.

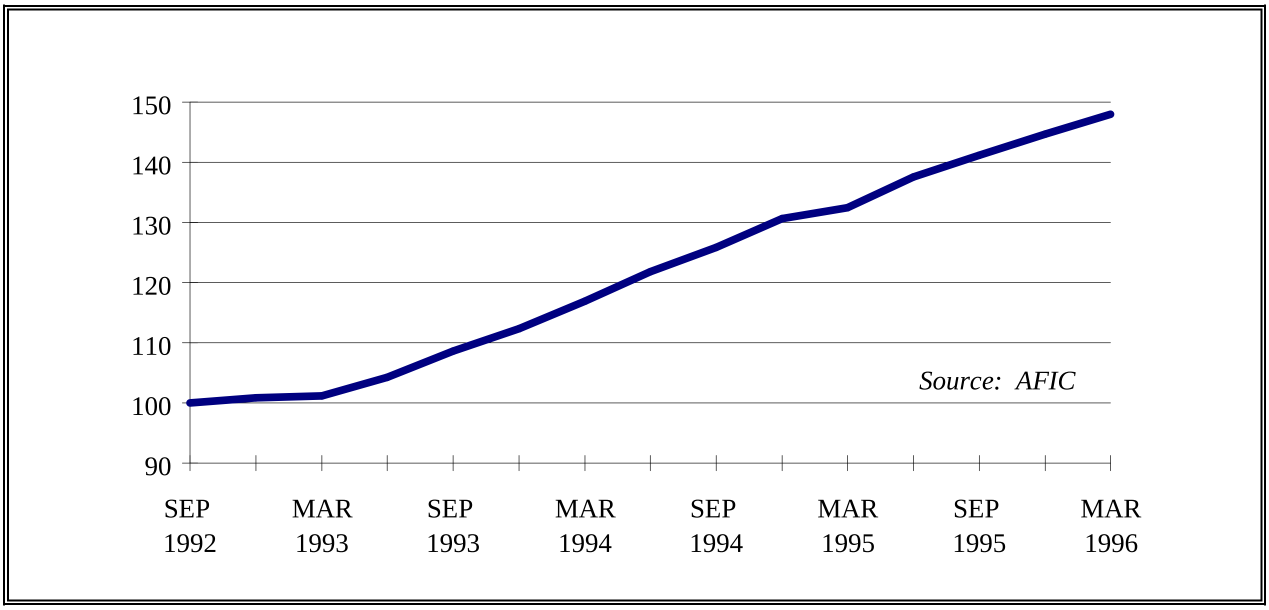
Substantial cost savings and ongoing economies would be possible in a truly national scheme.

2. THE BUILDING SOCIETY INDUSTRY: SIZE AND STRUCTURE

2.1. Market Growth

Despite the intensification of market pressures in the wake of financial deregulation, building societies that have remained building societies have grown steadily in size since the establishment of AFIC, as shown in Chart 2.1. Over the period since the September quarter 1992 the assets of the building society industry have increased by 48%, equal to an average growth rate of 9.1% per annum.

Chart 2.1: Growth in Building Society Assets Since the Establishment of AFIC (Base: September quarter 1992 = 100)



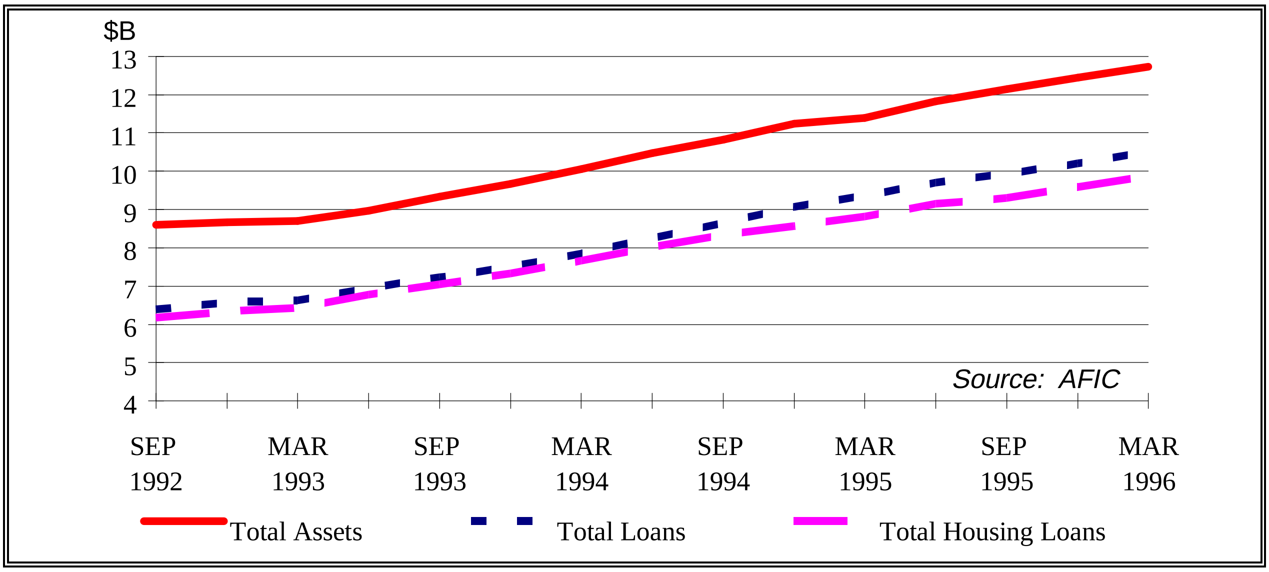
The growth rate in building society assets compares favourably with the growth in banks' assets - of 7.7% per annum on average - over the same period.

Currently there are 25 societies with total assets of $13 billion. Building societies raise their funds mainly in the form of retail deposits. In recent years several societies have successfully approached domestic capital markets for wholesale funding.

Over a longer time period the growth in building society assets is even stronger than in the period since the establishment of AFIC. The average annual compound rate of growth of currently existing societies over the decade to 1995 has been of the order of 13%.

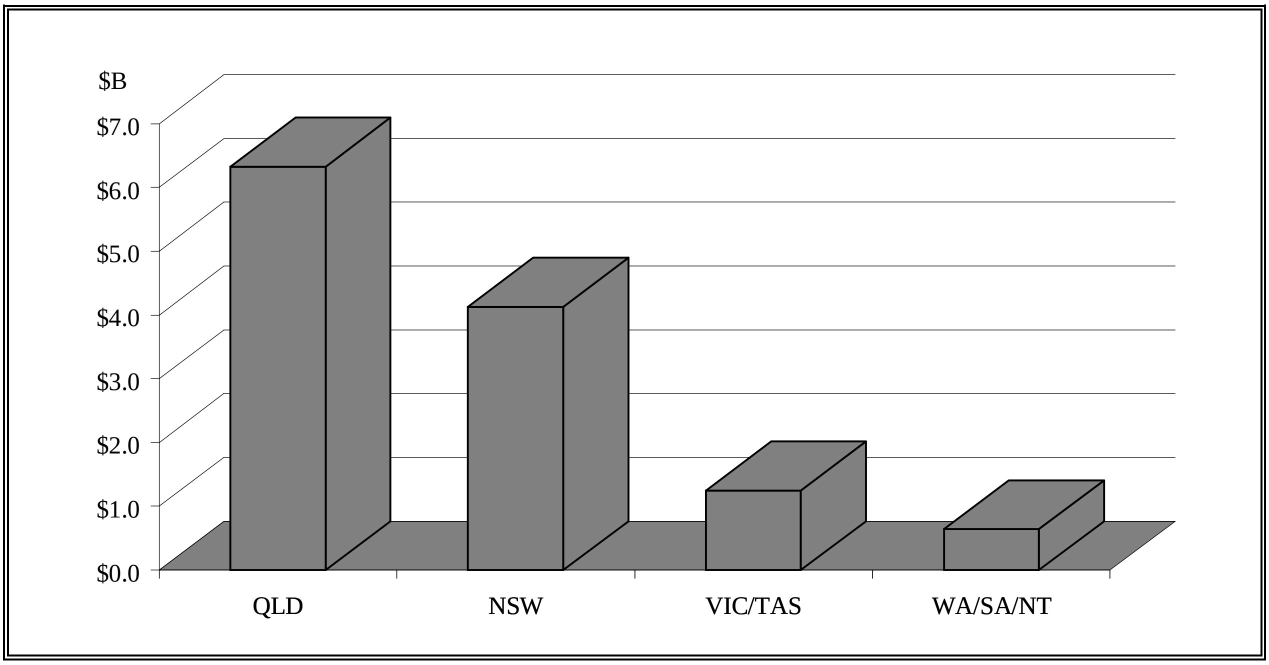
Building societies provide a core range of retail financial services to their customers, including $198 million in personal loans as at June quarter 1996, $393 million in commercial loans and $67 million in revolving credit. Notwithstanding the growth in these forms of lending, building societies are very much housing finance specialists, as shown in Chart 2.2. Housing loans accounted for 94% of total loans by building societies as at the June quarter of 1996, down from 97% in 1993.

Chart 2.2: Growth in Building Society Assets by Main Type Since the Establishment of AFIC



Building society assets are concentrated in Queensland and New South Wales (see Chart 2.3 - this includes Suncorp Building Society ($3,380m) which will convert to a bank by end 1996) but the industry is represented in all States and Territories. Nationally operating societies cover all States and cross border operations are growing in border regions.

Chart 2.3: Building Society Assets by State, 1995-96



Building societies are a highly competitive and community sensitive group of Australian financial institutions which contribute strongly to the financial and social development of Australian households. This is evidenced by the following features of current industry activities:

- as at 30 June 1996 almost 2.7 million Australians were members and customers of building societies;
- total loans grew by 12.2% to $10.9 billion in the twelve months to June 1996, compared with growth of 17.6% to $9.7 billion in the previous year;
- the core business of building societies is household financial services, centred on loans for home ownership. Currently some 176,000 Australian families are purchasing their home with a loan from a building society;
- residential lending for owner occupied housing amounts to some 75% of the total assets of building societies;

KEY STATISTICS OF BUILDING SOCIETIES

JUNE 1996

	$m
Total deposits	11,113
Total borrowings	730
Other liabilities	284
Shareholders' equity	904
Total assets	13,108
Number of institutions	25
Number of branches	528
Number of employees	3,121
Members	2.8 million
Weighted capital adequacy	13.0%
Return on average assets	0.7%
PLA	14.8%

Source: AFIC

- building societies differentiate themselves from their competitors in a number of areas, but in particular in terms of the level of customer service and range of innovative products; and
- building societies are an important source of regional employment in the financial sector, with staff levels reaching 3,121 as at June 1996.

2.2. Meeting the Competitive Challenge

The intensification of competitive pressures has had a profound effect on the way financial services are delivered in Australia. Two developments, in particular, are having an impact on the operations of building societies. These are the emergence of mortgage originators as a potent new force in the housing loan market and the emergence of new players, such as superannuation funds and other fund managers, competing in the market for retail deposits.

There is intense competition in the residential lending market from low cost mortgage originators and other new entrants. Competition in this segment of the market has intensified further with a reduction in new housing demand during the second half of 1995, although activity has increased in recent months.

The Reserve Bank Bulletin of June 1996 in "The Evolution of the Housing Market in Australia" explains these fundamental changes and records the responses (many still in progress) from established home lenders. In brief, the traditional gap between the cost of retail deposits of banks and building societies and the cost of funds from the wholesale markets have to a large extent been eliminated in the period since 1990 and new lenders have brought a major structural change to housing finance.

Analysis of ABS data by KPMG[9] on new secured housing finance commitments, shows a significant shift in market share between the banks, permanent building societies and other lenders. The 'other lenders' category mainly consists of credit unions/co-operative credit societies, life or general insurance companies, general government enterprises, superannuation funds and mortgage managers. This information is provided on a monthly basis and shows the market share of new lending to the housing sector.

On an Australia wide basis, banks have suffered a loss of market share, dropping from 90% in 1994 to 87% in 1995. Permanent building societies dropped by only 1% and now hold 5% of the market. Other lenders have doubled their market share during the year and now hold a market share of 8%.

Building societies have been holding their own against the mortgage originators, while the losers to date have been the banks. The mortgage originators appear to have been concentrating their efforts in the capital cities, leaving regional Australia relatively untouched. This is changing rapidly now.

A very clear implication for building societies is that they must closely match the new competition with a combination of price and service. Societies will need to provide added value to their customers, utilise new techniques including wholesale funding and lower cost delivery methods and increase non interest income. Diversification from the current FI Code regulated proportion of housing mortgage lending, however, is essential and should be undertaken (as Campbell recommended) with adequate capital and asset quality ratios in place and effective prudential supervision. It also indicates the expected transformation of building societies to broader-based, local institutions and community banks with a wider range of financial assets than has been the case in the past.

A State by State analysis reveals other interesting shifts in market share, particularly in New South Wales and Western Australia. In New South Wales, banks seem to have been extremely hard hit through the emergence of other lenders, losing approximately 10% of the market between 1994 and 1995. Other lenders now control approximately one fifth of the new secured housing finance market in New South Wales.

Similar trends can be seen in Western Australia, where other lenders have made significant inroads. Whilst permanent building societies have maintained their market share for new secured housing finance, the banks' share of new lending has dropped by 6% to 80%. Other lenders now have secured a significant 16% of Western Australia markets.

Other States, such as Queensland and Victoria did not experience such a dramatic shift, but nevertheless the analysis indicates that other lenders are making headway.

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9 These two paragraphs are drawn from KPMG *1996 Financial Institutions Performance Survey*, p6.

Borrowing consumers have benefited greatly by the new competition. The range of choice has expanded and established lenders have sharpened their pricing to match the market. As previously mentioned, reduced margins will result in the need to cut costs and charge for services to other consumers who hitherto, in part, have been cross subsidised by borrowing consumers.

Because mortgage securitisers are not DTIs they are not subject to the rigours and cost of prudential supervision and standards of banks and building societies. The industry considers that the advent of the new players and its impact on margins requires regulators of building societies to examine and streamline methods of supervision and inspection so as to level the playing field somewhat vis-a-vis securitisers. The issue of how the securitisers will comply with the credit code has yet to be determined. The trustee has the clear legal responsibility but the borrowing consumer’s contact is with an independent agent or salesperson where the code’s practical implementation needs to be effectively in place if consumers are to benefit.

The building society industry considers that there are a number of policy issues raised by the process of securitisation the Inquiry ought to examine, including the attainment of competitive neutrality, the implications for the regulation of DTIs, compliance with the Credit Code and the impact on the integrity of the provision of housing finance.

The emerging “commodity” approach to housing finance has implications yet unknown, for standards in home lending and, therefore, the incidence of foreclosures. Building societies as an industry have been very conservative lenders. Their policies emphasise the importance of borrowers’ ability to repay as well as security. Building societies also are in the business of establishing a long term financial relationship with customers built on the home loan mortgage. The longer term social and political consequences of households getting into financial trouble because of permissive and aggressive mortgage selling techniques, needs to be kept in mind.

Competition also is intensifying on the deposit side of the balance sheet with insurers, superannuation funds and other funds managers, competing for retail deposits. Consumers are increasingly sophisticated and prepared to shop around for financial products.

New players and technology have the potential to reduce returns to financial institutions from their retail deposit base. In the 1980s when foreign banks were allowed to establish in Australia they were obliged to establish retail banking operations. However, they were unable to take market share away from the major banks in this area due to the high costs required to establish a retail presence. With other avenues of distribution now becoming available, new entrants are being attracted into the retail market, unburdened by the need to establish expensive branch networks.

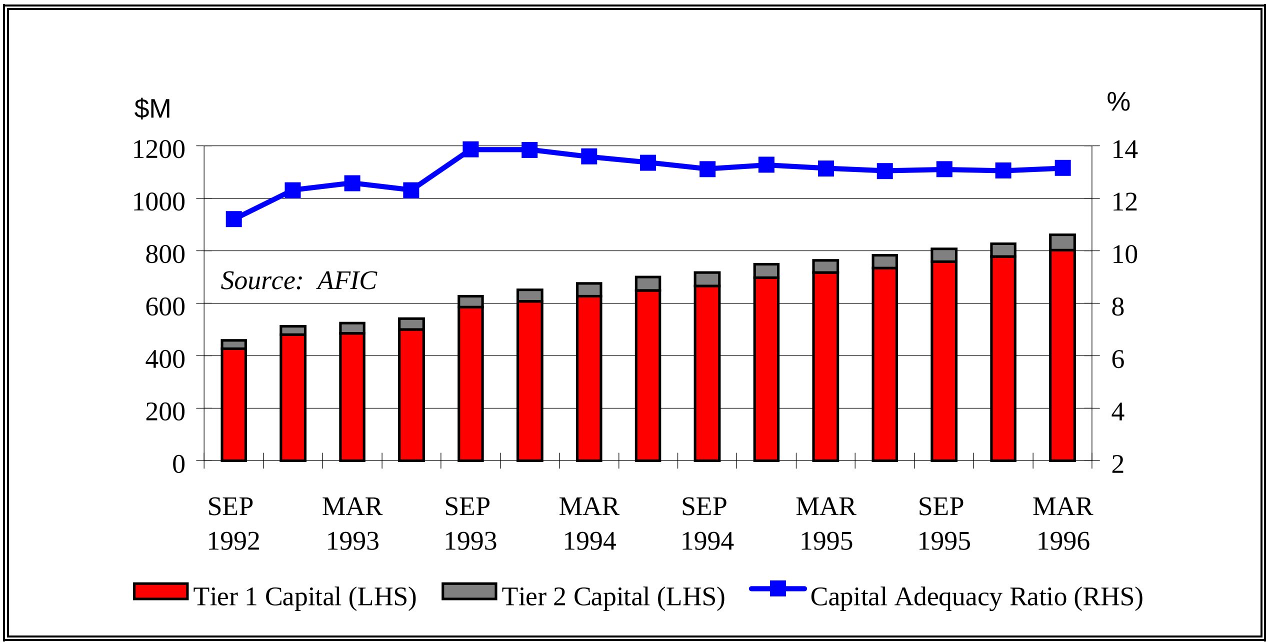
Retail deposits now account for 91% of the liabilities of the building societies. A small number of building societies have responded to the drain of retail deposits by entering into mortgage securitisation arrangements and other collateralised loan facilities allowing access to long term wholesale funding. As at June 1995, building society obligations to wholesale markets were $803 million ($538 million at June 1994). It is expected that the trend towards accessing wholesale funding will continue.

2.3. Prudential Standing of Building Societies

Building societies have observed very high prudential standards over the period since the establishment of AFIC. Building societies have consistently exceeded the AFIC minimum ratio of capital to risk-weighted assets of 8%, as shown in Chart 2.4. Building societies also have consistently held far more than the minimum requirement of 50% of capital in the form of core capital (Tier 1), also shown in Chart 2.4.

Again, the level and composition of building societies' capital adequacy compares favourably with the comparable ratios for banks. While banks, too, have exceeded the minimum risk weighted capital requirements set down by the Reserve Bank, they have held risk weighted capital equivalent to around 12% of assets over the two years to June 1995. Of this, 9.1% was in the form of Tier 1 capital, compared to more than 12% in Tier 1 capital held by building societies.

Chart 2.4: Building Society Capital Adequacy



2.4. Performance Drivers of Building Societies

2.4.1. Profitability

The building society industry has performed well in the 1990s (see Chart 2.5), reflecting, inter alia, the absence of major problems in societies' loan portfolios relative to those encountered by the banking sector. The trend in operating profit before taxation, however, indicates lower levels of profitability in the latest quarters of the current year, although many societies will report higher profits in 1995-96. Most, if not all, societies are expected to report lower profits in 1996-97.

The net interest margin of societies declined from about 4.1% of average assets in 1992 to some 3.75% in mid-1994. Subsequently, the net interest margin has varied within the relatively narrow range of 3.7% - 4% (see Chart 2.6). Building societies' profitability is very sensitive with respect to changes in their net interest margin in the absence of significant fees and charges. Thus, fluctuations in societies' operating profit before tax are dominated by and exaggerate fluctuations in societies' net interest margins. Non-interest income has been a small element of overall profitability, far smaller than for banks and credit unions. A number of societies have moved to introduce transaction fees in the current year.

Chart 2.5: Building Society Operating Profit Before Tax
(% of average assets)

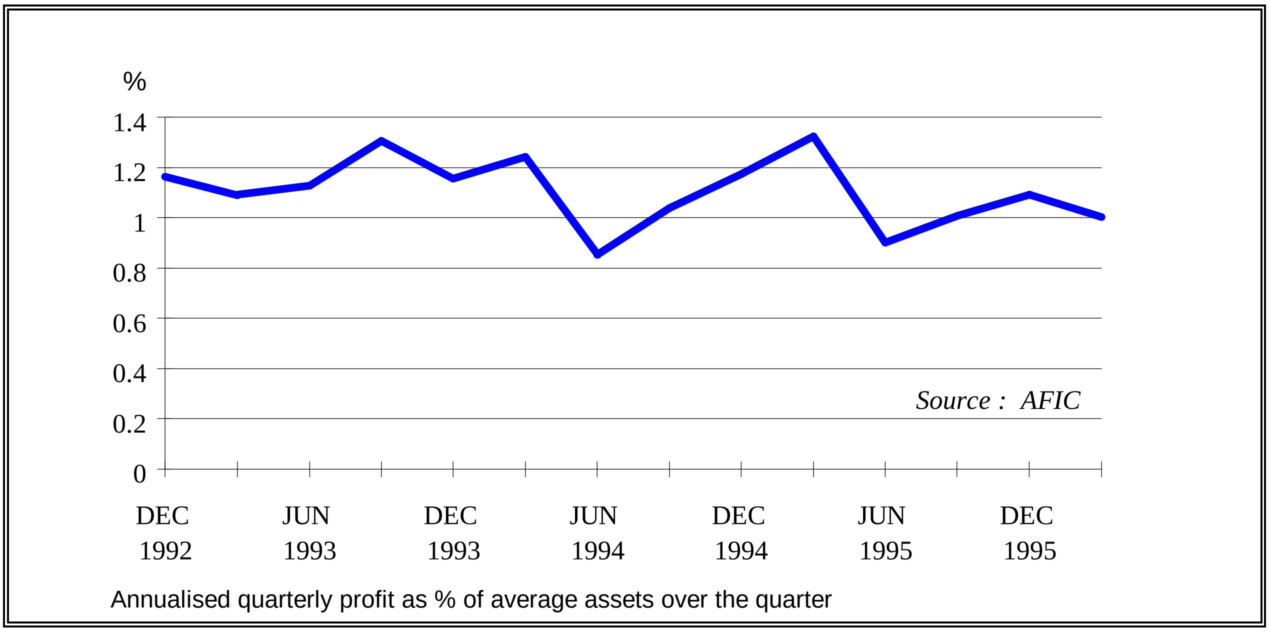
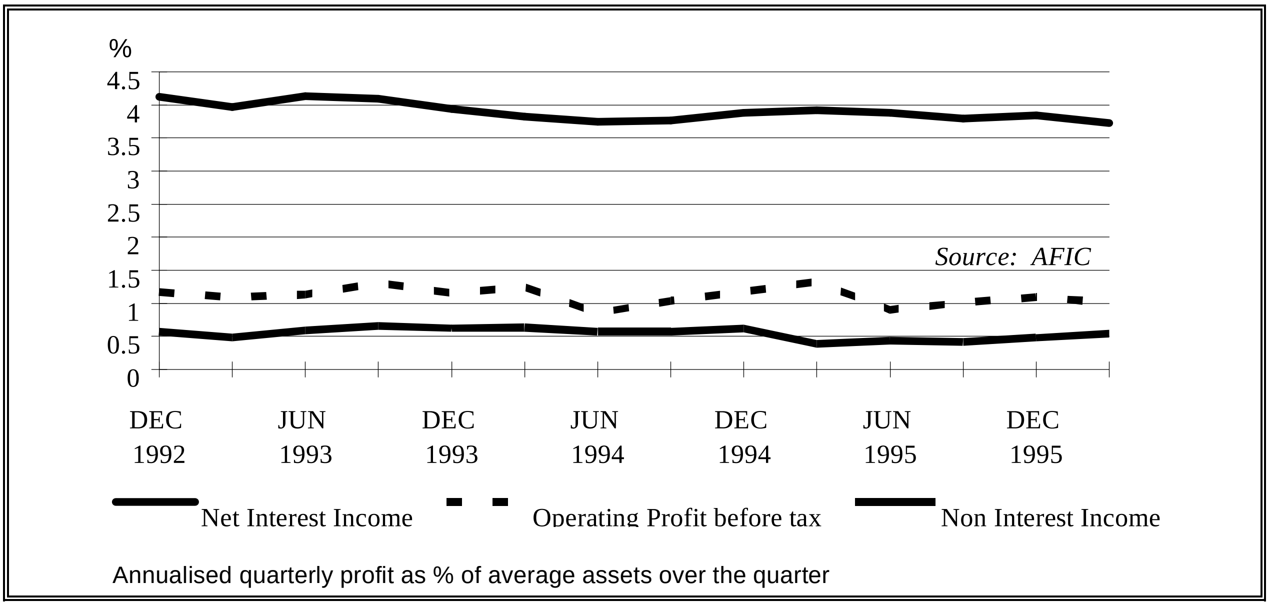
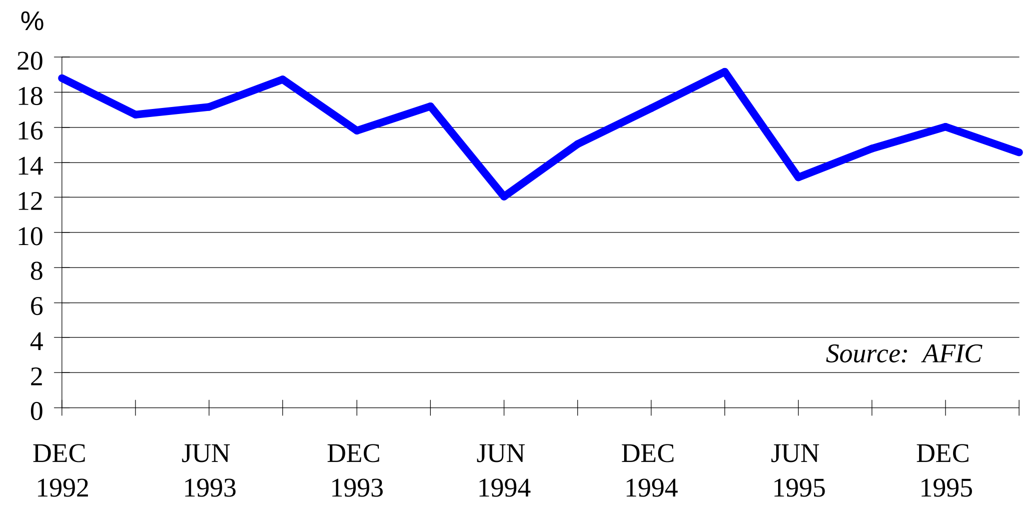


Chart 2.6: Annualised Quarterly Profitability of Building Societies
(% of assets)



Operating profit before taxation as a percentage of shareholders' equity is running at about 14.5% in the March quarter 1996 (see Chart 2.7). The quarterly fluctuations in the rate of return tend to mask the downward underlying trend in the rate of return on equity. In the year to March 1994 the rate of return was 17.2%, compared to 15.8% in the following year and 14.6% in the year to March 1996. By definition, what happens to the bottom line is an amalgam of all the many influences that affect building societies, but two factors that probably largely explain this trend are the intensification of competition over this period and the downturn in the housing sector.

Chart 2.7: Building Society Operating Profit Before Tax (% of shareholders' equity)



Annualised quarterly profit before tax as % of average shareholder's equity over the quarter

Profitability achieved by building societies seems to be generally below the levels of banks and major credit unions as illustrated in the Table 2.1 below. It is difficult to generalise on the basis of a single year's results, especially given the greater exposure of building societies to the housing finance market and the low level of activity in the housing sector in 1995.

Table 2.1: Comparison of Profitability of Major DTIs in 1995 (%)

Profitability 1995	**Building Societies**	**Major Credit Unions**	**Regional Banks**	**Major banks**
Operating profit after tax/average net assets	6.69	13.62	14.42	14.37
Net interest income/average total assets	3.86	5.47	3.12	3.12

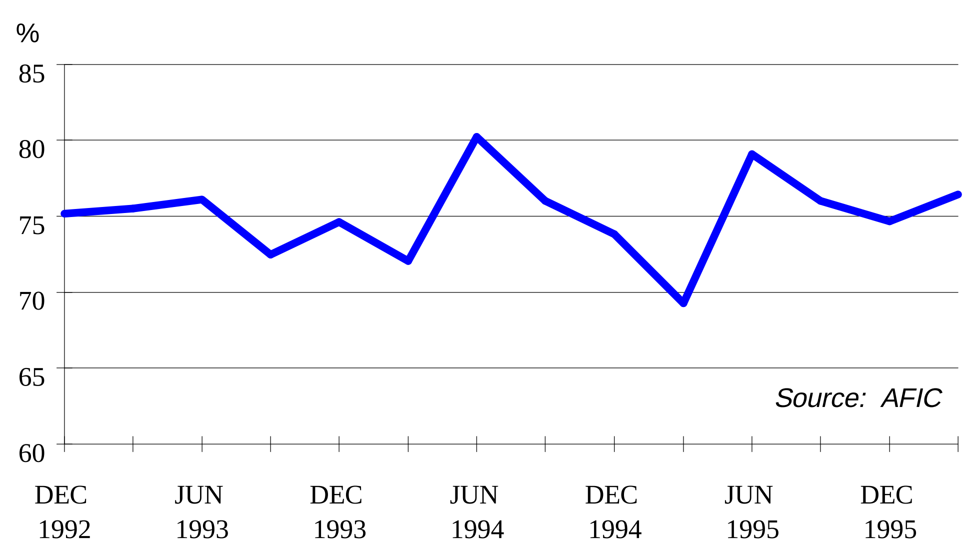
Source: KPMG

The comparisons shown in Table 2.1 reflect the fact that in 1995 building societies did not impose fees on deposit or other accounts on which transactions are made. It should also be noted that full income taxation on credit unions is not reflected in the table. (Income tax expense for the year ended June 1995 for credit unions represented some 15% of operating profit and for building societies some 33%.)

2.4.2. Efficiency and Margins

The ratio of operating expenses to operating income for building societies has been running at about 75% on a quarterly basis, as shown in Chart 2.8. This is above comparable levels achieved by both national and regional banks.

Chart 2.8: Building Society Cost to Income Ratio
(Quarterly operating expenses to operating income)



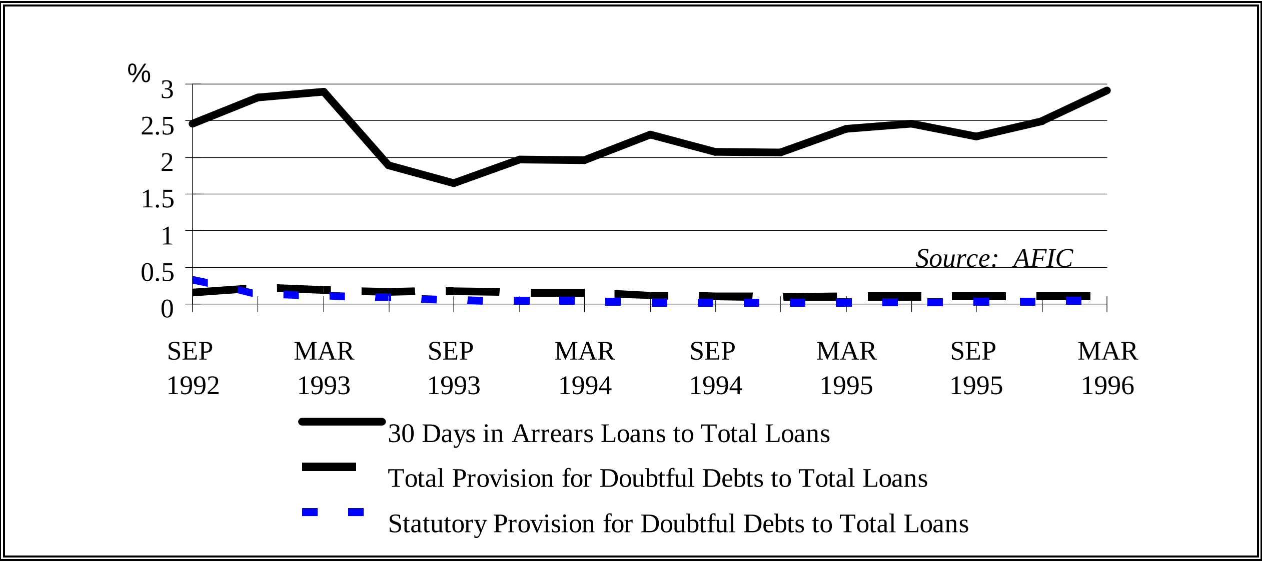
On other measures of efficiency, societies have reduced operating expenses as a percentage of average assets to about 3.25%. Operating income per employee is about $162,000 and operating profit before taxation per employee is about $40,000. Assets per branch have improved for the industry from $17 million in 1992 to about $23 million in 1996.

As shown in Chart 2.6 above, net interest margins are, significantly, on a downward trend from about 4.1% at the end of 1992 to about 3.7% in the first quarter of 1996, reflecting the effect of the intensification of competitive pressures on societies.

2.4.3. Credit Quality

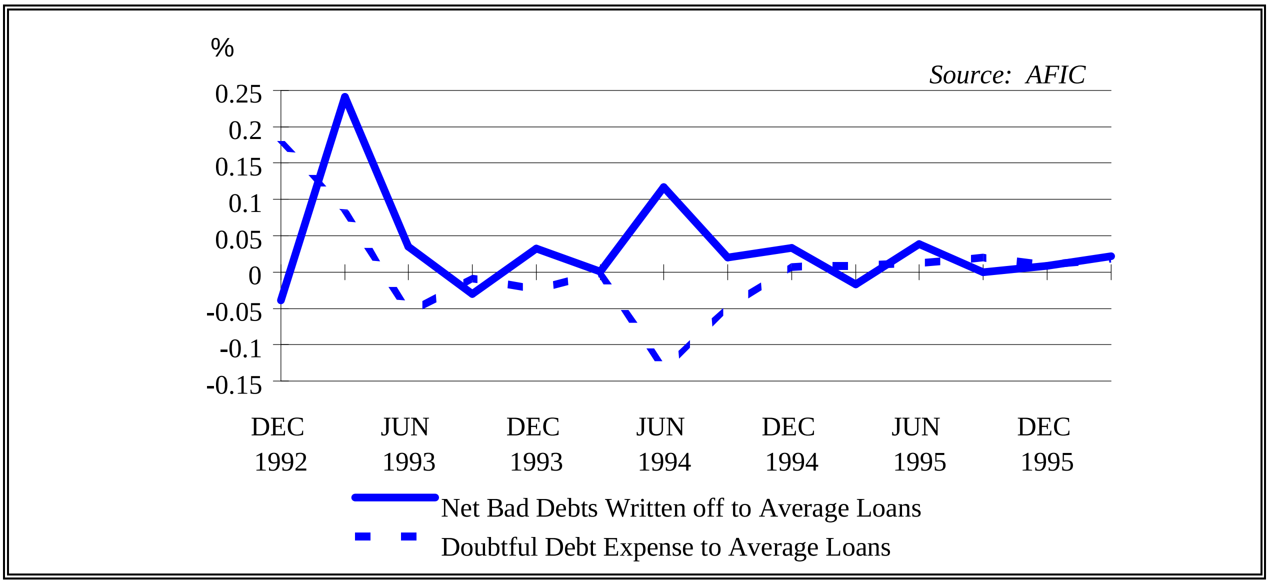
Building societies compare favourably to banks in terms of credit quality measures. Total provision for doubtful debts by building societies has consistently exceeded the statutory requirement over the period since the establishment of AFIC, as shown in Chart 2.9. The ratio of total provision for bad debts to total loans by building societies also is shown in Chart 2.9. This ratio has been stable at a very low level over the past four years, and is low relative to the comparable ratio for banks. Similarly, the ratio of loans (30 days in arrears) by building societies is low.

Chart 2.9: Provisions and Loans in Arrears Total Loans



Reflecting the low risk nature of much of building societies' lending activity, bad and doubtful debt expenses represent only a fraction of a percent of total building society loans, as shown in Chart 2.10. In the March quarter 1996 bad and doubtful debt expenses amounted to only 0.04% of total loans by building societies. Again, these ratios for building societies were well below the comparable ratios for banks.

Chart 2.10: Building Society Bad Debt and Doubtful Debt Expenses



2.5. Ownership Structures

With the enactment of the Financial Institutions Code and the establishment of AFIC, building societies were required to meet uniform prudential standards, including minimum capital requirements. While the principle of co-operative building societies issuing risk capital had already been established, endorsement of that principle by the FI Code hastened the trend nationally as a number of co-operatives moved quickly to meet the statutory requirements for adequate capital.

All fixed capital societies, where the capital was held by individuals, exited the industry in the post-Campbell period. An important and welcome new component of the building society industry has been the entry and growth of building societies wholly owned by major non-bank, high profile institutions. This has been the sole source of new entrants into the sector since the Campbell Report.

As a result of these trends, the building society industry is now comprised of co-operative mutuals (30% of assets), co-operative with shares listed on the ASX (17%), co-operatives with shares not listed (10%) and societies that are wholly owned by financial conglomerates (43%).

2.6. End Piece

The experience of building societies that remained in the building society industry shows that, despite the regulatory impediments, the building society industry has:

1. grown in size;
2. observed high prudential standards;
3. operated successfully with a diversity of ownership structures; and
4. remained profitable.

While many building societies exited from the industry over the post-Campbell period, the performance of those societies that have remained demonstrates that there is a niche for the services of financial institutions that operate in and have a close understanding of the needs of local communities.

The emergence of home loan securitisers as a significant new source of housing finance and the associated shrinkage of interest rate margins represents a major competitive challenge to building societies in the period ahead. The next section discusses the building society industry’s vision of its future role in this more competitive environment.

3. THE EVOLUTION AND FUTURE DIRECTION OF AUSTRALIA'S BUILDING SOCIETY INDUSTRY

Technological change will play a major role in shaping the future course of the financial system. Section 6 aims to identify the likely direction and main impacts of technological change on building societies and financial institutions generally. This section focuses on the evolving identity of building societies and the distinctive role that the building society industry usefully intends to, and can, play in the Australian financial system of the future.

3.1. Size and the Provision of Financial Services

In considering the future role of building societies, the first issue to be addressed relates to size. Given the trend toward financial conglomeration and likely further mergers among financial institutions that already dwarf building societies, is there a role for small financial institutions in the Australian financial system of the future?

To a significant degree, whether the answer to this question is in the affirmative or in the negative depends on the existence of *economies of scale and scope* in the provision of financial services. *Economies of scale* exist where the cost per unit of providing financial services decreases as the number of units produced increases. Economies of scale will be important if there are large fixed costs that must be incurred in order to enter a market, such as an infrastructure network or plant of a particular size.

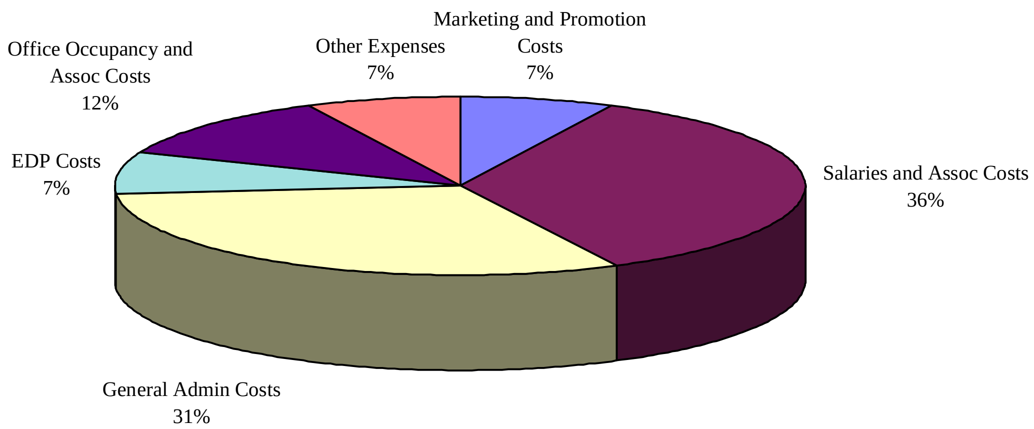
There are some fixed costs in entering the market for financial services, although these are not always easy to identify. For example, there are elements of fixed costs associated with incorporation or registration, information management systems, credit risk management systems, computer networks, establishing a branch. Other costs clearly are variable, such as wages costs, marketing costs and the size of the branch network.

Financial institutions generally involve a team of people contributing to the production of a range of outputs. *Economies of scope* exist where the total cost of *jointly* providing a range of financial services is less than the sum of the costs of providing each service separately. It is the desire to achieve economies of scope that is a major driving force behind the move toward financial conglomeration. Financial service providers want to achieve cost savings from utilising their distribution network to sell a range of financial products.

In principle, economies of scope either may exist independently of size or may be related to size. In practice, it is the view of the building society industry that smaller financial institutions, such as building societies, are able to reap economies of scope by utilising their branch network and their customer relationships to sell a range of financial services to their customers and, thereby, lower the cost of delivery of those services. If the experience of the building society industry is any guide and economies of scope are largely independent of size, then the issue of the advantages and disadvantages of size, hinge essentially on the issue of whether there are economies of scale in the provision of financial services.

In the view of the building society industry, there are very few costs that actually are fixed, at least in the relatively short term. Chart 3.1 shows the cost allocation of the building society industry in the latest year for which data are available. The largest component of costs is salaries and associated costs, which accounted for 35.1% of total costs. Marketing and promotion and other expenses (industry levies and bad and doubtful debts) each account for a further 7% of total costs. Thus, half of total costs are unambiguously variable costs.

Chart 3.1: Building Societies' Cost by Type, Year to March 1996



Much of the other half of building societies costs also are variable. While there are limits to the extent to which small institutions can squeeze general administrative costs, such costs are significantly related to size. EDP costs have an element of fixity, such as the acquisition of major software for use on an institution-wide basis, for example, for transactions processing or a society's accounting package or its management information package. Such institution-wide EDP costs, however, are a relatively small proportion of total EDP costs. Most EDP costs involve the purchase of equipment and software for use by individual staff members and vary in proportion to staff size.

In the short term DTIs have significant fixed costs tied up in their branch networks. However, office occupancy and associated costs can be varied relatively quickly, for example, by varying the number of branches in the network and altering the quality of accommodation. The next few years are likely to demonstrate the alacrity with which such changes can occur.

While there are likely to be some economies of scale in the centralisation of transaction processing, the provision of financial services does not appear to exhibit significant economies of scale. Essentially this derives from the fundamental nature of banking. There is no reason why a teller - human or automatic - cannot be just as efficient when employed by the smallest building society as by a large national bank. Similarly, the task of assessing credit risks of potential loans is no easier for a large bank than for a small financial institution. Banking is not like, say, the provision of telecommunications, which involves a large network with excess capacity and negligible marginal costs. Because of the human input required, there is a relatively large cost at the margin in the provision of financial services.

Of course, major improvements in efficiency in the basic functions of banking have occurred and will continue to occur. Any financial institution, including building societies, that ignores technological change does so at its own peril. To date, however, technological change has not imparted an efficiency advantage to large vis-a-vis small financial institutions. For example, a small financial institution is just as capable of providing home or telephone banking, smart cards, ATMs or EFTPOS as a large bank. If anything, these new forms of distribution, and especially the use of giroPost, make it easier for smaller financial institutions to compete with the large banks.

It is the view of building societies that there is a place in Australia's future financial system for small financial institutions. This view accords both with international experience and with empirical attempts to measure economies of scale and scope.

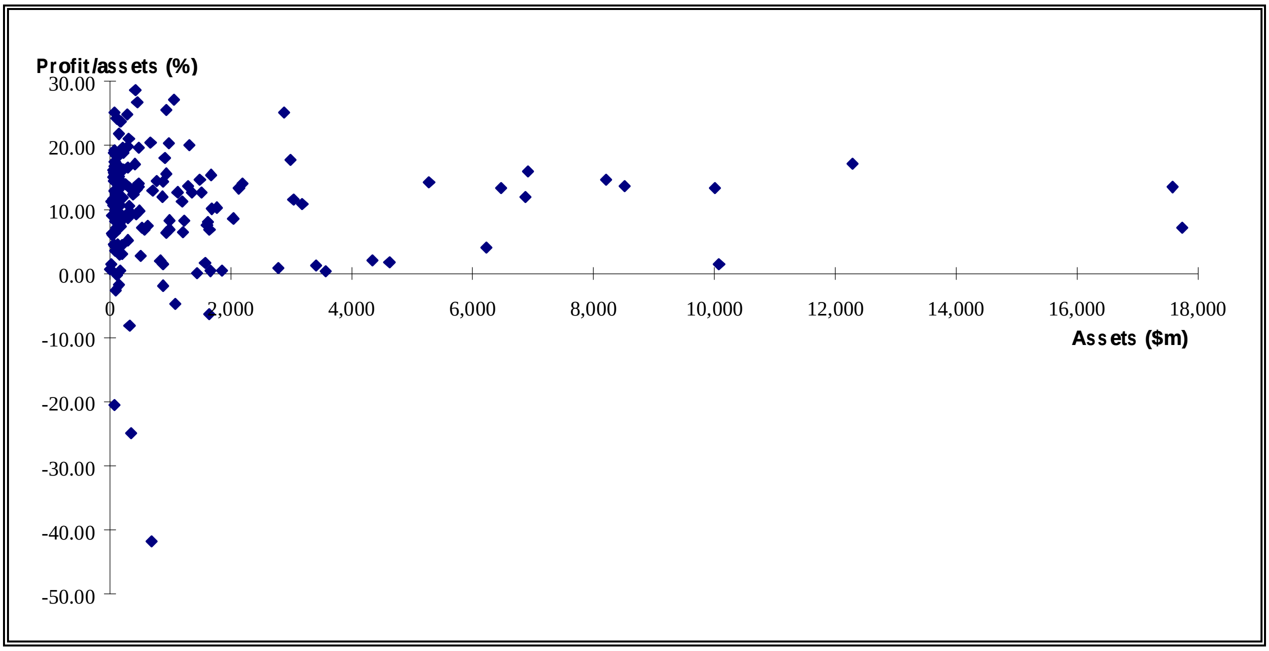
First, in Australia there is a wide range of types of financial institutions, including national banks, regional banks and community based financial institutions, such as building societies and credit unions. In addition, there are money market corporations, finance companies, friendly societies and mortgage managers and securitisation companies.

Second, there is a wide range of sizes of institutions within each of these groups. The banking industry in Australia is very concentrated. Of the 44 banks in Australia, the big four account for almost two-thirds of total assets. Even among these banks there is a significant variation in size, with the NAB about 29% larger than the ANZ. With average assets in excess of $77 billion, the big four banks are some 18 times greater than the average size of the other 40 banks. These average comparisons mask some considerably greater individual variations. For example, the NAB is more than 47 times larger than the Bendigo Bank.

There are similarly large variations in size in other sectors of the financial system. Among finance companies, Esanda Finance Corporation is more than 200 times larger than Equus Financial Services. Among building societies, Newcastle Permanent Building Society is 58 times larger than the Mitchell Building Society. Among the 69 largest credit unions, the Australian Central Credit Union was approaching nine time larger than the size of the Goulburn Murray Credit Union Co-operative.

In each of these sectors there are a wide range of sizes between the largest and smallest institutions. Chart 3.2 shows the relationship between profitability (operating profit after tax to average net assets) and size of institution (in terms of assets) for all institutions in the KPMG 1996 Financial Institutions Performance Survey except the big four banks. There is a similar lack of relationship between size and profitability for each of the sectors included in the survey when considered separately.

Chart 3.2: Size and Profitability



In the United States it has been suggested by one analyst that scale economies have been a factor leading to merger activity: *"The large number of mergers and acquisitions are also being driven by smaller banks not being able to compete on the same scale as larger banks. These larger banks are able to take advantage of new technologies allowing them to radically transform the distribution outlets for their products and services, reduce costs and make products more readily accessible to both consumers and businesses."*[10]

According to the same analyst, however, this did not spell the end of small banks in the United States: *"For the first time in a decade, American institutions are striving towards global competitiveness and presence. Not surprisingly, global aspirations play a critical role in shaping bank merger activity...While the 1980s saw multiple institutions with varying sizes, focussing on product, and geographical areas, in the latter part of this decade two distinct groups of institutions are emerging. They are separated by customer, not product and are unbounded by geographical barriers. Large national and global financial powerhouses congregate at one end, with the smaller regional and specialists at the other."*[11]

If the United States experience is any guide, there is a continuing role for small regional financial institutions.

The question of the existence of economies of scale has been the subject of considerable investigation by the economics profession. The Campbell Committee commissioned a study into the issue, which was charged with reviewing the results of relevant Australian and overseas

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10 KPMG *1996 Financial Institutions Performance Survey*, p52.

11 ibid, p52.

studies. The Committee concluded as follows: *"The available evidence suggests:*

- *there are moderate economies of scale in some aspects of banking, particularly in the management of the payments mechanism;*
- *there is weaker evidence of economies of scale in the operations of building societies and, on overseas evidence, credit unions; and*
- *there is no convincing evidence on the existence or otherwise of economies of scale in other forms of financial intermediation."* (Paragraph 32.85)

Given the increasingly important role played by technology and the rapid changes occurring in that aspect of banking, it is possible that economies of scale may become more important. At present, however, the building society industry considers that there is little evidence of significant economies of scale. There is strong evidence that small financial institutions can compete successfully against much larger institutions across the range of different sectors within Australia that make up the financial system. Building societies expect this to remain true for the foreseeable future.

3.2. Catering to Regional Needs and Markets

Building societies originated from the self-help movement which emerged towards the end of the eighteenth century in England. They have operated in Australia since the 1850s. While building societies have changed greatly over the past century and a half, the idea of saving, self-help and co-operation remain and underpin the service ethic in modern day building societies. The Saving Supplement attached to this Submission discusses Australia's poor saving record and associated policy issues.

The co-operative culture continues in the management of building societies whose corporate structures now include risk capital where voting rights remain co-operatively based (each shareholder has only one vote, rather than one vote per share). This ownership structure puts the focus on customers' interests, compared with banks where the first priority and pressure is to maximise the wealth of shareholders.

In Australia a reputation for the core values of service, innovation, fairness and reasonableness in lending and pricing has been successfully marketed and identified with the building society brand name. The movement of former building societies into the banking industry has created opportunities for societies to differentiate themselves from the banking culture by re-emphasising their commitment to these core values. Building societies have lagged behind banks in imposing fees and charges and this led to the migration of bank customers to building societies in recent times.

There are limits to the extent to which building societies can absorb customers that are dissatisfied with banks fees. Building societies will be aiming to reduce the ratio of their operating expenses to operating income, which is high relative to the ratio for banks. The extremely competitive environment ensures that the rigours of the marketplace apply fully to societies. The pressure on management to optimise profit imposes disciplines. Nevertheless, the co-operative structure provides scope, at the margin, for a different approach by building societies that benefits customers, particularly at times when market conditions are imposing strains on its borrowers.

The public benefit of Australia's building societies arises mainly from their location in regional and rural Australia, their community ownership and focus and the retail nature of their business, as shown in Table 3.1. The industry intends to build on these characteristics of building societies to enhance the role played by societies in the future.

Historically the best interests of individuals are served by real financial alternatives and not simply separate local brand names and subsidiaries designed to portray, for marketing purposes, a local identification. AAPBS agrees with the Reserve Bank when it said: *"The Bank believes that there is value in having a range of financial institutions."* (Annual Report 1990) In 1991 the House of Representatives Standing Committee on Finance and Public Administration also indicated: *"Concerns amongst various sections of the community about the trend towards concentration in the banking industry are shared by the Committee."* Building societies in Australia are part of the spectrum of difference, an alternative source of finance and service which deserves recognition and support in public policy relating to the financial system.

Building societies also consider that they will continue to operate with a variety of ownership structures in the future, but that there will be an on-going emphasis on the co-operative structure. Many societies have successfully issued risk capital, yet retained co-operative voting structures (one vote per shareholder). This has allowed societies to have a source of capital to underpin growth, efficiency and profitability, without changing the whole focus to maximising the wealth of shareholders. Societies that have issued share capital maintain share registers that are dominated by local individuals, local business and local investors, usually long-standing customers who do not regard themselves as typical shareholders. There is also a significant proportion of "mums and dads" who use the society's services.

Building societies want to preserve their unique identity as local, retail financial institutions. Traditionally, the principal area of lending by building societies has been housing loans, funded from their retail deposit base. Despite the difficult and drawn out history of housing finance deregulation, societies continue to concentrate on that sector of the lending market. The traditional prime purpose of building societies has been written into the FI Code legislation and requires that 50% of loans made by societies must be in the category of housing.

Currently, whilst the prime purpose clause is not a binding constraint on the operations of all building societies, it is likely that building societies will need to adapt to competitive pressures by broadening the range of lending activities they undertake. Building societies envisage that they are going to play a broader role as the local, retail lender and, therefore, seek the removal of the prime purpose clause to avoid any limitation due to the prime purpose clause on the scope of their lending activities in the future.

Table 3.1: INDICATORS OF LOCAL SIGNIFICANCE (ILS) - BUILDING SOCIETIES

Regional City	Share of Local Market		Estimated Ranking in Town's Financial and Commercial Sector as Employer of:					Ranking in Community Sponsorships
	Loans %	Deposits %	Men and Women	Women	Professionals	Under 25's	Outsourcing to local professions	
Albury	30	33	1st	1st	20th	1st	1st	1st
Bathurst	8	2	30th	15th	12th	N/A	N/A	7th
Bundaberg	25	15	2nd	1st	1st	1st	1st	1st
Cairns	20	20	1st	1st	1st	1st	1st	1st
Darwin	7	5	7th	7th	7th	8th	3rd	4th
Ipswich	38	35	3rd	1st	1st	1st	1st	1st
Mackay	20	N/A	1st	1st	Top 15	Top 10	Top 3	1st
Maitland	7	11	20th	15th	15th	20th	9th	1st
Newcastle	35	25	Top 5	Top 5	Top 10	Top 10	N/A	Top 10
Rockhampton	15	20	2nd	N/A	2nd	3rd	2nd	1st
Toowoomba	20	30	10th	3rd	1st	6th	1st	1st
Wollongong	12	45	Top 5	Top 3	Top 3	N/A	N/A	Top 10

Source: AAPBS

3.3. Community Financial Services

Building societies already provide a similar range of retail financial services as banks. Retail financial products are building societies core business and include mortgages, personal loans and revolving credit, and commercial loans. Building societies also provide payments services, including ATMs, EFTPOS, debit/credit cards, cheques, mortgage offset, mortgage power accounts, home equity loans, ADFs, Eligible Rollover Funds, Deeming Accounts, allocated pension accounts, financial planning services, travellers cheques, insurance services, term deposits, special purpose deposits, interest only loans, equity credit, retirement counselling, at call and term deposit accounts and CMTs.

Clearly, building societies provide the broad gamut of retail financial services maintaining pace with technological development. Until recently, however, building societies and credit unions have suffered by exclusion from the primary payments system run by the banks. With the formation of the Australian Payments Clearing Association and the granting of an Exchange Settlement account by the Reserve Bank to the industry's Special Services Provider, AAPBS Settlements Limited, societies have become more fully integrated into mainstream payments systems.

There remains a little way to go before the playing field is level. Building societies still do not participate in the high value system and cannot have cheques drawn on them, though prospect of change is in the wind.

While the building society name is highly valued by societies and well known in Australia, the services societies offer now and in the future will be broader than that which the building society name denotes. Many traditional societies want to develop their position as a strong, local, community financial institution and a system which provides greater flexibility in core functions is needed for these developments to take place. The concept of “community banks” in Australia could be advantageous to many consumers.

The building society industry considers that there is a niche for societies as local community based institutions, whether called building societies, credit unions or community banks. They would provide a safe haven for savings and are ideal institutions to provide an alternative in their region to national and globally operating banks, both in lending and providing financial services to small and medium sized businesses in regional Australia.

A likely scenario could see community based financial institutions developing relationship banking services for individuals and small business in the areas where they have skills and local knowledge of sound proposals. A business loans portfolio will emerge, with reduced dependence on housing. The trend is likely to be toward institutions offering a range of services. Outsourcing of non-core functions is expected and community based financial institutions will tend to concentrate on customer service, lending and loan administration.

Remaining a prominent, local, prudentially supervised financial institution will not preclude home lending exposure outside the local region. New customer delivery systems include use of so-called vanilla loans. The concept of a strong local presence with national access to markets via new delivery mechanisms is likely to become more popular among building societies in the future.

Building societies which are part of large financial conglomerates will seek to develop their institutions as a serious alternative to national and regional banks offering a wide range of financial services nationally in conjunction with their parent companies. These building societies already spread across all States but will also be strongly represented in the local and regional locations via their local parent company branches and agents.

United States experience supports the vision of building societies evolving into community based financial institutions as a viable long term strategic view of the way forward for the building society industry. There are over 2,000 community banks in the United States, with assets of $US1,017.2 billion as at June 1995[12]. Community bank earnings totalled $US7.1 billion in 1994-95, representing 0.73% return on assets. Equity capital rose to $US83.2 billion in June 1995, equivalent to 8.18% of assets.

Community banks in the United States are motivated in all their operations by the desire to strengthen their relationship with America's local communities. Lending has a community focus, with retail loans - consumer, credit card and residential mortgages - accounting for 78% of total loans. Community banks tend to fall into two categories:

- full service community banks offering a full range of products to consumers and small business customers in a community; and

- community banks with a defined niche offering a range of products and specialised services targeted at specific consumer and small business segments.

In a recent study[13], KPMG analysed the performances of 25 top performing US community banks in order to try and identify the factors that created successful outcomes. The study found a number of factors that contributed to superior performance, but identified having a strategic vision - involving an unwavering commitment to their community and the belief that their success lies in staying community based - as the single most important factor. Consistently top performing community banks in the United States stick to the basics and focus on executing their strategies well by:

- defining the business that they are in;

- providing engaged leadership;

- measuring and managing what counts; and

- putting employees first.

The area of business definition is an on-going process of balancing opportunities and capabilities. Successful community banks were in sync with their market place and were able to redefine their business as their community evolved. The study found that some institutions will have to define

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12 America's Community Bankers 1995 Annual Report, p6.

13 KPMG Project Excellence *Competing and winning - not merely surviving: A Profile of Top Performing Community Banks,* January 1996.

their businesses more broadly than in the past in order to enable them to meet the challenges posed by increased competition, rapidly advancing technology, more sophisticated and demanding customers, converging industry segments and regulatory change.

KPMG found that community banks have a keen sense of the opportunities in their marketplace and have exploited windows of opportunity left open by the big banks. The heart of community banking involves the servicing of that niche of customers, both consumers and business, that want a level of personal service and caring that simply is not provided by the big banks.

Community banks in the United States have a different operating culture than the large banks. There is more clarity of purpose as community banks take advantage of their smaller size to involve directly in strategic planning a greater proportion of stakeholders than is possible with larger institutions. Because of their size, the CEO of a community bank is able to provide more engaged leadership than is possible at a big bank. Management processes are unbureaucratic. Hands on attention by the CEO is the rule, not the exception. Community banks have the small business hard-nosed attitude to costs. Compensation practices tied to performance are prevalent. Employees have more power than in big banks to make decisions and are more inclined to "think like owners".

Community banks in the United States have been able to exploit their size by taking a different and successful approach to the central task of managing credit risk. Generally speaking, community banks maintain strong credit quality through discipline and by hands-on involvement of senior lenders, rather than by comprehensive credit risk management systems favoured by the big banks. This approach by community banks works because community banks have experienced lending staff who provide underwriting consistency, are themselves involved in the loan monitoring process and aim to attract the desired quality of business, rather than volume. Community involvement gives community banks higher knowledge levels than is possible at big banks.

Looking to the future, the KPMG study found that community banks in the United States considered that technology was the most commonly cited driver of change. The key question for community banks is whether technology will be "*what ultimately enables the banking giants to bury the community banks or will technology be what levels the playing field for banks, big or small. The answer coming from a majority of our banks [in the survey] is that technology will enable them to compete with the 'big boys'.*"[14]

The building society industry considers that building societies in Australia have much in common with community banks and, therefore, that many of the findings of the KPMG survey of community banks in the United States apply to Australia.

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[14] ibid, Chapter 7.

4. PRINCIPLES FOR PRUDENTIAL REGULATION OF FINANCIAL SERVICES IN AUSTRALIA

Previous sections have demonstrated the importance of regulatory arrangements in determining the terms on which different sectors of the financial services industry engage in competition. In particular, the regulatory regime for non-bank DTIs has played a large role in the transformation of the building society industry in the post-Campbell era.

This section presents the building society industry's views of the principles that ought to govern the competition and prudential arrangements for Australia going into the next century.

4.1. National Objectives and Competition Benchmarks for a National Industry

> *"The competitors to banks in the future will be, as we are already seeing in this country, anyone who has access to a customer base and access to technology."*
> Peter Costello, Treasurer, 5 June 1996

The building society industry believes in the efficacy of competition as a spur to efficiency in the delivery of financial services. The building society industry's post-Campbell experience is a case study in how regulations that stifle competition in the financial sector tend to be circumvented as products and/or institutions adapt to compete in ways that conform to the regulations.

Competition could reasonably have been expected to have been provided to banks from building societies in the post-Campbell era, had building societies operated under a best practice regulatory regime. Instead, much of the competition that would have come from building societies has taken the form of competition from regional banks that were former building societies. It is difficult to assess the impact of this on the overall level and intensity of competition in the provision of financial services. It is clear, however, that Australia now has a less significant range of non-bank financial institutions in retail financial services than would otherwise have been the case.

This experience suggests strongly that State-based regulation of financial institutions is out-of-date. The reason for this essentially is that one of the legacies of the Campbell Inquiry is that all financial institutions in Australia now operate in national markets heavily influenced by national forces and policy. Financial deregulation means that long-term interest rates are set in accordance with the same demand and supply forces in all parts of Australia, with international factors having a major influence in shaping those forces. The Reserve Bank sets the cash rate at the short end of the market and all players, irrespective of size or location, must operate on the basis of that rate.

Allied to the emergence of national financial markets, it is now technically easier to supply financial services to a wider geographic area than was the case in times past. The ease and reduced cost of communications has extended the 'competitive reach' of financial institutions and made the delivery of financial services based on a geographic branch network even less relevant. Automatic tellers were an early example of cheaper delivery mechanisms and new delivery mechanisms are emerging regularly. For example, EFTPOS allows customers of a bank to make cash withdrawals at a wide range of retail outlets. Australia Post's giroPost service allow customers of a number of different financial institutions to carry out a wide range of financial services at many delivery points. Home loans can be arranged over the telephone or in the customer's lounge room.

Another factor that is enforcing competition on a national basis is the blurring of traditional institutionally-based distinctions among providers of financial services and the emergence of new entrants into the traditional preserves of established players. To a significant degree, these developments reflect the dramatic change in the financial system brought about by the spread and increased importance of superannuation. Thus, mortgage securitisers are a potent new force in the home loan market. For example, the National Mutual has entered a partnership with superannuation funds to provide home loans sourced from funds to fund members and is planning to extend this partnership to include loans to small business.

Similarly, the AMP is leveraging off its direct sales network using telephone banking to challenge DTIs in the provision of home loans. The AMP plans to be offering the full range of banking services by the year 2000. CML has advanced the furthest down that path through its acquisition of the State Bank of New South Wales and is the closest institution in Australia to being a "bankassurance" conglomerate. DTIs have responded by entering the home loan securitisation business themselves through subsidiaries and offering superannuation and insurance products.

The trend toward the integration of the Australian market for financial services into a single national market is part of a broader phenomenon. The Australian market for financial services is being more closely integrated into the international marketplace for those services. This process was facilitated by the decision in December 1983 to float the Australian dollar and remove exchange controls. Subsequently, the same technological developments, especially in computing and communications, that are leading to a unified national market are also at work drawing Australia more closely into the international marketplace for financial services. The co-ordination of prudential arrangements in most countries through widespread implementation of the Basle accords also has assisted the internationalisation of the market for financial services.

Importantly, this process of internationalisation is being reflected in increased levels of offshore operations by Australian financial institutions and increased activity in Australia by foreign institutions. This has led to debate about the role of domestic merger policy in inhibiting the growth of Australian companies overseas, given the widely held view that a large share of the domestic market is a necessary launching pad for successful overseas expansion. Others argue that rivalry in a company's home market, rather than dominance of that market, is more likely to breed companies that are internationally competitive.

One effect of the internationalisation process that is clear is that :

> *"Increasing internationalisation of trade and commerce opens up domestic producers to international competition in domestic markets and forces Australian firms to seek greater efficiencies in production, distribution and management so as to be able to compete in overseas markets. There is increasing pressure on domestic firms to be innovative to keep ahead of, or just keep up with, rapidly evolving technologies and new products.*

> *Internationalisation of trade and commerce, therefore, has a dual relevance to mergers in those trade exposed sectors of the economy: it creates pressures for enhanced efficiencies to compete and reduces concern at the level of domestic concentration in trade-exposed sectors, given the presence of overseas sources of competition."*[15]

These considerations led the ACCC to propose that it review the impact of the changing structure of international business:

> *"...on competition in domestic markets to see whether a more general account should be taken of these factors in the Guidelines. As part of that review, the Commission will consult with domestic industry and industry groups as to the impact of globalisation on competition in domestic markets and on their opportunities to penetrate overseas markets."*[16]

The ACCC intends to report on the outcome of this review in 1997, including whether there should be any general revisions to the Merger Guidelines. *The building society industry considers that that review should be integrated into the work of the Inquiry insofar as it relates to financial services.*

Where do building societies, with their focus on serving local markets, fit into the overall market for financial services? Even though their share of assets of the total financial system is relatively minor, building societies tend to operate at the cutting edge of competition and, therefore, are going to continue to be useful in ensuring that consumers are provided with financial services on an efficient and competitive basis. In particular regional areas building societies account for a larger share of the market and, therefore, provide greater competition to banks and other service providers,. These tend to be areas outside the capital cities where other service providers may otherwise compete less intensively (see Table 3.1).

Also, it is more appropriate in this context to consider the role played by building societies, credit unions and regional banks collectively, rather than simply building societies alone in providing alternative services to those provided by the main banks and large life companies. Each of these institutional groups prides itself in the level of customer service that it provides and in this way differentiates itself from the large banks. Taken together, these groups are a vital element in Australia's competitive financial system.

The other distinguishing feature of building societies (besides attention to customer service) is the focus on serving the local community. Each building society (even if it now operates in a number of States) has grown up in a particular region of Australia and still has its headquarters in that region.

The local focus of building societies, however, is not at odds with the integration of the national market and the internationalisation of financial services, provided its regulatory framework is responsive to those forces. This essentially reflects the essence of the financial intermediation

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15 Australian Competition and Consumer Commission, *An Introduction to the Revised ACCC Merger Guidelines*, 16 July 1996, p11.

16 ibid, p13.

role played by DTIs, which is the accurate assessment of credit risks. This process is informed by local knowledge in the case of building societies and provides them with a competitive edge over more globally dispersed institutions. Also, building societies are able to build a rapport with their communities that larger institutions are unable to emulate. Further, it is possible for a building society to retain its local focus in terms of its branch network, and thereby maintain its local presence in a physical sense, while at the same time conduct a significant proportion of its activities in more geographically dispersed markets (and in the process achieve a geographical diversification of its loan portfolio). Provided cost and product availability are at least similar, many regional customers prefer to deal with their local institution.

In summary, there is a continuing role for a diverse range of financial institutions to service the Australian market, including those which have no ambitions to expand offshore or even to have a national branch network.

4.2. National Prudential Regulatory Benchmarks for a National Industry

"When financial institutions are subject to different regulatory regimes, it is difficult to ensure that they bear an equal burden."
Professor Tom Valentine, May 1996

The building society industry considers that, in general, the best outcomes for Australia as a whole are likely to be achieved with the minimum amount of government regulation, including prudential regulation, consistent with the achievement of appropriate public policy objectives. The greater the involvement of the authorities in the regulation and supervision of financial institutions, the more likely it is that operational efficiencies will be sacrificed as normal incentives and market disciplines facing shareholders are blunted.

In the case of the prudential oversight of financial institutions, therefore, building societies consider it important to preserve the principle that the main responsibility for the prudent management of a financial institution rests with the institution itself. Public policy objectives designed to override free market outcomes generally have been justified either on the basis that they protect the interests of bank depositors or that they promote the stability of the banking and financial system and, especially, the payments mechanism.

The riskiness of a DTI essentially stems from the fundamental nature of the business of deposit taking, which is to borrow short and lend long. With largely illiquid assets and capital that is small relative to other business, even a sound DTI can be exposed to the risk of a liquidity shortfall. Of itself, this is not a problem. The threat to the stability of the financial system - systemic instability - caused by the failure of an individual bank to meet a demand for payment arises because of the possibility of so-called financial contagion, whereby the failure of one bank spreads to others, via the payments system.

The philosophy underlying bank supervision has been remarkably little changed since the 1937 Royal Commission on Monetary and Banking Systems in Australia. According to the Royal Commission, bank supervision ought to be directed at "*the object of safeguarding the banking system as a whole*" but not the shareholders of a particular bank (a troubled bank should be allowed to fail). The central bank would need to distinguish between a bank that was solvent but unable to meet its immediate obligations due to an insufficiency of liquid funds, and a bank that was in a fundamentally unsound position. While the actions of the central bank would differ in each of these cases, in both cases the central bank would be motivated "*by providing the utmost security for depositors*". The Campbell Committee espoused the same philosophy.

It was not the intention of the Commission or, subsequently, of the Campbell Committee that the "utmost security for depositors" extend to a government guarantee or the provision of a lender of last resort to banks. The Campbell Committee may have encouraged the view that the government stands behind bank depositors by promoting the notion of a spectrum of risk. This notion is motivated by the desire to provide depositors with a range of riskiness of deposits and rewards. Banks were intended to be a "safe haven", whereas other DTIs were not afforded the same privileges as banks under the Banking Act.

The building society industry considers that the notion of the spectrum of risk should be a reflection of the mix of business of a financial institution, rather than the classification of the institution. The Campbell Committee notion of a spectrum of risk offends the principle of competitive neutrality, which should be a central to the design of any system of prudential regulation. The building society industry attaches considerable importance to the attainment of this objective.

In framing its recommendations, therefore, the Inquiry should ensure that similar types of financial transactions are treated on the same basis under its preferred prudential arrangements. In this way, the arrangements will treat financial institutions with the same mix of business on an equal basis, irrespective of their institutional classification. The mix of an institution's business, rather than its institutional status, will determine its overall riskiness. Thus, there will still be a spectrum of choices available to savers and investors involving varying combinations of risk, return and liquidity. That spectrum should be determined by the market, not the regulators.

This raises the issue of whether the current depositor protection measures that apply to banks[17] *are still appropriate and whether they should continue to be restricted to banks. Building societies consider that there is such a widespread expectation in the community that deposits are safe, that it would not be possible to alter the depositor protection provisions that apply to banks. To ensure competitive neutrality, stability and public confidence, these provisions should be extended to all DTIs.*

Another problem with a prudential system organised along institutional lines is that it is too easy for institutions to emerge specifically in order to avoid the regulations. This is more likely to happen the greater the regulatory burden imposed on complying institutions. This is undoubtedly a factor driving the growth of mortgage securitisation. Mortgage originators are being encouraged by the cost of regulation on DTIs and by the traditional cross subsidies by borrowers to depositors due to pressures that prevent DTIs from charging appropriately for services to depositors.

Increasingly, technology is changing traditional patterns of delivering financial services. Technology is making it possible and profitable for some financial activities to be provided in

[17] Depositors rank ahead of all other creditors and the Reserve Bank can take over the running of a bank that it considers to be under threat.

isolation from others and this is drawing non-traditional players into the financial system. For example, Australia Post is offering payments system services and Telstra is involved in Visacard. It is important that the system of prudential regulation be sufficiently flexible to cope with these sorts of developments. Again, this suggests that regulation organised along institutional lines will be too rigid and cause unequal sharing of regulatory burdens (refer section 4.3.).

It also is desirable that the system of prudential regulation be formulated and administered on a national basis. This will help minimise the problem of gaps and overlap which are more likely to occur if different jurisdictions have responsibility for different financial institutions. Even when all prudential regulation is formulated and administered at the national level, gaps and overlaps are more likely if responsibility for prudential regulation is shared among a number of regulatory agencies. If the division of regulatory responsibilities is institutionally based, then problems of gaps or overlaps can arise from several sources, including:

- institutions or functions that escape regulation (for example, mortgage originators under the present arrangements);

- functions that are regulated differently according to the institution that carries out the function (for example, deposits of banks compared with deposits of building societies under the present arrangements); and

- functions that are carried out by an institution that are subject to multiple regulators (for example, managed fund products of DTIs under the present arrangements).

Perhaps the key issue that has emerged since the Campbell Committee is the appropriate response, in terms of the design of the prudential arrangements, to the emergence of financial conglomerates. Initially, in the development of the prudential arrangements in the 1980s, the Reserve Bank did not extend prudential requirements to include subsidiaries of banks, such as finance companies or merchant banks. Reflecting Reserve Bank concerns about the risk of contagion from subsidiaries, capital adequacy and large exposure reporting requirements were extended to consolidated groups. In recent years the challenges caused by financial convergence has occupied much energy of regulators, both in Australia and internationally.

The process of convergence of financial institutions is a response to market pressures. It seems desirable, therefore, in the interests of facilitating efficiency in the provision of financial services that Australia’s future prudential arrangements avoid stifling this process.

Finally, prudential regulation is likely to require information disclosure and reporting to the authorities, together with inspections by the authorities. It is desirable that the compliance costs of the arrangements are kept to a minimum, consistent with meeting the objectives of regulation. AAPBS estimates the cost to the building society industry of compliance with government regulations and requirements (excluding actual levies for prudential supervision) was of the order of $11 million in 1995-96, representing 0.08% of average assets and 12% of profit after tax.

In summary, the building society industry suggests that, in making recommendations for change, the Inquiry should be aiming to design prudential arrangements that:

- allow optimisation of the benefits of competition;

- are cost effective, flexible and involve consultation;
- avoid gaps and overlaps in regulation which distort competitive neutrality; and
- allow for changes in the supervisory framework, if changing circumstances so dictate.

4.3. National Regulation of Payments Providers

The key question arising from new technology fostering non-traditional players is the balancing of enhanced competition with risk management. Provision of payments system services is a function which, under a functional approach to supervision, would carry prudential standards in keeping with the risk.

The Inquiry's attention is drawn to the role of the Australian Payments Clearing Association and the model it uses to determine participation. It is noteworthy that APCA obtains trade practices authorisation for its activities seeking authorisation on the basis that the public benefit outweighs any detriment.

APCA uses a system of co-operative regulation across a range of institutional types. APCA's clearing systems are not based on institutional status but on objective criteria relating to payments clearing and settling requirements. Participants in payments services therefore have available an objective and transparent set of eligibility criteria which, if met, would facilitate their participation.

The objective criteria developed are:

- preserving the integrity of the payments system to avoid compromising its technical and operational standards and standing;
- minimisation of settlement risk by having a high degree of confidence that a participant can provide finality of payment (currently by debiting or crediting an Exchange Settlement Account at the Reserve Bank) and a high degree of prudential supervision commensurate with the risks involved;
- a minimum level of operational efficiency so as not to impair the overall efficiency of the system; and
- promotion of competition by establishing objective criteria for entry and participation while not referring to institutional status.

The building society industry endorses the approach of APCA and recommends that:

- *the Wallis Inquiry accept the role of APCA in determining eligibility to participate in the payments system; and*
- *as a requirement for settlement, finality of payment requires a settlement account operated at the Central Bank by an institution of high prudential standing.*

5. CONSUMER REGULATION OF BUILDING SOCIETIES

Previous sections have been concerned with the prudential regulation of financial institutions, which is intended to reduce the likelihood of systemic instability due to the risk of one bank failure spreading to other banks through the payments system. The other motivation for regulation of financial institutions is depositor or investor protection, which is largely intended to provide investors with more information about the risks inherent in their assets. This is known as consumer regulation and is discussed in this section.

5.1. Rapid Increase in Government Intrusion

Banks, building societies and credit unions have been subject to a rapid increase of government intrusion into their customer relationships, under the broad headings of consumer protection, credit legislation, social services, competition policy and taxation collection policy.

State and Federal government agencies are often placed in the position of responding to political pressure to curb or regulate the practices of banks. These regulations invariably are not costed and are difficult to co-ordinate as between States.

This trend has been in marked contrast to the thrust for deregulation of the financial system and is a major concern to the building society industry. As the "small businesses" of the finance industry, the trend for official regulation and governmental monitoring threatens efficiency, competitive position and diverts management time from prime functions.

The consumer movement has been extremely successful in exploiting poor bank lending practices in rural areas in the late 1980s and poor customer relations. Banking industry and official responses to the consumer backlash flowed through to building societies, irrespective of the fact that societies did not have customer relations problems and the level of complaint experienced by banks.

5.2. Responsibility for Customer Relations

Societies have built and sustained their business on a range of factors but paramount among these has been customer service. A long established and excellent record of effective customer relations is in place and the industry holds the view that this relationship is a key competitive advantage of societies.

The philosophy of societies is to ensure systems and staff training such that the customer is well serviced and satisfied with the societies' processes and products. To illustrate the point, on each occasion a building society has converted to a bank, the new bank has made public statements of policy, enhanced in marketing campaigns, to the effect that traditional "building society service" will not be lost in the conversion process.

Building societies place great store on their excellent record of customer relations and regard it as a defining quality vis-a-vis big banks. It is expected to provide societies with a significant competitive edge in an increasingly competitive business. Centralised initiatives interfere unnecessarily in customer/society relationships. Measures which treat all institutions the same, in their customer relationships, are ill advised and bureaucratic, and also assume a significant level of disputation. In the case of building societies this is a false premise for formulating policy.

5.3. State-Based Consumer Credit Law

The Rogerson Report (1969) and the Molomby Committee Report (1972) proposed a legislative scheme of regulation of consumer credit that eventually found expression in the Credit Acts of New South Wales, Victoria and Western Australia in 1984 and in Queensland in 1985.

The Credit Acts (and their related legislation) are credited with established a licensing system for credit providers (ie finance companies) introducing comprehensive disclosure requirements to assist borrowers to shop around and providing consumers with certain protections, such as those dealing with the repossession of goods.

The Credit Acts will be replaced by a new and purportedly uniform Consumer Credit Code on 1 November 1996. Reasons for the changes include Tasmania, South Australia and the Northern Territory not having equivalent consumer credit legislation. The various Credit Acts present significant difficulties of interpretation for credit providers, borrowers and their advisers and the Acts are highly prescriptive and technical. Penalties and cost imposts for contraventions of the Credit Acts are extremely onerous and they stifle the introduction of new products as they were designed for a regulated credit market where a limited number of products were available.

The Credit Code is a product of nine years of deliberation, consultations, frustrations and compromises, in the main due to the extremely difficult and cumbersome task of having to achieve agreement among eight separate States and Territories to the precise wording of a single piece of legislation intended to be uniform throughout Australia. The task was made even more difficult due to changes in governments that occurred during that period.

The objectives of the Credit Code include the provision of laws that apply equally to all forms of consumer lending and to all credit providers, and which are uniform in all jurisdictions in Australia, to promote the principle of truth-in-lending which allows borrowers to make informed choices when purchasing credit, to regulate a credit provider's conduct during the life of the loan without restricting product flexibility and consumer choice and to give borrowers significant redress against credit providers for contraventions of the Credit Code.

5.4. Deficiencies in the Credit Code

Under the Credit Code (which is due to commence on 1 November 1996), credit providers will still encounter difficulties similar to those encountered under the existing Credit Acts. These include the prohibitive cost, particularly to smaller credit providers, of implementing and strictly complying with the stringent requirements of the Credit Code. This is particularly so for building societies, which generally were not subject to the credit acts designed mainly for the finance company personal lending market.

The Credit Code is overly prescriptive and imposes significant compliance costs due to the ambiguities and interpretational difficulties that are inherent in the Code.

The draconian penalties prescribed by the Credit Code for contraventions of the Code may be imposed despite the fact that the borrower has suffered no loss.

The very real possibility that the Credit Code will be construed differently depending on the jurisdiction in which the matter is heard and, particularly, the emerging trend for a Court/Tribunal to consciously depart from a ruling made on the same subject in another jurisdiction (in the State Bank decision of the NSW Commercial Tribunal, the Tribunal refused to have regard to earlier decisions of the Full Court of the Supreme Court of Victoria).

Following from the previous point, the clear risk that a credit provider cannot rely with any certainty on the interpretation of a Court/Tribunal in one jurisdiction as binding in another - the matter would need to be litigated in each jurisdiction separately. There is, therefore, a compelling argument that in order to ensure that the Credit Code is interpreted consistently and uniformly, a national judicial jurisdiction should be established.

The ability to amend the Credit Code in a timely manner to accommodate market trends and changing lending practices will be seriously impaired due to the cumbersome mechanics of requiring eight separate States and Territories to agree to amendments. The delays and inefficiencies caused by the present system is evidenced by the fact that, for example neither Western Australia nor Tasmania have, as at end May 1996, passed the template Credit Code, which was passed in Queensland as long ago as 2 September 1994. The proposed commencement date of the Credit Code has been deferred no less than three times because of critical deficiencies in the Code which rendered it impossible for credit providers to properly comply with the Code by the proposed commencement date.

A major deficiency of the Credit Code is the absence of a central secretariat which could develop and administer policy, compliance and administrative matters on a national basis. To overcome the inefficiencies of the present system; such a secretariat could be authorised to issue rulings to clarify difficult or ambiguous aspects of the Credit Code on the basis that such rulings could be confidently relied on by credit providers when introducing new products or lending practices.

In view of these problems the building society industry is firmly of the opinion that credit legislation should be transferred to the national arena and overhauled prior to its full implementation.

5.5. State-Based Laws Regulating the Taxation of Financial Transactions

State-based taxes such as FID, debits tax and stamp duty are in the process of being reviewed by State and Territory governments. The Inquiry should, nonetheless, have regard to the significant compliance difficulties encountered by financial institutions in relation to these State taxes.

The compliance burden imposed on financial institutions as a consequence of State transaction taxes may be summarised as follows:

- The cost of compliance in terms of human resources and dollars is significant and, in respect of FID for example, disproportionate to the revenue collected.

- On-going compliance is extremely onerous for financial institutions in view of the complexity of the legislation and the interpretational difficulties inherent in the legislation. Consequently, the use of expert external advice, predominantly from accountants and lawyers, is indispensable, but costly.

- State transaction taxes are unable to cope with emerging technological developments and, in particular, the increased use of electronic methods to transfer funds between accounts of the same person or between parties. For example, under the FID legislation, the concept of receipt is linked to the crediting of an account, whereas the electronic transfer of funds does not involve the physical receipt of cash.

- State transaction taxes are applied differently in the various States and Territories and this has resulted in inconsistencies and difficulties experienced by financial institutions operating in more than one State. The lack of uniformity in the various State laws (both in terms of definitions and application) makes it difficult to determine the application of the various State taxes to a particular transaction.

- As the financial marketplace has become increasingly national in character (due largely to technological development as discussed in Section 4.1), the lack of uniformity in the various State laws will significantly undermine the efficient delivery and processing of financial products and payment transactions.

- The imposition of FID, for example, by seven separate State and Territory Acts, adds another dimension to the problems associated with movements of funds between accounts. In addition to any general inconsistencies, the territorial application of FID to movements of funds between States and Territories can cause problems, especially in relation to company groups with operations in more than one State or Territory. This often leads to double duty being imposed on financial institutions.

- Even if the present review of these taxes by State and Territory governments achieves some degree of uniformity, there is still the time-consuming and tedious task of having seven separate States and Territories agree to the precise wording of any amendments that may be required in the future. For example, some of the State laws on transaction taxes discriminate against non-bank financial institutions. The amendments necessary to address this issue will need to be effected on a State by State basis.

Given the origin of much of the compliance burden is the Federalist nature of these taxes, it is clear that transaction taxes should be uniform in those States which impose the tax. The best way for this to be achieved would be for the collection and administration of these taxes to be undertaken by a central agency and, net of costs, the proceeds be distributed to the States concerned. This will ensure that the relevant legislation is interpreted consistently and uniformly, that double taxation is avoided and that amendments to the legislation (necessitated by technological developments and market trends), can be effected in a timely manner.

5.6. Privacy Legislation

Apart from the Commonwealth Privacy Act (1988), most States and Territories have attempted to legislate on the issue of privacy during the past fifteen years or so. In 1971 Queensland became the first State to enact specific information privacy legislation which dealt with the licensing of private inquiry agents and the regulation of listening devices. Victoria passed the Credit Reporting Act which, as its name suggests, was concerned with the regulation of certain credit reporting practices. Like the Queensland legislation, it could not, however, be described as comprehensive information privacy legislation.

Tasmania introduced a Privacy Bill in 1974 to create a statutory tort of privacy which would have applied to public and private sectors. The bill lapsed and was never re-tabled. Similarly, in South Australia, a bill was introduced to create a statutory tort of privacy, but failed to pass through Parliament. Privacy Bills were again introduced into the South Australian Parliament in 1990 and 1992, but failed to pass. There is no privacy or data protection legislation in Western Australia or the Northern Territory.

In New South Wales, the Attorney-General has announced details of a "revolutionary" NSW Privacy and Data Protection Bill 1996 which is likely to be introduced into Parliament in the near future. It appears that the data protection principles would apply directly to New South Wales government agencies, but could be modified for specific public sector bodies by regulations. Insofar as the private sector is concerned, the procedure would be different in that no enforceable principles would apply until the Commissioner drew up codes of conduct applying to various parts of the private sector. These codes would be issued by means of regulations.

The New South Wales Bill purports to be a catalyst for the development of a "national" approach to privacy and data protection. However, even if the other Sates and Territories enacted similar legislation, financial institutions will still be confronted with the same inefficiencies, compliance difficulties and cost burdens that are encountered under the existing State-based consumer credit legislation and State laws on transaction taxes, such as FID, debits tax and stamp duty.

5.7. End Piece

It is submitted that a national approach to consumer credit legislation, State transactions taxes, privacy and data protection is highly desirable. Experience to date in all these areas with both uniform and non-uniform State-based legislation clearly demonstrates the inefficiencies, problems and costs arising as a result of interpretational, definitional problems and inter-jurisdictional overlaps.

6. THE IMPLICATIONS OF TECHNOLOGICAL CHANGE FOR REGULATORY STRUCTURES

Technological change underlies most of the changes being experienced in the financial services industry.

6.1. Wholesale Markets

In the wholesale financial markets, change has been wrought by the availability of powerful inexpensive processors, enabling derivative instruments to be structured, valued and therefore traded in large variety and volume. The evolution of derivatives has been technology driven - the financial mathematics had been awaiting the availability of increased cost effective distributed processing power.

Globalisation of markets has also been technology driven. Communications technology has allowed the proliferation of data feeds and trading links. Data feeds have become digitised, and now interface directly with computer applications which revalue positions and execute trades.

Clearing and settlement processes are being significantly altered by technology. At the central bank level, exchange settlement account operation is, as a worldwide trend, moving from deferred net settlement to Real Time Gross Settlement. Australia is no exception to this trend, driven by the availability of the enabling technology.

Settlement of transactions across exchanges is being achieved on progressively shorter cycles. Transaction execution is increasingly automated. Computer based systems lie behind both these developments.

6.2. Retail Financial Services

Similarly, at the retail level, the changes which are visible to the ordinary customer in the financial products available, and in their method of delivery, are essentially technology driven.

The paper based transaction is in rapid decline for many customers. This is conspicuously the case for cheque transactions and over the counter cash withdrawals. Electronic transfers, in the form of direct debits and EFTPOS are in the ascendancy, and ATMs are displacing over-the counter transactions.

Telephone based financial services are capturing an increasing slice of the retail market.

In this instance, the fundamental technology of telephony is not at all new. The ability of the telephone network to support the provision of financial services has, however, been transformed by the convergence of modern digital telephony with computing technology. Compression technologies are used to extract performance from copper cable networks. Fibre optics and satellite technology are rapidly altering the overall telecommunications environment.

The emerging telephone based business model involves a customer service/sales person equipped with real time screen access to a high level of integrated product, account, transaction and customer data.

A great deal of media exposure has been given to the prospect of financial services being provided or delivered in even more radical and unfamiliar ways, through the use of technology. The Internet, in particular, has been widely promoted as a future potential carrier of significant financial services traffic.

Already, some US securities firms are conducting meaningful proportions of their business on the Net.

Security issues in relation to the Net are, in the medium term, resolvable. Even credit card based transactions, which current research indicates are likely to be the near term consumer preference for Net based commerce are capable of being made secure through SET.

"Virtual banks" are emerging in the US. The only contact with such banks is via electronic means and particularly via the Internet. They exist solely in cyberspace and know no geographic bounds.

Digital Cash is another development capable of exerting a significant influence on the pattern of commerce, through stored value cards and stored value in other computing devices.

6.3. Electronic Commerce

Clearly, technology is the underlying factor driving all these developments which collectively can be referred to as Electronic Commerce.

The rise of electronic commerce (EC) is a worldwide phenomenon affecting business processes that reach into executive offices, shipping and receiving docks, and out to individual consumers. EC is reshaping marketplaces, trading relationships, and even international trading boundaries.

In EC, trading partners interact through electronic communications and automated computer systems. EC is used by businesses and governments to speed the exchange of information, gain improved service levels, and reduce operating costs.

Some form of EC has occurred among a significant number of large companies for almost two decades. In fact, the number of companies using electronic data interchange (EDI), the most common form of EC, is soaring. According to IDC, almost 121,000 companies worldwide used EDI in 1995, an increase of 50 percent in one year. As the number of EDI participants has reached critical mass, its ability to include trading partners in business process reengineering has made EDI even more compelling.

The recent rise of the Internet as a consumer technology has broadened the Electronic Commerce horizon. More than 30,000 companies have Internet addresses, and 2,000 companies have home pages on the Internet as of February 1995. Payment mechanisms are becoming more robust, and security and reliability concerns are being addressed by a host of existing transaction processors and startups that are offering solutions to protect transactions over the Internet. Although actual consumer transactions over public and private networks are small relative to the volumes conducted through traditional methods, the number is increasing dramatically.

The Internet's rise as a viable conduit for EC has initiated a reexamination of the contribution of value-added networks (VANs) that were previously relied upon for EDI and other transaction services. Remarkably lower transmission costs and the ubiquity of the Internet tempt many companies to consider it a viable alternative or supplement to services offered by the VAN providers. In response, VAN providers are broadening their product offerings to incorporate the Internet.

Meanwhile, the volume of traditional electronic funds transfers among financial institutions has continued to grow. Paperless transactions became more attractive with the June 1995 shortening of the five-day securities settlement process to three days in the U.S. Major banks face increasing competition from VAN as well as Internet providers. In response, financial institutions have increased the scope of the data they transmit in the payment process, thereby becoming “Value-Added Financial Institutions” - supporting the exchange of business settlement information that accompanies the standard payment. Financial institutions are also extending their services over the Internet.

6.4. Trends which will exert further influence upon the industry

Important changes are occurring to the fundamental technologies through which financial services are delivered. In the previous sub-section, reference was made to the general shift towards electronic transactions, and towards the provision of remote electronic access to financial services. When proper weighting is given to the further technology developments already in the pipeline, the full significance of these trends can be seen.

In particular, the convergence of telecommunications and computing has direct major ramifications for building societies and other financial services providers.

Telecommunications services are provided using a range of communications technologies and over various media such as copper wire, fibre optics and radio channels. Such services have long been an important component of business competitiveness. As the information needs of businesses grow, the importance of telecommunications grows even greater.

Telecommunications has evolved beyond the traditional analog service for voice communications to digital voice service, and from stationary voice to mobile voice services, with these changes involving significant shifts in culture and technology. Achieving the next level of service, integrated voice and data digital communications, is a multi-step process that also involves significant cultural and technological adjustment. These new services support combinations of voice, data, and video information over a variety of communication media. Thus, telecommunications service providers must address requirements such as local-area network (LAN) interconnection, image transmission, on-line information services, interactive video communications, multimedia, and television.

These new services require high bandwidth; therefore, the leasing of private, dedicated lines becomes an increasingly expensive option. Consequently, high bandwidth applications are more frequently being offered through switched services and virtual circuits. For voice services, quality is already high in many countries; switching system intelligence will be the major area of further improvement.

Dramatic advances in fibre optic and digital technologies are continuing. Ultimately, these advances together with advances in data compression technology will provide the bandwidth necessary to foster mass-market adoption of these emerging communications applications. However, the true mass market for these services will not develop until the end of the decade.

Technology inside and outside of the telecommunications sector is driving much of the change. Worldwide deregulation and increased levels of competition are also playing important roles. In some areas, these changes are bringing uncertainty and consternation; in the U.S., for example, regulatory policy is often inconsistent. Even so, deregulation and competition are also bringing lower prices and more choices for customers. Thus, telephone companies, cable companies, power companies, and possibly others will compete to offer telecommunications services.

Communications improvements based on digital technologies will provide the bandwidth necessary to enable new classes of applications, such as multimedia and videoconferencing

Technological change is blurring the boundaries between once-distinct industries. As the means of handling all kinds of information types (including audio, video, data, and images) converge, there is convergence among industries such as computing, telecommunications, publishing and broadcasting. The recent merger activity is just the beginning of a process that will ultimately define a new industrial structure based on different or non-existent boundaries.

New spectrum allocations and advanced technologies will increase wireless capacity by at least an order of magnitude. Most, but not all, of the emphasis in this area will be on voice and low-speed data. Although technical and marketing issues remain (for example, signal quality, battery life, selection of transmission standards and roaming charges), there seems little doubt that prices will continue to fall and that the number of subscribers will continue to rise. However, the data seem to indicate that average monthly usage per customer (for voice services) has been falling. In large part, this phenomenon is the result of increasingly marginal users; that is, new subscribers appear to want services, but with limited usage.

Amid the confusion and turmoil in the legislative process, the general direction is toward deregulation. The legislative process often follows a complicated path of negotiation and compromise. Thus, one cannot measure success, assuming deregulation is a positive event, in a time span of less than a few years.

The principal issue for business planners and regulators becomes the rate of adoption of these innovations.

6.5. Key Technology issues for the Building Society Movement

An important question for the Inquiry is how technological change can be expected to impact upon the competitive position of market participants such as building societies.

There is currently a genuine diversity of view in the finance industry on whether a business strategy based on low transactions cost or on customer relationships will yield future success in the retail financial services marketplace.

It is an unassailable fact that electronic transactions are far cheaper for an institution to provide to its customers than paper based transactions. This, taken with the relative willingness of younger affluent customers to adopt new technology, has led many industry participants to conclude that the successful business model of the future will involve a major emphasis upon telephone banking, electronic transactions and minimal emphasis upon physical high street branch networks. An extreme version of this model would be the “Virtual Bank” - examples of which already exist in the US - where all interaction between customer and institution is remote and electronic.

An alternative view is that the principal key to success in retail financial services provision in future will be the creation of value through development of the relationship with the customer. The cross selling of a range of products, which enrich the fees and margins earned from the customer base, requires a relationship based approach and an emphasis on loyalty. Technology also has a vital role to play here, but it is principally through the mining of databases containing information about customers and their behaviour.

These two dimensions are not strictly mutually exclusive, but there is some real tension between them.

Some industry participants see the customer relationship cross-sell model as paramount, and express concern that the “commoditisation” of financial services and products which tends to occur with remote electronic delivery, may work against the establishment and leverage of deep customer relationships.

This debate is likely to become more vigorous. There is as yet no definitive fundamental market research which would enable reliable prediction of customer behaviour, in the face of the various initiatives implementing the range of alternative business models in the marketplace.

In practice, Australian consumers already tend to have more than one relationship with financial service providers. Even with a single functional offering, such as credit cards, plurality of holdings is the norm in this market.

Some financial institutions may succeed with a low cost commoditised model, others with a model which makes building the customer relationship the central issue - but some may succeed along both dimensions, and there will be significant advantages accruing to such organisations as a result. Later on in this section, where issues of scale are discussed, the role of the building society as a customer focussed organisation is considered in detail.

The entry of new participants with a low cost strategy is probably the major threat to traditional institutions with substantial high street presence and a strong customer focus. The early effects of “commoditised” low cost competition can already be seen in the mortgage market, with significant margin erosion for the established participants.

Many institutions have begun systematically to segregate their customer base into ‘value creators’ - customers who create more revenue than they cost to service, and ‘value diluters’ - typically those who hold small balances and transact frequently, particularly using non-electronic media. It is predicted that there will be increasingly strenuous competition to acquire and retain ‘value creators’, and also to encourage behaviour which turns borderline customers into value creators. It is here that cross selling can be vitally important, along with encouraging changed patterns of transactional activity. Fees may be an important element in influencing behaviour or turning borderline customers into value creators. Realistically, many institutions may also seek to shed customers who cannot be converted into value creators.

New entrants into the financial services marketplace are able to target customer segments with desirable characteristics, without the need to continue to service unprofitable segments or maintain extensive infrastructure for that purpose.

Mortgage originators exemplify this, as do the “direct” providers of telephone based financial services. Clearly, existing DTIs are obliged to react to the potential loss of market share. Yet, extensive infrastructures traditionally maintained out of earnings sourced from low cost deposit funds - now rapidly eroding - confer little if any advantage to those institutions in retaining or attracting customers prepared to source their mortgages from non-traditional providers and to transact using now available technology.

For building societies and other smaller financial institutions with existing traditional infrastructure, this dilemma is as real as for the major high street banks. One policy issue here (and raised elsewhere) is whether new entrants potentially subject to lesser regimes of prudential supervision than existing deposit taking institutions may exert competitive pressure on existing market participants, damaging or destabilising the market as a whole.

The special legal and regulatory status of a deposit, and hence of deposit taking institutions, has perhaps become an anachronism. Current directly competing institutions come from different historic streams, for example, a bank on the one hand and a mutual life office on the other. Their regulatory frameworks are significantly different, yet their product offerings are rapidly converging. New entrants are virtually able to select a regulatory framework which offers the most favourable constraints. A regime of industry-wide product based regulation would be one solution to this potentially unsatisfactory state of affairs.

The factor which makes the new entrants so potentially threatening is their ability to operate with an effective low cost of delivery from the outset, and to “cherry pick” desirable customer segments. Nevertheless, the establishment of a customer database takes time, and cannot precede the organisation of the customers themselves. It is, therefore, in this area that the established players - large and small - can seek to establish a strong defensive line. Established retail financial services businesses already have extensive customer bases, and could move to extract greater business benefit from these relatively quickly.

It is important to recognise that new innovators in the financial service industry will in many cases not be one type of financial institution broadening its product range into the traditional territory of another, but rather entirely new entrants to the industry. Examples are retailers (Marks & Spencer), capital goods companies (General Electric), telecommunications companies (Telstra) and other organisations which bring some strategic competency.

Another technology related issue of concern to building societies and other smaller financial institutions is the matter of access to the payments system and to nationwide networks for payments and electronic service delivery.

This issue can be viewed as a matter of economic efficiency. If a delivery network is established, at great capital cost, parties putting their capital at risk to establish it have an expectation of earning a return, both through their direct access to that network, and through exacting a rent from other parties wishing to use it. If the initial barrier to entry is high enough in terms of capital cost, small market participants can be disadvantaged. The EFTPOS network is seen as an instance of this dilemma.

Such issues of scale certainly arise in relation to capital intensive investment in connective technologies which allow access to entire markets. The interests of small institutions will need to be considered, if their continued presence as competitors is deemed desirable as a matter of public policy. A cause for concern is lack of equitable and efficient access to privately owned networks which, for reasons of economies of scale, could be owned by a few large institutions. A current example is that of EFTPOS acquiring which is dominated by the major four banks and competition from outside the four is effectively discouraged. *Specifically, we recommend that, given the importance of economically viable access to networks by small institutions, such networks should be regarded as essential facilities in terms of the national Competition Principles Agreement.*

It is often assumed that issues of scale relating to the capacity to afford in-house systems investment also tend to disadvantage smaller institutions. This is less clear. Diseconomies of scale are often evident in Information Technology. Expensive failed major or systems development projects - some reaching into nine figures of expenditure - have been exclusively undertaken by larger institutions. Institutions at the smaller end of the scale range have tended by necessity to avoid this pitfall.

Particularly given the emergence of the shared facilities market, or outsourcing, it is not self-evident that smaller financial institutions need operate at a relative technology cost disadvantage, at least as far as industry standard functionality which can be sourced as a “commodity” from third party providers is concerned.

Smaller institutions have consistently over recent years maintained higher levels of customer satisfaction than their larger competitors. Satisfactory experience with face-to-face contact with customer service staff well trained in handling the requirements of a relatively simple and uncluttered product range has been one of the driving factors behind this customer satisfaction.

The relationship driven model for successful future retail financial services organisations appears more naturally capable of being based on a culture of customer service than upon cultures which focus primarily on low cost of delivery. Building societies and other smaller institutions have an advantage in this regard. Typically, institutions with a smaller product range have on average only a small number of financial products sold per customer. This is often referred to as the cross-sell ratio. The challenge for the smaller institution, therefore, is twofold - firstly, leveraging its tradition of customer service across a broader product range, and secondly achieving a delivery cost which does not set it at an unsustainable disadvantage when compared to the larger market participants. Technology provides potential solutions to both these challenges.

The key technology acting as an enabler for organisations focussed on cross-selling and deepening customer relationships is the relational data base, supporting an enterprise - wide data warehouse architecture. Customer service personnel are being equipped with access to a wide range of customer data held in a form which enables them to be vastly more effective, both from a sales and a service perspective. This technology is realistically not limited only to larger institutions.

Cost efficiency is an entirely different issue. Here, the greatest potential for smaller institutions lies in shared facilities - accessing true economies of scale by outsourcing processes which do not confer any distinctive advantages, either to independent third parties or to joint venture consortia established to access large scale processing efficiencies. Evidence that this direction is being taken in Australia already exists in mortgage processing, for example. One likely effect of the establishment of large central processing centres by major players is to generate overall surplus processing capacity, which progressively leads to the offensive of processing services offered on a marginally costed basis.

There is a general global movement today towards shared facility provision, by outsourcing specialists. These generally used to provide only computer operations, but are now extending to entire business processes. This is potentially capable of making competitive processing costs available to a range of smaller institutions, including the building societies. As such, it is a most important development in helping to provide an environment in which smaller institutions can continue to be viable, and to provide a distinctive contribution to the overall financial services environment.

7. MODELS FOR THE FUTURE REGULATION OF PROVIDERS OF FINANCIAL SERVICES

The current regulatory arrangements for financial institutions are in need of reform. Currently, there are too many regulators, including at different levels of government, with overlapping powers and responsibilities.

The current arrangements do not involve enough co-ordination among regulators and single-mindedness of purpose in the design and administration of the regulations. There is insufficient clarity or transparency in the current arrangements. Building societies acknowledge the useful steps taken by the Council of Financial Supervisors in recent years to stimulate and facilitate communication among the four main regulators, but for Australia to have a dynamic financial system more formalised co-ordination is required than is possible under the present arrangements.

From the building societies' point of view, a national approach to the regulation of all financial institutions is a matter of great importance in any re-design of Australia's regulatory arrangements. The present State-based regulation of building societies is inconsistent with the reality of the current day financial system. Building societies must play their part in a national financial system. Even the most remote community in Australia is integrated into national financial markets and cannot escape the competitive pressures that pay no attention to State borders.

The industry is advised that for constitutional reasons building societies and credit unions cannot incorporate under Federal legislation unless the States agreed. However, the Commonwealth has the power to regulate and prudentially supervise building societies and credit unions. Incorporation would relate only to the usual requirements that apply to companies and all prudential and other regulations governing the operation of building societies would be at the national level.

An important public benefit from adopting a national approach to the regulation of all financial institutions is that it would help achieve competitive neutrality among financial institutions. It is fundamental to the future efficient operation of the financial system that all institutions engaged in the provision of particular financial services be regulated in the same way.

There has been much discussion of different regulatory models and approaches to regulation. In large part, this discussion has been stimulated by the emergence of financial conglomerates and the challenges they pose for traditional institution-based regulation. The need to ensure that the regulatory arrangements do not distort the terms on which different sectors of the financial system engage in competition, suggests that regulation ought to be conducted on a functional basis. That is, a financial institution carrying out a particular function should be subject to the same regulator and regulations as any other financial institution carrying out the same function.

That said, the building society industry considers that the debate about functional versus institutional regulation is not particularly fruitful. As proponents of institutional regulation are fond of pointing out, at the end of the day, regulators are going to be interested in the overall prudential standing of an institution, not of functions performed by an institution. This does not, however, rule out conducting prudential regulation on a functional basis, with overall institution-based measures of risk and creditworthiness as a final overlay. It seems more important for the same regulator to be responsible for prudential regulation on a national basis, than whether prudential regulation is organised along institutional or functional lines.

It is important that new regulatory arrangements should be sufficiently flexible to accommodate a range of changes in the structure of Australia's financial system in the future. A development that appears likely to continue is the trend towards financial conglomeration. This suggests that the regulatory arrangements would best be organised along functional lines, rather than strict institutional lines, because of the inherently greater flexibility of functional regulation.

It is likely to be increasingly more difficult to assign financial institutions to institutional boxes. Indeed, to do so, runs the risk that such boxes become coffins. Building societies want the new arrangements to allow smaller financial institutions to be able to choose to be building societies, credit unions or community banks, providing they meet the relevant prudential requirements.

The financial system of the future is likely to continue to contain financial institutions of widely varying sizes. Perhaps Australia will evolve towards the United States model where there is a trend towards financial institutions with a global outlook, at one end of the spectrum, and smaller institutions serving local markets, at the other. Whatever the outcome, it is highly desirable that the arrangements involve regulation of large and small institutions engaged in the same functions on an equal footing.

Technology will bring about many changes to the structure of Australia's financial system in the future. As discussed in Section 6, it is difficult to foresee the direction and nature of technological change. It is important that the prudential arrangements do not inhibit innovation and the adoption of cost-saving technologies of the future.

For all these reasons, the regulatory arrangements must be flexible. They should avoid being prescriptive. They should avoid being based on definitions of institutions that apply in 1996. They should be capable of evolving with the rapidly evolving system that they are regulating. In particular, the regulatory arrangements should avoid themselves determining the structure of the financial system of the future. The overall prudential standing of an institution should be a reflection of the range and nature of activities that it undertakes, not where it fits in terms of some spectrum of risk that is determined by the regulatory authorities.

Thus, the building society industry considers that the Campbell Committee erred when it favoured the creation of a safe haven for investors and savers by restricting Reserve Bank supervision to banks. The creation of this privileged regulatory position for banks meant that the regulatory structure was determining the shape of the financial system, rather than responding to changes in the structure of the financial system. DTIs do have a vital and central role to play in the financial system and are likely to continue to do so for the foreseeable future. However, particular institutions should not be accorded DTI status. Rather, those institutions that carry out deposit taking functions should be accorded the same regulatory treatment in respect of those functions, irrespective of whether they are banks, building societies, credit unions, community banks or other financial institutions. The depositor protection provisions that currently are restricted to banks should apply to all DTIs.

These considerations suggest to the building society industry that Australia would be best served by adopting regulatory arrangements that allocated a clearly defined role at the national level for each regulator. This could most easily be achieved by defining the main regulatory functions, rather than the main financial services functions of financial institutions, and allocated a single regulatory function to a single regulator.

There are three main regulatory functions that need to be carried out in order to ensure that Australia has a modern, competitive set of regulatory arrangements for its financial system, as follows:

- competition regulation;
- prudential regulation; and
- consumer regulation.

If this regulatory functional split is accepted, then in each case there is an issue as to how many regulators there appropriately should be. One approach would be to have a mega-regulator that undertook all three regulatory functions. In the view of the building society industry, the creation of such a mega-regulator would be sub-optimal. It would require ceding competition policy for financial institutions from the ACCC and vesting the mega-regulator with that responsibility. This would be undesirable as it would lead to the fragmentation of competition policy, contrary to the trend to ensure uniformity of treatment across industries in this very important area of regulation. Special bodies with power to determine competition policy for particular industries run the risk of capture by industry interests.

There are not very strong linkages between competition regulation, prudential regulation and consumer regulation. Different skills and experience are required in each case and there would need to be largely separate divisions within the mega regulator to cope with each of these disparate responsibilities. Providing a mega-regulator with such a broad range of responsibilities, therefore, would be likely to result in the creation of an unwieldy body that was unable to respond quickly to changing regulatory needs.

A related but separate issue is whether it is appropriate to vest so many regulatory powers in the one body. Other things being equal, the building society industry would prefer arrangements that avoided such concentration of regulatory power. The industry also believes that having a division along regulatory functional lines avoids the problems of gaps and overlaps, fragmentation and lack of uniformity of treatment that might accompany other regulatory models involving more than one regulator.

For these reasons the building society industry does not favour a single mega-regulator for the financial system. There is nothing that so distinguishes the financial system from other industries that demands a separate competition regulator for providers of financial services. So far as competition policy is concerned, the simplest and best approach in terms of the arrangement most likely to produce consistency of treatment across industries, is to leave responsibility for competition regulation with the ACCC. This has the advantage of avoiding the creation of a new regulator.

The industry strongly supports the consolidation of all consumer regulation into a single new regulator at the national level. The national consumer and disclosure regulator would assume the regulatory functions currently performed by the ISC and ASC, and under the Consumer Credit Code and State privacy and data protection legislation. All State consumer regulation should be transferred to the national arena and overhauled prior to its full implementation.

There should be a single prudential regulator for all financial institutions, with prudential regulation organised along functional lines. The prudential regulator would assume all the prudential supervisory responsibilities currently exercised by the Reserve Bank, AFIC and the ISC. The industry has a preference for the prudential regulator being the Reserve Bank because it is the major existing prudential regulator and has the expertise and standing to assume responsibility for prudential oversight of all financial institutions. It matters less which institution carries out prudential supervision in Australia, as long as it is appropriately staffed and has overall responsibility in this area. Skilled divisions within the single prudential supervisor to service sectors such as major banking, life and general insurance and regional and community financial institutions is a model the industry supports.

The establishment of AFIC and the administration of the FI Code has developed considerable expertise in prudential supervision of building societies among SSAs. It therefore could be helpful for appropriately skilled persons engaged by AFIC and the SSAs to transfer to the national prudential regulator, whether it is the Reserve Bank or its successor. This would help ensure continuity and conservation of essential expertise, including in the inspection of regional financial institutions.

The building society industry considers that within the divisions the user pays principle should apply to the funding of the new prudential regulator, with individual institutions in the case of building societies contributing to the cost of core supervision in proportion to their assets. A consultative process should be established to enable financial institutions to have an input into government deliberations on the budget for the prudential regulator. (As noted earlier in this submission, in respect of building societies in Queensland, and credit unions in five States including Queensland, costs of supervision have been met from reserve/contingency funds established and funded by societies and credit unions. Clearly, equitable arrangements would need to be made for the ongoing application of those industry funds to the cost of supervision in the new regime.) This approach would be facilitated by the concentration of all prudential oversight within the control of a single regulatory body since the cost of running that body would be readily identifiable.

SAVING SUPPLEMENT: PROMOTING A SAVINGS CULTURE

DTIs have traditionally played the major role in marshalling and allocating the nation's saving. That role is under threat, both from the dwindling amount of private saving in Australia and by changes to the composition of saving as a result of the adoption of compulsory superannuation. Both these developments are of importance to the future vitality of Australia's financial system.

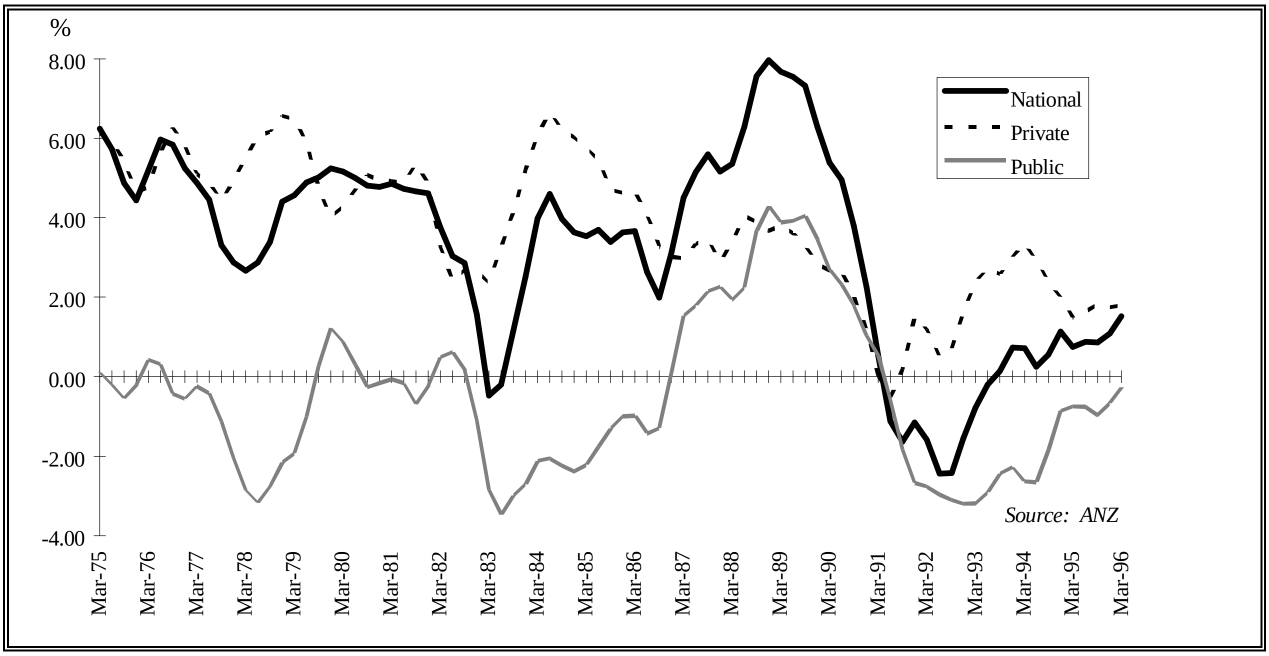
S.1 The Need to Lift Australia's Savings

The need for Australia to lift national saving has been well established in a number of studies over recent years[18] and is widely accepted, including by the Federal Government. This section of the Supplement briefly reports on the main points that have emerged from these studies.

Australia's gross national saving has fluctuated in the range 16-18% of GDP over recent years, compared with around 22% for most OECD countries. Apart from the two World Wars and the Depression, this is the lowest level of national saving this century. A significant proportion of gross national saving is devoted to financing depreciation. Net national saving is the amount of saving after financing depreciation and is the preferred measure of saving because it represents the increment to the nation's net wealth. Trend measures of net national saving, together with the private and public net saving components, are shown in Chart S.7.1.

Chart S.7.1: Trend Measures of Net National, Private and Public Saving

(% of GDP)



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[18] These include, *Australia's Foreign Debt: Choices for the Future*, a report prepared by Access Economics for the Business Council of Australia's National Summit on Debt, February 1990; *National Saving*, a report to the Treasurer by Vince FitzGerald, June 1993: *National Commission of Audit*, report to the Commonwealth Government, June 1996.

Over the period for which data are available, there is a clear downward trend in net national saving (see Table S.1). This is dominated by the downward trend in net private saving over successive five year periods, despite the effects of the economic cycle on the propensity to save. Public saving has exhibited the greatest volatility, reflecting swings in fiscal policy (from deficits to the Federal surpluses in the second half of the 1980s and back to deficits again).

Table S.1: Five Year Averages of Trend Net Saving (% of GDP)

Five years ending:	**National**	**Private**	**Public**
1979-80	4.50	5.32	-0.80
1984-85	3.28	4.61	-1.31
1989-90	5.29	3.54	1.72
1994-95	-0.07	1.65	-1.70

Despite the length of the economic recovery from the 1990-91 recession, net national saving in the 1990s has been broadly zero. That is, as a nation Australia has consumed (including depreciation) all of its income. As a result, there has been no increase in national wealth from Australian saving over this period. The increase in the nation's net capital stock has been financed by overseas saving (the current account deficit) and this is reflected in the build up in Australia's foreign debt. The saving/investment gap and the related build up in Australia's foreign debt are shown in Chart S.7.2 and Chart S.7.3, respectively. If the forecasts are anywhere close to the mark, there is little prospect of any respite from the build up in foreign debt.

Chart S.7.2: Gross National Saving and Investment (% of GDP)

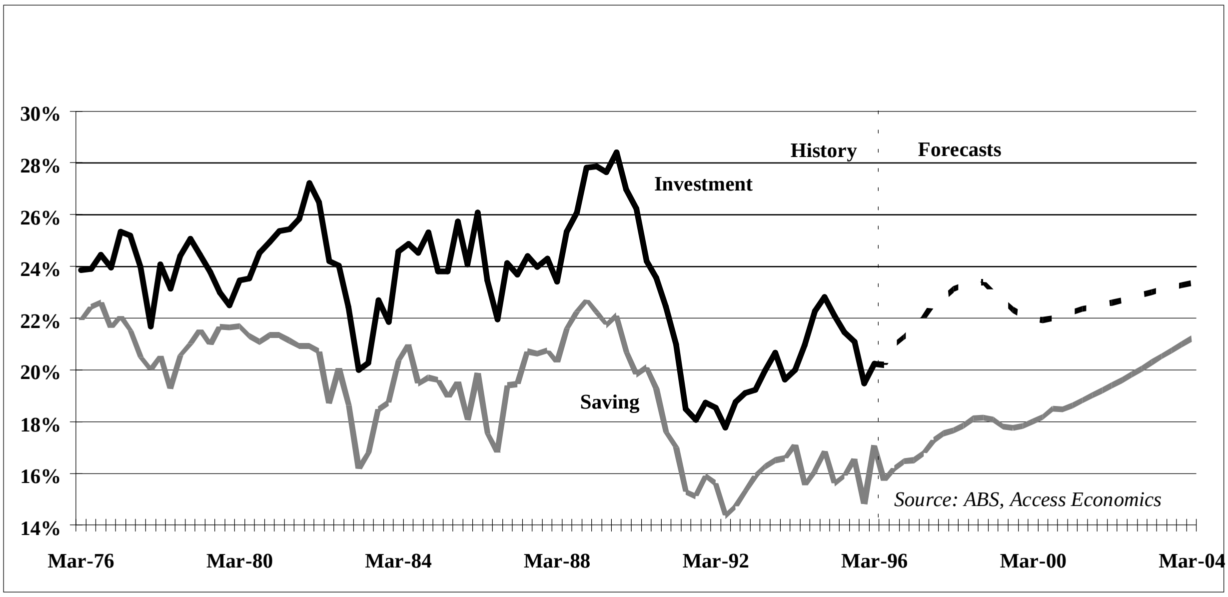
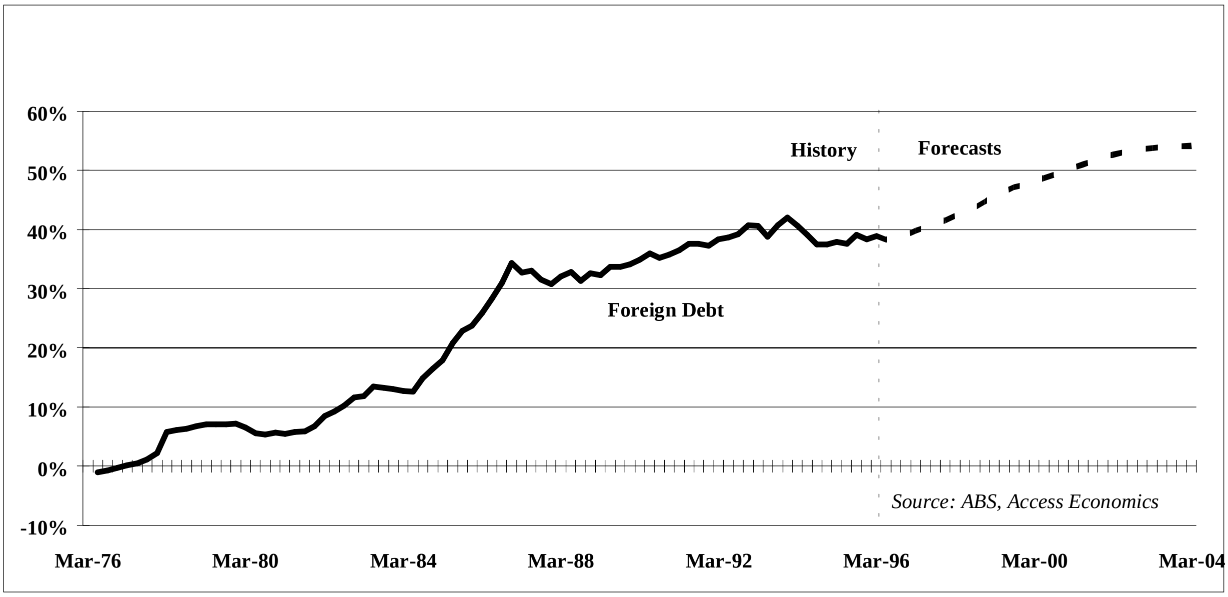


Chart S.7.3: Foreign Debt as a Percentage of GDP



Private saving is composed of saving by households and saving by businesses. It is the fall in household saving that explains much of the fall in national saving. The household saving ratio fell from about 15% of GDP in the mid-1970s to 6.3% in 1994-95. As the National Commission of Audit noted: *"Of particular concern is the failure of this ratio to rise after the recession of the early 1990s. If anything, the trend suggests a possible worsening in the longer term capacity of ordinary Australians to achieve self sufficiency in retirement."*[19]

S.2 Saving for Retirement

The public policy response to the decline in household saving has been the promotion of superannuation as the nation's chief saving vehicle for retirement. This has taken the form of the compulsory employer Superannuation Guarantee (SG) contribution (which is set to increase to 9% of wages and salaries by 2000-01) and through taxation concessions designed to encourage voluntary superannuation contributions. The SG is to be supplemented by award based member contributions from 1996-97 encouraged by a government co-contribution from 1998-99, although there are doubts as to whether the latter is technically deliverable.

These reforms have achieved a massive increase in the coverage of superannuation (from 40% of employees in 1986 to 92% of employees currently) and in the level of contributions. Despite these successes, superannuation has not stemmed the decline in household saving. The National

[19] op cit p 146.

Commission of Audit identified the major risks to the present superannuation-based strategy to promoting national saving as:

- *"superannuation saving becoming largely offset by households reducing non-superannuation saving; and*
- *superannuation arrangements that allow dissipation of a substantial share of superannuation savings before retirement or in early retirement, followed by access to public outlays."*

The National Commission of Audit also noted the inordinate complexities associated with superannuation and various anomalies. One anomaly is that people not in the workforce have zero or different access to age related superannuation contributions to people in the workforce, even though they have just as much need for retirement income and also have access to the age pension.

The current arrangements also are clearly inequitable. Small savers in Australia get a raw deal, especially compared with the well-off:

- they are forced to contribute to superannuation under the SG contribution arrangements, but often face income tax penalties, rather than the tax concessions enjoyed by higher income groups, and/or confiscatory management charges that eat away their principal;
- because they are very risk averse, and have little if any free cash flow, they are forced to invest any other savings mainly in interest-earning assets or in their own home. Negative gearing for deferred capital gain generally is beyond their capacity;
- and interest income is penalised compared with the tax treatment of most other investment assets.

Changes can and should be made to give lower income groups a better deal, and in the process improve national saving - and the allocation of that saving.

The Commission of Audit recommended that policies be implemented to develop a stronger saving culture. The Commission emphasised the need for a comprehensive approach because piecemeal measures to promote private saving tend to produce offsets - either reductions in other private saving or public saving - with ambiguous impacts on total saving. The Commission recommended that the government undertake a comprehensive review of options for improving the contribution of household saving to national saving, including a full review of tax and social security arrangements in terms of how they affect incentives to save.

The building society industry strongly supports this recommendation of the Commission of Audit and favours policy initiatives designed to level the tax playing field for saving. The current income tax penalties on interest income could be reduced if:

- income from personal exertion (wages, etc.) continues to be taxed under the current income tax rate scales; and
- interest income attracts a tax discount, either (a) as a fixed percentage discount from the present income tax rate scale, or (b) as a fixed percentage point discount.

The Budget cost of any income tax cuts for private saving generally should be offset to ensure that national saving is increased. Financing options include:

- further restraint on public sector outlays;
- allocation of future fiscally responsible income tax cuts to interest income tax concessions only, rather than being applied generally;
- increases in other taxes, either indirect taxes or income taxes:

However small their effects, properly financed tax changes in respect of interest income should contribute to a better national saving effort.

The proposed tax changes also promote a better, that is, less distorted allocation of savings as between different assets.

And they are *much* fairer.

S.3 Role of Deposit Taking Institutions

"Deposits can now be traded at fluctuating prices, like securities.
Securities can be transferred and rendered cashable as efficiently as deposits."
Al Wojnilower, June 1991

Technological change and market pressures are making it more difficult to sustain the legal distinction between deposits - which do not require the issue of a prospectus - and other forms of savings and investment - which do. The other side of the same coin is that the distinction between depositors and investors is being blurred. This blurring is motivated by the desire on the part of those offering deposit-like products to escape the burden of the prudential regulations that apply to DTIs.

In breaking down the traditional distinction between deposits and other forms of savings and investment, Australia is following the United States. There the most significant free riders on the prudential system are the market mutual funds operating in conjunction with major finance companies owned by large industrial companies. The money market funds invest largely in the commercial paper (unsecured short term obligations) of these "captive" finance companies.

In some respects, money market fund balances are more attractive and flexible than cheque accounts at banks. *"The price is pegged at one dollar per share. They earn a competitive or higher rate of interest. Holders are generally permitted to write cheques of $500 or over, and to transfer funds by telephone to or from other mutual funds, such as bonds and stock funds, operated by the same sponsor. The moneyness of these balances is so palpable that they are included in M2"*[20].

The same kinds of developments are in progress in Australia. For example, superannuation funds are, in effect, lending their own members' contributions back to them as housing loans by lending

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[20] Al Wojnilower, *Some Principles of Financial Regulation: Lessons from the United States*, in Ian Macfarlane (editor) *The Deregulation of Financial Intermediaries*, Reserve Bank, June 1991.

to mortgage originators who securitise the mortgages of the superannuation members. Because there are no deposits involved, the mortgage originators simply have to comply with the Corporations Law (under the supervision of the ASC) and are not subject to the same prudential regulations as building societies and other DTIs.

Traditionally, Australians favoured deposits as their preferred form of saving. Increasingly, however, saving is taking the form of market-linked collective investment schemes or managed funds (MFs). Funds under management has been the fastest growing sector of the financial system, with fund managers utilising a range of investment vehicles, including superannuation funds, public unit trusts and life insurance products. Non-DTIs' (funds managers, life offices, superannuation funds) share of the total assets of Australian financial institutions increased by 50% over the past decade and a half, from 26% in 1980 to 39% in 1995.

The regulation of the investment vehicles used by MFs and the taxation treatment of them varies. Moreover, the regulatory burdens attaching to these investment vehicles differs according to the institution offering the investment product. In particular, a building society that offers MF products, generally through a subsidiary, is subject to up to three different regulators (for example, a building society offering MF products would be subject to regulation by AFIC/SSAs, the ISC and the ASC) and more onerous functional regulation than a funds manager.

The Government has indicated that DTIs that offer RSAs can do so on balance sheet and, given the protections that apply, are not subject to the trustee structure of the SIS Act. Building societies agree that the advent of RSAs on the basis envisaged by the Government will improve the access of DTIs to the retirement saving market. However, it is probable that RSAs in practice will be small amounts and RSAs are likely to remain a relatively small proportion of the retirement savings market. Conventional market segmentation is restricting competition for the retirement savings market unduly.

Building societies consider that DTIs should have broader access to this market by being able to offer to saver consumers superannuation and other managed fund products. The building society industry accepts that the quid pro quo for this would be for non-DTIs to be permitted to take deposits over-the-counter from the public, providing they observe the same prudential regulations that apply to deposits as apply to DTIs.

The present arrangements subject essentially the same financial products to different regulatory requirements that are based primarily on institutional differences and different taxation treatments. In the view of building societies, differences in the prudential arrangements should reflect differences in the risk and return characteristics of financial products on offer in the marketplace, not on which institution makes the offer.