NATWEST MARKETS

NATWEST MARKETS AUSTRALIA LIMITED

SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

September 1996

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A. INTRODUCTION

- NatWest Markets Australia Limited ("NWMA") is pleased to submit its views to the Financial System Inquiry.

- It does so from the position of:

  - being one of Australia's leading financial institutions, holding or managing over A$11 billion of assets as at December 1995;
  - being an integrated investment bank, having a significant presence in debt intermediation, stockbroking, derivatives, investment management, corporate advisory and corporate lending;
  - being a licenced Australian bank;
  - being part of a major international banking group, headed by National Westminster Bank Plc;
  - conducting extensive research into banks and other financial institutions in Australia on behalf of investors worldwide; and
  - undertaking significant assignments in the banking and finance industry including;

    - **Commonwealth Bank**: acting as joint lead manager to the CBA3 public share offer;
    - **Westpac**: advice on its $570 million share buy back;
    - **Bank of Western Australia**: acting as joint lead manager for the initial public offering of shares;
    - **Westpac**: issuing warrants over 100 million WBC ordinary shares with an underlying value of $530 million;
    - **Bank of Queensland**: advice on the proposed four way merger between Metway Bank, Suncorp, QIDC and Bank of Queensland; and
    - **AMP**: an agreement with AMP's subsidiary Priority One, to offer fixed term bank deposits to its client base, the first structure of this kind in Australia.

  - This paper concentrates only on a limited number of the issues facing the Commission. We have sought to avoid repeating positions which we know others will be making in detail. We have commented only on those aspects of the enquiry which we consider relevant.

B. KEY ISSUES

1. Overview

- We believe the enquiry should focus upon the overall 'macro' issues facing the financial system. There is a danger of becoming embroiled in specific interest questions.

- In that light, we actually believe the regulatory and indeed the basic financial system is in sound shape and does not require major overhaul. Like all things, it can however be improved and adapted for changes in the operating environment.

2. Major Issues for the System

- **Stability of the system;**

  In our view stability should remain the paramount driving force in regulation of the financial system. We do not advocate the creation of a 'Mega-regulator' with extensive powers but rather the strengthening of the existing co-ordinating entity of lead regulators. We believe that when Lender of Last Report facility of the Reserve Bank is fully appreciated, this will preclude the setting up of a 'mega-regulator' and point toward the development of the Council of Financial Supervisors when addressing the further issues set out below.

  We would propose that the Council be given some legislative backing or underpinning and be responsible for; co-ordination of disclosure, regulatory overlaps, appointing lead regulators for conglomerates, and generally overseeing the process of regulation. We would propose all current members (RBA, ISC, ASC, AFIC) remain on it and that it should be expanded to include the ASX or other representation for equity markets. We would look for more industry participation in the body and secondments from each regulatory body. It would continue to report to the Treasurer. Ultimately this still leaves specialist regulators to look after specific areas of the system.

- **Disclosure**

  We believe that the best protection for depositors and investors is co-ordinated disclosure laws. While some favour a single Disclosure Regulator, we believe the question of consistency and conformity can be dealt with by our proposed reformulated Council.

- **Capacity for innovation and global integration**

  In order for Australia to remain a competitive regional financial centre it must have a flexible and responsive regulatory environment. Hence the need for something like the Council working within an international context. This why we also advocate strongly the need for expert knowledge in regulators.

- **Regulatory Efficiency**

  Allied to the above is the need to reduce unnecessary regulatory overlap and costs.

  Capital requirements can also more easily be kept to levels commensurate to the underlying risk of the system in a flexible, co-ordinated, ‘expert’ environment.

- **Competition**

  NWMA does not have a strong view on bank mergers. Obviously the issues lie somewhere between the dangers of concentration risk for prudential supervision and the legitimate desire for market share and lower costs. Provided proper consumer safeguards are established, concerns about market dominance should fall away. Of course such safeguards can be self defeating if they do not permit the realisation of merger benefits which in certain cases may be significant.

3. Issues Paper

- We understand that the Committee intends to produce an Issues Paper following the first round of submissions received.

- This Issues Paper should discuss at least those major issues we have identified above, as well as proposing various options for change.

- These options may encompass:

  - new institutions;
  - new legislation;
  - new principles of regulation; and
  - new priorities for government policy.

- NWMA is prepared to make a more detailed contribution once the conceptual framework is developed.

C. REGULATION OF THE FINANCIAL SYSTEM

1. Perspectives on Regulation

- We suspect that there is a great danger that specific regulatory issues come to dominate this enquiry, which could then lead to structural change that may not have been fully assessed at a fundamental level.

- Fundamentally we are in favour of a regulatory environment that avoids overlap, unnecessary cost and is in tune with the needs of the finance industry. The adoption of across the board, simplistic rules is neither desirable nor appropriate.

- Whilst not debating what constitutes a “bank” from a legal perspective, we believe any institution offering (close to) at-call capital guaranteed products must be seen as comparable to a “bank” by the investing public.

- Regulation also includes prudential supervision and this goes to the heart of what most customers of the financial industry are expecting and what is a pre-requisite for policy makers; stability.

- Ultimately, within the core of the system comprising the Licensed Banks, this comes down to the Lender of Last Resort (LLR) facility made available by the Reserve Bank. While not always explicit, it is considered implicit within the system.

- The existence of LLR does not mean that all banks will be prevented from failing in the sense that all creditor groups are totally protected. It is certainly true however that the size of some financial institutions and their importance to the economy are such that to all practical extents they are too big to fail.

- The real use of LLR in times of economic crisis, is to provide a buyer when a bank is having solvency problems, not just liquidity problems. That is when the economic impact can be really severe. Technology and a more efficient payments system cannot get around this.

- Shareholders and management will always pay a large price in such a situation.

- Arguably, this is why the OECD has avoided a depression since the 1930s and indeed the whole push to regulation, both prudential and other, accelerated out of that decade. At all costs an effective LLR facility should not be compromised.

- We would argue that any institution supervised by the RBA will be seen to have that LLR access. Hence, the RBA should only supervise the core of the financial system that requires this, and no more.

- Arguably this "financial core" extends to credit unions and building societies. Certainly the functions of AFIC could be absorbed by the RBA. In so doing the RBA would merely be building on its existing skills base.

- Apart from prudential supervision, the Reserve Bank and other financial system regulators are also concerned with the behavior and conduct of the institutions they regulate.

- In considering establishment of a "Mega-regulator", one must look either to promoting one of the existing regulators to fulfill that role or for the establishment of a new entity.

- Most of the current regulators are too specifically identified with specific aspects of the financial system, have restricted mandates and are accordingly staffed with individuals with relatively narrow expertise. Only the RBA has depth of experience in both financial prudence and institutional conduct on a wider front, but even here it is restricted to the banking sector.

- The RBA is however too closely identified with its role of promoting financial stability, particularly via LLR or protecting bank deposits. We believe the establishment of the RBA as "Mega-regulator" would lead to all financial institutions being imbued with the cachet of prudential soundness, irrespective of whether they are prudentially supervised or otherwise.

- However, if a completely new 'Mega-regulator' is established from scratch there would still be problems in relation to the LLR facility. This 'Mega-regulator' would have to approach the RBA to provide support for a key failing institution. Given the ramifications for liquidity conditions and even economic policy the RBA will want to know real details about the problem. That could be very costly and inefficient. In essence, as the RBA would be central to managing any problem, then it should be involved in regulating and understanding the institutions (ie. banks) that may require LLR. Trying to subsume the RBA into a 'Mega-regulator' for this particular function would in effect really mean two regulators. We believe our proposals to be more simple.

- In effect then, LLR suggests a simple 'Mega-regulator' could be a difficult proposition.

- We would therefore propose that more efficient regulation can be pursued through further enhancing the role of the already established Council of Financial Supervisors. This avoids the potentially very costly alternative of establishing a new entity as "Mega-regulator" and enables the expertise and skills of the specialist regulators to be captured.

- A further dimension is the extent to which supervision should be focused on preserving the stability of the institution offering a financial product, as opposed to regulating disclosure or other characteristics of the product itself.

- It is important to consider the different legal and structural premises which are in fact adopted by various industry participants in conducting their business activities.

- In particular, we believe, a distinction needs to be drawn between those arrangements where an institution is making a "promise to pay" and consequently exposing its investors to a balance sheet risk on the part of the institution itself, and those arrangements where an institution is acting solely as a professional intermediary engaged to invest its clients' funds in financial markets.

- In cases where the institution acts as a *principal*, there is an obvious balance sheet liability which clearly does raise the question of capital adequacy in respect of the institution's own business and undertakings to its clients. In cases where the institution acts as an *agent*, investors are not exposed to a risk of losing their funds if the Fund Manager itself becomes insolvent.

- Distinctions such as this mean that it is unlikely that a mega-regulator could meaningfully frame uniform prudential standards, even in cases where the institutions concerned are marketing their products to the same consumers.

2. The Council of Financial Supervisors

- In disagreeing with the notion of a mega-regulator for the Australian financial system, we by no means intend to suggest that there is no scope to improve or rationalise current regulatory arrangements.

- The transition to this environment may well involve considerable rationalisation of functions among existing regulatory bodies - a process that can still occur while preserving the fundamental goals of maintaining systemic stability and ensuring that prudential controls are appropriately attuned to the specific risks adopted by various types of financial institutions.

- Some instances of regulatory confusion and duplication that we currently experience within the NatWest Markets Group are illustrated in the Case Study on page 8. We would propose a suitable avenue to pursue resolution of issues such as these would be through further enhancing the role of the already established Council of Financial Supervisors.

- The Council currently consists of the RBA, ISC, ASC and AFIC.

- The 1995 Annual Report of the Council sets out what has already been achieved. It is worth noting its stated aims:

  "The Council aims to enhance the quality of financial supervision and regulation in Australia by;

  - *facilitating exchanges of information bearing on the efficiency and health of the financial system;*
  - *assisting each supervisory agency to be aware of, and to understand, developments in parts of the financial system outside its particular area of responsibility;*
  - *identifying important issues and trends in the development of the financial system as a whole; and*
  - *avoiding unintended gaps, duplication or inconsistencies in regulation.*

  The Council reports and, as appropriate, makes recommendations, to the Federal Treasurer and other Ministers."

- This already seems to cover much of what we, as a financial intermediary, are keen to see happen. For instance;

  *"Accordingly, the Council is undertaking a project entitled **Financial Supervision Boundaries and Approaches** which covers the common basic principles of financial regulation and which will identify proposals to remove or remedy unintended gaps, overlaps or inconsistencies in the regimes regulating sales and advice practices for functionally similar retail savings and risk products."*

  "Three examples of regulatory overlap which the Council considers warrant early attention are product disclosure, financial adviser regulation and complaints handling."

- We also note that the Council has already done a lot of work on the regulation of conglomerates in an international context.

- The Council as currently constituted, can be improved. In particular, we feel that the Equities markets in Australia, while well regulated by the ASC, are not well understood by supervisors and need better representation. The Australian Stock Exchange (ASX) or a market based body must be added to the Council in order to broaden its understanding of financial markets.

- In addition, we would also propose that the Council be strengthened in the following ways:

  1. Giving it a legislative basis.
  2. Staffed full time by seconded employees from all member groups, supplemented by representatives of market participants.
  3. More regular meetings.
  4. Encouraging a more formal process for reviewing topics of interest to the financial industry and regulators (albeit not at the transaction level).
  5. Having the ability to recommend legislative change where necessary including the governing statutes of its members.

- We believe it should look at least at the following topics:

  1. Regulatory principles.
  2. Regulatory consistency and co-ordination.
  3. The roles and ambit of individual regulators.
  4. The appointment of lead regulators for conglomerates.
  5. Responsibility for consistency and co-ordination in Disclosure Laws.
  6. Financial system Licencing questions.

- We believe by 'beefing up' the Council, the drawbacks of a simple super regulator can be avoided while maximising the benefits of regulators operating in a co-ordinated fashion.

- We do not believe that the expanded role envisaged will increase the overall costs of supervision. Rather, any additional costs for the Council should be more than met by the efficiencies generated in its constituent bodies through the removal of duplication etc. These efficiencies should however be monitored and measured.

3. Disclosure

- In this light, one area in which considerable progress can be made is the harmonisation of disclosure rules applying to products offered by various market participants, notwithstanding that different prudential standards might apply to them in accordance with their particular risk profile or legal status.

- In the area of prudential supervision, we have argued that differential standards as between different institutional types are warranted on the basis of systemic and institution-specific risk factors. But in the area of investor disclosure, the paramount concern should be comparability of investment choices from the point of view of the investor.

- Consumers should be able to select investment products on the basis of disclosure of key product attributes to as uniform a standard as possible, and should not be expected to discriminate between products on the basis of some presumed understanding of the full legal status of the offering institution.

- There are a number of well-documented disparities between disclosure rules applying to different market participants under current regulatory arrangements. Some have been highlighted in our case studies, while others have been identified by the Council of Financial Supervisors in their report noted above. A concerted effort to identify and address these disparities would both improve investor protection and overcome many of the current instances of competitive inequity as between different institutional types.

4. Let Experts Regulate

- This brings out another key issue. We believe that regulators do need expert knowledge about the institutions and markets they are regulating.

- This supports the idea of specific regulators dedicated to specific areas.

- Importantly, we would be concerned that a new Mega-regulator could be a vehicle for "experts" without actual market / institutional experience.

- Basing regulation in existing bodies with hands on experience who are then co-ordinating their efforts through the Council would seem more appropriate. In this regard we see the ASX or some market based supervisor as a missing link in the Council.

- Consideration should nevertheless be given to a formal system of staff interchanges between the regulators and industry participants.

5. Black Letter Law and the Courts

- A related topic in some ways to this is the general approach to regulation in terms of highly defined and complex written laws (black letter regulation) and a more "risk management" approach.

- The further the regulator is away from the institution/market and the more legalisatically based, we believe the more pedantic and unnecessarily defined and complex the regulations can become. This can be very expensive and often leads to Court action.

- At the other end of the scale is a regulator that knows the institutions, markets and products well. This can lead to a more flexible and consultative approach to matters of detail within general regulation.

- An example might be seen in the UK Takeover Panel system where an industry based body operates successfully within more general guidelines and where there is in practice less recourse to the Courts.

6. Aspects of Capital Requirements

- Finally, this can be tied into capital adequacy.

- There is a danger that mega-regulators and less market orientated regulators introduce multiple layers of capital requirements on the system (which are not needed) in order to be 'sure' the system is safe.

- Regulators close to the markets will tend to rely upon the risk management systems (technological and management) more to be sure that the system is well provided for. Capital adequacy is in effect about risk management.

- For instance, intermediaries with superior systems/management could require less capital than without. We believe this is being discussed by regulators around the world and is an approach we would support.

- This would contrast with black letter law regulation that weights product by product in a mechanical sense, setting specific capital requirements. That is valid in some instances, but not in all.

Case Study - Why we need better Co-ordination

The activities of our Investment Management subsidiary County NatWest Australia Investment Management Limited (CNAIML) are regulated by three separate bodies - the Australian Securities Commission, the Insurance and Superannuation Commission and the Sydney Futures Exchange. This means that CNAIML has a licence from each of these bodies with considerable overlap, particularly between the ASC and the ISC.

For example, in the last quarter of 1995, CNAIML was subject to audits by all three bodies which consumed a significant amount of management time both in meeting with the different regulators and responding to their comments and reports.

In Investment Management's principal business of offering managed funds, different rules apply to the various funds in terms of ability to accept application monies and disclosure requirements depending on the type of product and its regulator. CNAIML also assumes different roles in respect of these funds depending on whether the fund is regulated by the ISC or the ASC (ie. either a direct fiduciary role as the Approved Trustee for superannuation pooled funds, an agency role for discretionary portfolios managed on behalf of external trustees or, pending proposed changes to Collective Investments legislation, an joint role with external trustee companies for non-superannuation pooled funds).

An example of the confusion that this multiple regulatory system can create is the high incidence of queries from clients and financial advisers who expect compliance with certain requirements which in fact apply to a different segment of the market. For example, when the ISC recently issued new guidelines for dealing with life agents, CNAIML was approached by a large number of financial advisers seeking to enter into agreements to comply with the new requirements, notwithstanding that the new requirements did not apply to CNAIML as it is not a life insurance company. Similarly, when the ASC issued its new master fund disclosure requirements, CNAIML received numerous queries from master funds offering superannuation products requesting that information memoranda be provided to comply with the new ASC disclosure requirements. The requirements did not apply to funds offering products regulated by the ISC.

A further example of this confusion is in the issue by the ISC of derivatives risk management statement guidelines which were drafted in such a way that a risk management statement has to be prepared even for funds not regulated by the ISC if there are trustees of superannuation funds which invest in them. This has created significant confusion in the market with clients and some fund managers not being certain what their obligations in this regard are.

We do not put the blame on individual regulators, rather it is the over lapping nature of their mandates which gives rise to the problem. These examples illustrate the extensive overlap and cross-investment which in fact occurs between superannuation and non-superannuation investment products, and the need for greater harmonisation of regulation in cases where effectively-identical products are offered to the same classes of investors through different institutional channels.

Liability for prospectuses in another area where problems arise from a multiple regulatory system. Different tests for liability apply under the Corporations Law and under the superannuation legislation. In addition, defenses available to directors and the issuers of prospectuses under the Corporations Law, are not mirrored in the trade practices legislation. This results in uncertainty over how effective a due diligence procedure is for a corporation which issues prospectus.

D. COMPETITION

1. Merger Policy and Banks

- If banks proposing to merge meet the banking supervisor's prudential requirements and are cleared by the ACCC, in the interests of commercial certainty it is hard to see how the Treasurer can veto the merger on competition policy grounds over the above those set by ACCC.

- However, prudential requirements are in our view different from those of straight forward industrial companies. It could be argued that more concentration in the system could lead to more systemic risk were a mega-institution to become insolvent.

- Generally, merger policy in Australia, as elsewhere, seeks to balance the positive effects of merger efficiencies against the negative effect of lessened competition. Provided proper consumer safeguards are established, concerns about market dominance should fall away. Of course, such safeguards can be self defeating if they do not permit the realisation of merger benefits.

- A wide range of studies of bank efficiency show no positive correlation with bank size. There are high and low ROE/ROA banks across every size of bank. Recent overseas examples suggest however that bank mergers, if properly managed, can produce significant efficiency savings. Such anecdotes do not guarantee a positive result from any merger of major Australian banks; much will depend upon the rigour and discipline with which individual organisations become involved in what could be a merger frenzy.

- Branch rationalisation will eventually come from a fully efficient bank sector. Big bank mergers are not the only way to achieve such rationalisation.

- The national champions argument supported a much more liberal merger environment between 1976 and 1993. This resulted in concentration in the road transport industry in a manner that probably provided little net national benefit. Overseas studies (particularly that by M.E. Porter) have provided much evidence against the national champion argument.

E. SPECIFIC ISSUES FOR BANKS

1. Depositor Protection

- Pursuant to Division 2 of the Banking Act, it is the duty of the Reserve Bank to exercise its powers and functions for the protection of depositors of banks. Although the assets of a failed bank are available to meet its deposit liabilities in Australia in priority to all other liabilities, this does not guarantee their full return.

- It is submitted however that the general public believes bank deposits to be in some way guaranteed by the Reserve Bank.

- It has been suggested by others that giving depositors an explicit first call on a failed bank's assets will provide sufficient protection and comfort. Such a system does not ensure that assets will exceed liabilities once a bank's affairs are finally settled (which could take months if not years), let alone that the liquid assets on hand will be sufficient in the short term to meet the demands of depositors.

- It is submitted that such a proposal, if implemented, would provide an incentive for depositors to immediately withdraw funds from any bank perceived to be in financial difficulty. Even if a rumor is without foundation, few banks would be able to long withstand a run on their deposits.

- In such a system rational depositors would increasingly discriminate between banks on the basis of debt rating. This would generally be at the expense of the smaller regional banks.

- It is also relevant to consider that the general public is currently precluded from depositing monies with Australian branches of foreign banks, notwithstanding the superior debt ratings such banks often enjoy.

- Foreign bank branches are precluded from accepting retail deposits on the basis that the Reserve Bank does not prudentially supervise these entities, and as such is not in a position to protect any Australian deposits they may have. Whatever the merits of this argument in current circumstances it must fall away if the depositor protection regime is itself compromised.

2. Prudential Statements

- As part of its supervisory responsibilities the Reserve Bank has developed a range of Prudential Statements which serve to prescribe the conduct of banking in Australia.

- Some of these statements mirror international prudential standards, in particular that relating to minimum capital adequacy requirements. Such convergence is not only highly desirable but essential if Australia is to develop as a regional financial centre.

- Other Prudential Statements are however uniquely Australian, for instance those relating to the composition of bank boards, association with non-banks etc. In other instances, (for instance, funds management and securitisation) although there are similarities with international practice the local standards are significantly more prescriptive. At the very least these impose an additional regulatory burden on banks operating in this country.

- The Prudential Statements must be adhered to by all banks, irrespective of their size, ownership, products offered and clientele. As such the Statements appear addressed to the lowest common denominator, with the result that some banks are undoubtedly disadvantaged.

- In recent years significant advances in risk management techniques employed by most banks have arguably rendered a number of the Statements absolete.

Case Study - Licencing Overkill

The Corporations Law provides for a licencing system to regulate those carrying on business in the securities and futures industries. The purpose of the system is to set minimum standards of competence, integrity and financial soundness in order to protect investors.

Licences for authorised banks generally do not have financial covenants attached. The same is not true for bank subsidiaries, notwithstanding that stockbroking, futures trading and funds management subsidiaries will be closely supervised by the ASX, SFE and ISC respectively. Licence covenants also ignore the integration of these subsidiaries within bank risk control procedures and inclusion within bank capital adequacy calculations.

All representatives of licence holders must have a "Proper Authority" to so act. All appointments and terminations of representatives must be advised to the ASC, involving a significant reporting burden. No doubt there is also a significant administrative cost for the ASC in maintaining these records. It is submitted however that few if any potential clients consult the ASC records to ascertain which officers have been awarded Proper Authorities. Careful re-evaluation of all roles carried out by regulators would seem appropriate if scarce regulatory resources are to be best directed.

The NatWest Markets Australia group has eight such licences (five dealers and three futures) with a total of 360 proper authorities issued thereunder. This notwithstanding a predominately wholesale and corporate clientele, and compares with an Australian workforce of only 620 in total. It is difficult to see the benefit if any to investors outweighing the substantial compliance cost this involves to the bank.

It can in any event be argued that the "Indoor Management Rule" contained within S164 of the Corporations Law renders such licencing redundant.

That is, persons dealing with a company are entitled to assume that anyone held out by the Company to be an officer or agent of the Company has been duly appointed and has the authority to perform the duties customarily exercised by such an officer.