September 6, 1996

The Secretary
Financial Systems Inquiry
Treasury Building
Parkes Place
CANBERRA ACT 2600

Dear Mr Smith

We are pleased to be able to make this public submission on government policy and regulatory practices for the financial sector.

This firm has a long history of service and advice to State based financial institutions in New South Wales and Queensland. In particular we act for credit unions and building societies in these States.

The views expressed in this submission are solely those of the practice and are motivated by considerations of finance sector efficiency only. They are deliberately brief. Further information or comment may be obtained from the writer or Mr Paul Gallagher of this office as the Inquiry requires.

We submit as follows:

1. The Financial Services Market

While the market consists of a diversity of products the number of financial functions are relatively small viz; deposit taking, loan provision, full financial intermediation, insurance and various other discrete functions which could be named in a number of ways.

Every entity, be it a bank, an insurance company, a building society, a mortgage securitisor etc should be subject to the same prudential standards. Those prudential standards should attach to each function rather than to the type or name of the institution. Prudential standards should be additive so that if an institution wishes to take deposits it must satisfy the prudential coverage requirement for that function. If insurance is to be added then a further set of requirements should be imposed. There is some clear evidence that functional risk is not fully additive. Consequently, the prudential coverage required for some additional functions should be less than if that additional function was undertaken on its own.

We would not regard as material the risk to fund providers reflected in the lending process per se. Consequently we see no point in specifying a capital adequacy component to those entities which do not engage in any retail function other than lending. However, any entity which lends money as a business must satisfy the prudential standards unless they can demonstrate their funds come from a party who does satisfy the prudential requirements. This notion of source of funds we regard as very important.

The cost of prudential coverage should be proportionally the same for each function group regardless of size.

Mortgage securitisors are presently not directly required to satisfy any prudential capital requirements. The basis of this position would appear to be that there is no public cost if the retail mortgage provider should fail, because the retail mortgage lending and deposit taking are separated. We believe this is the appropriate course provided the mortgage lender can demonstrate their funds are subject to and satisfy the prudential tests elsewhere.

2. Prudential Standards and Supervision

Prudential standards should be established for all financial functionaries by a single national body. Whether that be the Reserve Bank or another separate body is not a matter on which we have a strong view. However, on balance, we would prefer to see standard setting and supervision in one body and that be separate from the other functions of the Reserve Bank.

Apart from the matter of tradition we cannot see any benefit to the finance industry by the Reserve Bank continuing in the role of prudential standard setter and supervisor. We do hold the view that the Australian Securities Commission should neither be the supervisor or regulatory body. The ASC is not industry specific in its skills and its regulatory approach to public companies does not sit easily with the notion of financial intermediation. The stock in trade of those involved in the finance sector is money. Money is the product rather than the means of producing the product. Consequently the need for prudential coverage does not arise outside this sector. It would be a retrograde step to move from the notion of capital adequacy and prudential regulation to a Corporations Law approach.

It is a critical element of the success of the finance industry that prudential supervision be enhanced.

The precedent established by the AFIC model for a hands on supervisory approach with some emphasis on transaction analysis and oversight of auditors is valid. As well its approach to ensuring consistency in fundamentals between institutions including provisioning for non-performing loans should be introduced to the industry through this

Inquiry. Unless there is a high degree of consistency in the detail of the application of prudential standards there is a weakening of supervision and a potential differential in the cost of providing adequate prudential coverage by individual functionaries.

As stated our preference is for a single national standard setter and supervisor. The costs of that body should be met by the whole industry on a proportionally equitable basis. In our view equity would be achieved where those costs were split in accordance with the relative gross asset position of each entity and the number of financial functions which the entity undertakes.

There must be safeguards that supervision will be adequate. Standards are useless without proper guaranteed supervision.

3. Mergers

If prudential standards are set in accordance with functional intentions of each entity, we are in favour of approvals being available for any merger subject to the broad issues of competition policy only. In our view, market efficiency and effectiveness would not be jeopardised by allowing mergers to occur whatever the reason. Put more positively there are clearly efficiencies available by allowing amalgamations, mergers and takeovers to occur within the framework of prudential adequacy.

4. State Based Financial Institutions, particularly.

The present AFIC system has been of major benefit to the community and to a lesser extent to the building society and credit union industries.

The scheme suffers from duplication but it is not that which causes the current supervision cost differential between states. That is principally the result of inconsistency in the application of supervision technique from state to state.

In our view, there is no reason why these societies should not be treated in precisely the same way as every other financial institution for prudential standards. As well they should have access to the payments and settlements systems, have no limitation on their functions or the types of financial accommodation they may provide, but they should meet the same taxation requirements etc as every other financial institution which satisfies the prudential standards for each function undertaken.

There has been no evidence produced by AFIC which encourages the view that asset size is a basis for determining functionality. Capital adequacy and the ability to maintain prudential coverage is the proper criteria for viability within the industry.

5. Entry to the Market

No entity should be allowed to undertake any financial function without first satisfying the supervisor of potential prudential performance and viability.

We wish members of the Inquiry well in their deliberations.

Yours faithfully
Kendalls KBM

Terry O'Dwyer
Managing Partner