

## *Chapter 1*

### **EXECUTIVE SUMMARY**

#### **1.1 Background to the Inquiry**

The 1980s deregulation of the financial system has had a profound impact on the efficiency of the financial services sector. Australian consumers and businesses are better off by billions of dollars. The efficiency improvements achieved as a result of deregulation have been passed through to savers and to borrowers. Customers have benefited from greater competition. There are many more financial products and services for customers to choose from, and they have many more options as to how and when they carry out their financial transactions. And despite some major stresses in the late 1980s and early 1990s, the stability and integrity of the financial system has been maintained.

But while much has been achieved since the early 1980s, the financial services industry still faces significant change. A range of demographic shifts and technology advances, together with the continued trend towards the globalisation of ideas and financial services markets, are driving major changes in the structure of the industry.

Technology has allowed the disaggregation of what previously were considered inseparable core functions of financial services. As a consequence, many new competitors specialising in the provision of the now disaggregated products and services are entering the market. The entry of originators into the mortgage market and the activities of investment banks in securitising home loans are one example. Another consequence has been the blurring of boundaries particularly between the product ranges of banks and life offices, as banks move into the life and funds management business, and life offices once again actively compete for home loans.

The needs of customers are driving changes in the structure of the industry. Today customers, whether they are Australian consumers, small business proprietors, or large corporations, are much more sophisticated in their approach to buying financial services. Customers shop around for the deal which best suits them, and, regardless of the size and complexity of their needs, are demanding more convenient access to financial services. The trend is to anywhere, anytime, any place banking. ATMs, EFTPOS, and telephone banking are making this possible. And in future the Internet may allow customers to conduct even more transactions from the convenience of their home. While the precise shape of the future of financial services has yet to be defined, one trend is clear: customers will place less and less reliance on branches as a way of carrying out their financial transactions.

These changes are having a direct impact on the way participants operate and compete. Financial institutions are pursuing more customer focused strategies. The disaggregation of financial services means that there will be diminishing scope for cross subsidisation between parts of an institution's business. For instance, institutions will no longer be able to charge higher rates to customers with housing mortgages to subsidise customers with high activity, low balance transaction accounts. And the intensity of competition from both traditional and non-traditional players means there will be immense pressure to reduce costs.

With the accelerating pace of change, this Inquiry into the financial services sector is timely.

Not only must the Inquiry pay due regard to the lessons of deregulation and the current trends in the evolution of the industry, but it must advise on how the regulatory system can best ensure that the financial sector will continue to meet the community's needs, and support Australia's economic objectives. A lot is at stake.

As a nation, Australia faces a number of significant challenges. Key amongst these is the need for broadly-based economic reform to improve Australia's international competitiveness. Governments need to create the conditions which will achieve higher sustainable living standards and stronger economic growth.

The Financial System Inquiry is a core part of this broad reform agenda and is central to the achievement of Australia's economic and social objectives. An efficient and stable financial system is critical to the workings of a healthy economy; it is central to facilitating the achievement of the personal goals of individual Australians; it is central if Australian businesses are to flourish; and it is a core ingredient in the larger goal of achieving international competitiveness for the Australian economy as a whole and for the hundreds of enterprises which operate in it.

As a result, the success of the Inquiry in promoting the interests of users, and thus a more competitive and stronger Australian economy will depend critically on the achievement of three key objectives, namely that:

- The **stability and integrity of the financial system** must be maintained;
- The **efficiency** of the financial system must continue to be enhanced; and
- Regulatory arrangements must be sufficiently **flexible to enable financial institutions to respond and adapt** to emerging trends in the industry.

Getting the answers right in this Inquiry, consequently, is of vital importance to the future of all Australians.

## **1.2 A Regulatory Approach for the Twenty First Century**

Westpac has framed its recommendations for a comprehensive reform of the regulatory system with these three objectives in mind, after taking account of the lessons of deregulation and an assessment of the future direction of the industry.

This submission outlines, in over 80 separate recommendations, the changes Westpac considers are necessary to achieve, a more efficient and adaptable regulatory system.

This Executive Summary focuses on the key recommendations which relate to the Inquiry's three objectives of stability and integrity, efficiency, and flexibility. The full list of recommendations follows the Executive Summary.

### **1.2.1 Stability and Integrity**

There are two key reasons why maintaining the stability and integrity of the financial system is critical.

- First: Consumers, businesses, and governments, and hence the economy, are totally dependent on being able to exchange value efficiently, accurately, irrevocably, and in a timely manner. The way value is exchanged is commonly referred to as the payments system. The sheer size and importance of the payments system is highlighted by the fact that on average, over \$100 billion a day passes through the system. This is equivalent to the payments system turning over Australia's entire GDP each and every week. The daily settlement of these vast amounts is usually carried out by licensed banks.
- Second: Consumers must have confidence that promises made by financial institutions to pay or repay specific financial promises will be kept. Thus a depositor must have confidence that an institution such as a bank or building society that takes deposits will be able to repay the principal and interest on-demand or at a specified time. Equally, a consumer needs to be confident that a life or general insurance claim will be honoured.

There is a clear distinction between promises where an institutional guarantee exists as to the amount and timing or circumstances of any payment; and obligations where there is no such institutional guarantee. In the latter case, the eventual payment depends solely on the performance of the underlying investment and the investor bears the risk. In the former case, the institution bears the investment risk, effectively "intermediating" on behalf of the depositor or policy-holder.

It is these two factors - the need to maintain the stability and integrity of the payments system, and the need to ensure financial institutions are able to honour financial "guarantees" to consumers - that drive the nature of regulation required to ensure the overall stability and integrity of the system.

Where the public are provided with an "institutional guarantee", prudential supervision of the institution is usually warranted. Such supervision is currently carried out by the Reserve Bank (RBA), the Insurance and Superannuation Commission (ISC) and the Australian Financial Institutions Commission (AFIC).

Where the risk is borne by the consumer, a requirement exists that investors and borrowers will be fully informed and treated fairly and equitably. Appropriate disclosure is key. This requires functional regulation applied uniformly across all providers of the same service or product. Such regulation focuses on the business conduct and practices relating to a specific product and is currently provided by a raft of regulators including the Australian Securities Commission (ASC), the Australian Competition and Consumer Commission (ACCC), the RBA, the ISC, and various State Consumer Affairs Departments.

In line with this approach, Westpac makes the following key recommendations on prudential and functional regulation:

- Separate agencies should be responsible for prudential supervision and for the regulation of financial practices. (Recommendation 6.1).

### ***Prudential Regulation***

- Prudential supervision should be applied on an institutional basis where institutions incur obligations to investors in the form of guarantees as to the timing or circumstances in which payment will be made and the amount of that payment. (Recommendation 6.2)
- In the interest of ensuring the integrity of the payments system and the protection of deposits, the prudential supervision of banks should be undertaken by the Reserve Bank. To protect policy holders, the prudential supervision of life and general insurance companies should be undertaken by the ISC. (Recommendation 6.3)
- Responsibility for supervision of credit unions and building societies should be transferred to the Reserve Bank. However, these institutions should remain separate from and not be called banks, and should continue to individually access the clearing and settlement systems through agency arrangements. (Recommendation 6.4)

### ***Regulation of financial practices***

- Regulation designed largely to protect consumers should be applied on a functional basis equally across all institutions. (Recommendation 6.8)
- Responsibility for the regulation of financial practices and conduct should be drawn together in one agency, involving the creation of a new Financial Practices Authority (FPA) or an extension of the existing functions of the ACCC or ASC. (Recommendation 6.9)
- The financial practices regulator should be responsible for the registration and regulation of all financial advisers involved in the distribution of retail savings and risk products - securities advisers, insurance agents and brokers. (Recommendation 6.10)
- The financial practices regulator should be responsible for the regulation of all funds managers. (Recommendation 6.11)
- The financial practices regulator should be responsible for the regulation of finance company fund raising from retail investors. (Recommendations 6.12)

### ***Co-ordination of Regulation***

The nature of financial obligations drives the distinction between prudential and functional regulation. In turn, different supervisory skill requirements dictate that regulation of banking and insurance promises should be carried out by different regulators. But while it is sensible to have different regulators for banking and insurance, it is desirable to have effective coordination among all financial system regulators.

The main co-ordination options are either to have a single prudential regulator or to have a “lead” regulator approach, together in this case with a body that co-ordinates the various prudential and functional supervisors.

Westpac favours the latter approach. The key reasons for not favouring a single regulator are: the risk of an over concentration of power in one authority; the “moral hazard” risk that the lender of last resort responsibility which must attach to the bank supervisor will be viewed as applying to all other types of institutions and activities; and the risk of there being dis-economies of scale in the cost of a single regulator. Westpac therefore recommends the following:

- A lead regulator approach should be adopted to the prudential supervision of diversified financial organisations, with the Reserve Bank being the lead regulator where a bank represents a major part of the group. (Recommendation 6.15)
- The Council of Financial Supervisors should continue to be responsible for coordinating prudential and functional supervision. (Recommendation 6.17)
- The Council of Financial Supervisors should be given a charter requiring it to coordinate the responsibility of individual supervisors and to implement a regulatory approach which balances efficiency and stability objectives with consumer needs. (Recommendation 6.18)

### ***Extent of Depositor Protection***

Westpac proposes that the protection of depositors’ funds is based on deposit-taking institutions putting in place robust control systems under the supervision of the Reserve Bank.

This means that non-viable banks should be allowed to fail. If a bank were to fail, however, the Reserve Bank must have the authority and ability to act in an orderly way to ensure that depositors’ interests are safeguarded. This means that the preferred treatment of depositors ahead of other claimants must be maintained.

Equally, however, if a run were to occur on a bank that is otherwise fundamentally sound, the Reserve Bank must have the explicit authority to act as a lender of last resort. Westpac therefore recommends.

- The Reserve Bank should make clear in public statements, including its Annual Report, that banks which are not soundly managed and viable will be allowed to fail. (Recommendation 7.3)
- The Reserve Bank Act should be amended to include provision of a lender of last resort power. Loans made by the Reserve Bank would be confined to soundly managed and viable banks, where the soundness and integrity of the financial system is likely to be affected by a general loss of confidence. (Recommendation 7.4)
- Section 12 of the Banking Act should retain reference to depositor protection but be amended to explain clearly the limits of the Reserve Bank’s responsibility, ie that it is responsible for safeguarding, but not providing a guarantee for bank deposits. (Recommendation 7.5)

## ***Payments System***

The payments system is a set of mechanisms through which individuals, businesses, and governments meet their monetary obligations to each other. Strictly speaking, it is not a single system, but numerous systems through which small and large payments, domestic and international, are transacted, processed, cleared, and settled.

While access to a market or function is recognised as an important determinant of competition, in the case of the **settlement** of payments, who has access to the system is also a key element of risk control. The objectives of greater competition need to be balanced against public policy concerns with the soundness of the financial system. Clearly, the freedom of entry that is implied by vigorous competition is not compatible with the stability and integrity of the payments system.

The pivotal role of banks in the payments system is integrally linked to the fact that ultimately value is transferred between deposit accounts held at banks and to a lesser extent other deposit taking institutions. For this reason, strict access criteria are laid down by Central Banks worldwide, with the right to participate directly in value transfer systems (clearing and settling) being conferred only on those who are able to bear the risks involved - predominantly banks. Consistent with international practice, Westpac recommends:

- Only banks and industry based Special Service Providers (for non-bank deposit takers) should be allowed to operate an Exchange Settlement Account with the Reserve Bank, and hence have direct access to the clearing and settlement components of the payments system. (Recommendation 8.1)
- Only licensed deposit taking institutions should be allowed to issue stored value cards. (Recommendation 8.6)

The proposed framework, as outlined above and set out in Figure 1.1, will eliminate regulatory duplication and overlap, ensure that regulatory bodies have clear and concise responsibilities, and result in a more accountable and transparent regulatory approach. In addition, the recommendations made in respect of the payments system and the extent of depositor protection are intended to ensure that the stability and integrity of the financial system is maintained.

### ***1.2.2 Efficiency***

Since 1980 the domestic interest spreads earned by the major banks have reduced from 5.0% to 3.9%. An indicative net financial benefit for the community of this reduction is of the order of \$3 billion, in current day terms.

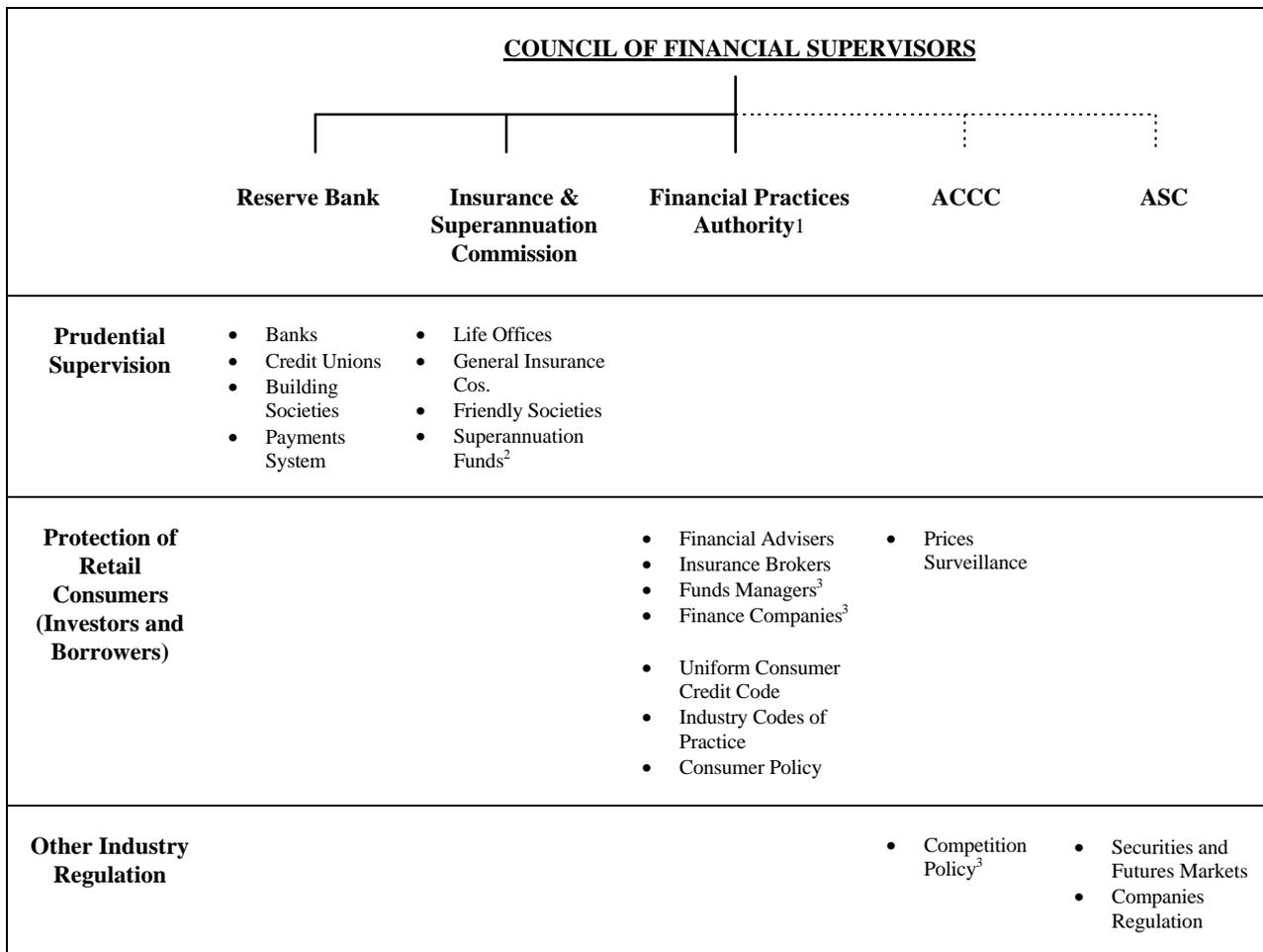
This reduction in interest spread has been feasible because the efficiency of banks has improved. The average non-interest expense to income ratio of the major banks, for example, has reduced from 72.9% in 1982 to 61.4% in 1995, and the non-interest expense to total average assets has decreased from 4.2% in 1980 to 2.9% in 1995.

Bank's improved productivity appears to be a result of the impact of deregulation, although the affect of the large bank mergers in the early 1980s should not be under estimated.

To the extent that these benefits have been passed predominantly to consumers, Australians are significantly better off. In the final analysis, it is only through improved efficiency and productivity that consumers can continue to receive benefits.

Future pressure for efficiency improvements will be driven by changes taking place in the structure of the industry. The challenge is to ensure that: the regulatory framework is one that allows efficiency gains to be realised for the benefit of all Australians; allows new players to compete in a competitively neutral way with existing players; and does not prevent existing players responding to the significant changes taking place in the industry.

**Figure 1.1**  
**PROPOSED APPROACH TO FINANCIAL SYSTEM REGULATION**



<sup>1</sup> The Financial Practices Authority will either be a new body or possibly a division of the ACCC or the ASC.

<sup>2</sup> Whereas prudential supervision of life offices and general insurance companies involves setting out and monitoring solvency standards, superannuation funds are the focus of standards relating to internal disciplines and controls, and disclosure to members.

<sup>3</sup> The FPA would be responsible for prospectus requirements associated with continuous fund raising by financial institutions, but not by non-financial companies, responsibility for which would remain with the ASC.

More specifically, within the constraints of maintaining the stability and integrity of the financial system, the general principles that underpin Westpac's approach to improved efficiency are:

- new participants should be encouraged to enter the industry
- existing players should not be inhibited from adapting to industry changes
- the banking and financial services industry should be treated the same way as other industries, apart from meeting prudential requirements; and
- prudential and functional regulation, should aim to be less prescriptive.

Our key recommendations in line with these principles are outlined below.

### ***Entry of Participants***

- The minimum capital requirement for new banks should be reduced from \$50 million possibly to as low as \$20 million of Tier 1 capital, subject to new entrants being able to meet other prudential requirements as laid down by the Reserve Bank, including the ability to raise additional permanent capital, if required. (Recommendation 7.10)
- Where there is no institutional guarantee, there should be no restriction on entry to the financial sector, subject to compliance with rules and protocols. (Recommendation 7.13)
- Existing policy which prohibits mutual organisations establishing or owning banks in their own right should be preserved, but supervised mutuals should be permitted to establish a non-bank deposit-taking institution so long as all prudential requirements are met. (Recommendation 7.11)
- Non-financial enterprises should not be permitted to establish deposit-taking institutions, and participation in bank ownership should continue to be limited under the Banks (Shareholdings) Act. (Recommendation 7.12)

### ***Competition Policy***

- Competition policy should be applied to the banking and financial services sector in an identical manner to its application to other industry sectors. (Recommendation 9.1)
- Treasurer approval for bank mergers should be removed from the Banking Act. The Reserve Bank should be responsible for approving all mergers from a prudential perspective and the ACCC should administer competition policy. (Recommendation 9.2)
- The "Six Pillars" policy should be abolished. (Recommendation 9.3)
- When examining a potential merger among diversified financial organisations whose prime business is banking, the ACCC should adopt a broad functional approach to determining who are the market participants, with the focus on the major products and services that are supplied. (Recommendation 9.4)

- The market definition should reflect the dynamic, increasingly fragmented nature of the market and its growing reliance on remotely administered technology for the delivery of products and services. The geographic boundary for the market for financial services should be national. (Recommendation 9.5)
- The ACCC should adopt the Industry Commission's suggested competition review threshold figures, beyond which proposed mergers would be subject to review. (Recommendation 9.6)

### ***More Outcomes-Oriented Regulation***

#### **1. Prudential**

- The Reserve Bank should, wherever practicable, express prudential standards in the form of guidelines as to expected outcomes, allowing banks discretion as to how they achieve these. Observance of the guidelines would be monitored by the Reserve Bank, either directly or in conjunction with bank auditors. (Recommendation 7.1)
- Where it is necessary for the Reserve Bank to set specific standards, these should take account of the risk profile of individual banks (and other deposit-taking institutions). (Recommendation 7.2)
- Self regulation should continue to be the core approach for the governance of wholesale financial markets. (Recommendation 7.21)

#### **2. Financial Practices**

- In any review of the Uniform Consumer Credit Code after responsibility has been vested in the financial practices regulator, the following broad reforms should be made:
  - Restrictions imposed under the Code should balance the need to protect consumers with that of ensuring credit providers can respond flexibly and efficiently to customer needs.
  - Regulatory impact statement should be used to ensure that:
    - regulation under the Code achieves an appropriate balance between user protection, and efficiency and equity considerations; and
    - the Code evolves in a way which enables credit providers to adapt to the changing market place.
  - Disclosure requirements should have regard for broader efficiency implications, including the costs of compliance.
  - Disclosure should emphasise the need for consumers to exercise care and judgement in choosing financial services and assist in this through clear and simple disclosure requirements. (Recommendation 10.3)

In summary, improving the efficiency of the financial services sectors offers significant benefits for all Australians. A lot is at stake in ensuring that, consistent with meeting

stability and fairness requirements, Australia's financial system achieves levels of international competitiveness, while still being equitable from the perspective of consumers.

### **1.2.3 Adaptability and Flexibility**

A key challenge is to ensure that the regulatory environment is able to flexibly adapt to change and that it fosters adaptability and the capacity to change among market participants.

Change is a certainty and the broad direction in which the industry is headed can be defined. However, the specifics as to the future are not clear. For instance, while trials are currently going on with smart cards, they might or might not take over from cash. Equally, it is uncertain as to the extent to which transactions over the internet may substitute for telephone banking, credit cards, or even writing a cheque.

In the absence of such clarity and given the pace of change, a regulatory framework is required that as described above is more outcomes-oriented and less prescriptive in nature. Some of our specific recommendations in that area have already been outlined.

But, in addition, steps need to be taken to ensure that trends that are currently able to be identified are catered for and a process is put in place that allows regular reviews to take place.

The key trends not already addressed that need to be accommodated are:

- The ability of financial service providers, if they so desire, to put in place an organisation structure that accommodates the offering of a diverse range of financial services
- The ability of financial service providers to stay competitive and respond to emerging technology by selectively being able to form strategic alliances with non-financial services providers
- The ability to eliminate cross-subsidies.

Our key recommendations in respect of adaptability and flexibility are:

#### ***Review process***

- To ensure that the regulatory framework adapts in a timely way to evolving market changes, financial system reviews should be conducted every 7 years, with the specific intention of ensuring that regulation is not impairing the efficiency of the financial system. (Recommendation 6.21)

#### ***Establish More Flexible Organisation Structures***

- Banks should be permitted to establish non-operating holding companies, and to become subsidiaries of the parent holding company. (Recommendation 6.14)

***Strategic Alliances***

- Prudential Statement G1 on banks' associations with non-banks should be retained, but the Reserve Bank should adopt a flexible approach to determining what activities fall within "the field of finance", having regard for the changing market place. (Recommendation 7.15)

***Cross-Subsidies***

- Banks should be free to use fees to encourage customer transaction usage that reflects the underlying costs. (Recommendation 11.1)
- Where the Government is concerned that the charging of such fees will cause particular problems for some sectors of the community, it should seek to resolve these problems through the provision of subsidies through the budget. (Recommendation 11.2)

***1.2.4 Concluding Comments***

The significance of the potential outcome of this Inquiry should not be underestimated. A more efficient financial regulatory system is integral to the larger domestic economic reform agenda currently being implemented and is needed to maintain the international competitiveness of the financial sector. Westpac's recommendations, if adopted, will bring about the goals of having an efficient, competitive and stable financial system.

## 1.3 Recommendations

### Chapter 6: Future Approach to Regulation

*Recommendation 6.1:* Separate agencies should be responsible for prudential supervision and for the regulation of financial practices.

#### ***Prudential supervision***

*Recommendation 6.2:* Prudential supervision should be applied on an institutional basis where institutions incur obligations to investors in the form of guarantees as to the timing or circumstances in which payment will be made and the amount of that payment.

*Recommendation 6.3:* In the interest of insuring the integrity of the payments system and the protection of deposits, the prudential supervision of banks should be undertaken by the Reserve Bank. To protect policy holders, the prudential supervision of life and general insurance companies should be undertaken by the ISC.

*Recommendation 6.4:* Responsibility for supervision of credit unions and building societies should be transferred to the Reserve Bank. However, these institutions should remain separate from and not be called banks, and should continue to individually access the clearing and settlement systems through agency arrangements.

*Recommendation 6.5:* Credit unions and building societies should be subject to the primary objects tests, but individual institutions should be exempted on a case-by-case basis where they can satisfy the Reserve Bank that:

- they have the necessary management skills and Board members with relevant experience to ensure they can diversify without compromising their ability to meet their obligations to depositors; and
- they maintain a level of capital which is consistent with the riskiness of the activities being undertaken and the relative importance of those activities to the institution.

*Recommendation 6.6:* Superannuation funds should continue to be subject to prudential regulation by the ISC.

*Recommendation 6.7:* Friendly societies which provide financial services to their members should be supervised by the ISC.

#### ***Regulation of financial practices***

*Recommendation 6.8:* Regulation designed largely to protect consumers should be applied on a functional basis equally across all institutions.

*Recommendation 6.9:* Responsibility for the regulation of financial practices and conduct should be drawn together in one agency, involving the creation of a new Financial Practices Authority (FPA) or an extension of the existing functions of the ACCC or ASC.

*Recommendation 6.10:* The financial practices regulator should be responsible for the registration and regulation of all financial advisers involved in the distribution of retail savings and risk products - securities advisers, insurance agents and brokers.

*Recommendation 6.11:* The financial practices regulator should be responsible for the regulation of all funds managers.

*Recommendation 6.12:* The financial practices regulator should be responsible for the regulation of finance company fund raising from retail investors.

*Recommendation 6.13:* The RBA and ISC should be consulted on any proposals for increased regulation of financial practices (including consumer regulation) and should have formal roles in any inquiries which may be undertaken on such issues.

### ***Co-ordination of Regulation***

*Recommendation 6.14:* Banks should be permitted to establish non-operating holding companies and to become subsidiaries of the parent holding company.

*Recommendation 6.15:* A lead regulator approach should be adopted to the prudential supervision of diversified financial organisations, with the Reserve Bank being the lead regulator where a bank represents a major part of the group.

*Recommendation 6.16:* In instances where the Reserve Bank is the lead regulator, the Insurance and Superannuation Commission should still have responsibility for the prudential supervision of individual insurance companies, including their superannuation activities.

*Recommendation 6.17:* The Council of Financial Supervisors should continue to be responsible for co-ordinating prudential supervision and financial practices regulation.

*Recommendation 6.18:* The Council of Financial Supervisors should be given a charter requiring it to coordinate the responsibility of individual supervisors and to implement a regulatory approach which balances efficiency and stability objectives and consumer needs.

*Recommendation 6.19:* The Reserve Bank should chair the Council of Financial Supervisors and report annually to the Treasurer on actions pursuant to its charter.

### ***Adaptability of the regulatory framework***

*Recommendation 6.20:* The boards of regulatory agencies, including the proposed Financial Practices Authority, should include individuals with relevant industry experience and understanding of the changes occurring in the industry.

*Recommendation 6.21:* To ensure that the regulatory framework adapts in a timely way to evolving market changes, financial system reviews should be conducted every 7 years, with the specific intention of ensuring that regulation is not impairing the efficiency of the financial system.

*Recommendation 6.22:* Regulatory impact statements should be prepared by the relevant Government agency and publicly issued for all new regulatory proposals, including those of an informal nature. These should be timely and should not delay the implementation of proposals for reform made by either the Government or business. They should specifically address the implications for:

- the efficiency, including the adaptability, of the financial system;
- the stability of the financial system and the interests of depositors and policyholders;
- consumers and business users, including equity among users; and
- the effectiveness of proposed regulation compared with fiscal intervention, where appropriate, so that market forces may operate more freely.

## **Chapter 7: Prudential Supervision of Banks**

### ***Level and degree of supervision***

*Recommendation 7.1:* The Reserve Bank should, wherever practicable, express prudential standards in the form of guidelines as to expected outcomes, allowing banks discretion as to how they achieve these. Observance of the guidelines would be monitored by the Reserve Bank, either directly or in conjunction with bank auditors.

*Recommendation 7.2:* Where it is necessary for the Reserve Bank to set specific standards, these should take account of the risk profile of individual banks (and other deposit-taking institutions).

### ***Financial and payments system stability***

*Recommendation 7.3:* The Reserve Bank should make clear in public statements, including its Annual Report, that banks which are not soundly managed and viable will be allowed to fail.

*Recommendation 7.4:* The Reserve Bank Act should be amended to include provision of a lender of last resort power. Loans made by the Reserve Bank would be confined to soundly managed and viable banks, where the soundness and integrity of the financial system is likely to be affected by a general loss of confidence.

### ***Depositor protection***

*Recommendation 7.5:* Section 12 of the Banking Act should retain reference to depositor protection but be amended to explain clearly the limits of the Reserve Bank's responsibility, ie. that it is responsible for safeguarding, but not providing a guarantee for bank deposits.

*Recommendation 7.6:* Section 14 of the Banking Act, which states that the RBA may assume control of and carry on the business of a bank which is unable to meet its obligations, should be retained, but with amendments to clarify the circumstances where the RBA may or may not assume control.

*Recommendation 7.7:* Section 16(1) of the Banking Act, which ranks a bank's deposit liabilities in Australia ahead of all other liabilities in the event that it is unable to meet its obligations should be retained in the Banking Act.

*Recommendations 7.8:* Section 16(2), which requires banks to hold assets (other than goodwill) in Australia at least equal to the amount of its Australian deposit liabilities should be retained in the Banking Act.

**Ownership**

*Recommendation 7.9:* The Banks (Shareholdings) Act should be amended to provide for the Governor of the Reserve Bank to:

- permit shareholdings of between 10% and 15%; and
- make recommendations to the Treasurer for approval where applicants seek shareholdings in excess of 15%. The Treasurer could only reject the proposal where it was determined that this would not be in the national interest. Applications rejected by the Reserve Bank would not be subject to appeal to the Treasurer.

*Recommendation 7.10:* The minimum capital requirement for new banks should be reduced from \$50 million possibly to as low as \$20 million of Tier 1 capital, subject to new entrants being able to meet other prudential requirements laid down by the Reserve Bank, including the ability to raise additional permanent capital, if required.

*Recommendation 7.11:* Existing policy which prohibits mutual organisations establishing or owning banks in their own right should be preserved, but supervised mutuals should be permitted to establish a non-bank deposit-taking institution so long as all prudential requirements are met.

*Recommendation 7.12:* Non-financial enterprises should not be permitted to establish deposit-taking institutions, and their participation in bank ownership should continue to be limited under the Banks (Shareholdings) Act.

*Recommendation 7.13:* Where there is no institutional guarantee, there should be no restriction on entry to the financial sector, subject to compliance with rules and protocols.

*Recommendation 7.14:* Foreign ownership of banks should continue to be subject to control under the Banks (Shareholdings) Act and under the Government's foreign investment policy.

**Investment in non-financial companies**

*Recommendation 7.15:* Prudential Statement G1 on banks' associations with non-banks should be retained, but the Reserve Bank should adopt a flexible approach to determining what activities fall within "the field of finance", having regard for the changing market place. It should be willing to approve investments by bank holding companies which exceed 10% where these fall within "the field of finance", and do not pose a threat to the stability of a bank.

**Supervision of diversified financial organisations**

*Recommendation 7.16:* When regulating diversified financial organisations, a 'consolidation' approach should be adopted, where the assets and liabilities of individual companies in a group are consolidated for assessing capital adequacy requirements.

*Recommendation 7.17:* Prudential Standard C2 on Funds Management and Securitisation should be simplified, replacing the existing prescriptive approach with a requirement that banks should be required to disclose the nature and limitation of the bank's obligations to investors.

**Regulatory capital**

*Recommendation 7.18:* The Reserve Bank should seek to persuade the Basle Committee for banking to adopt an approach to capital adequacy which recognises superior bank-developed systems for credit risk management, subject to these systems being of a standard acceptable to the Reserve Bank.

*Recommendation 7.19:* The Reserve Bank should apply its national discretion under the Basle accord and adopt risk asset ratios for credit risk which better reflect the true underlying risk for each category of lending.

**Liquidity**

*Recommendation 7.20:* The Prime Asset Ratio should be abolished as an instrument of prudential regulation. In the case of individual banks or other deposit-taking institutions, this should be conditional on satisfying the Reserve Bank as to their liquidity management policies, programs and expertise.

**Miscellaneous**

*Recommendation 7.21:* Self regulation should continue to be the core approach for the governance of wholesale financial markets.

*Recommendation 7.22:* Legislative change, if required, to ensure legal certainty for netting is an immediate priority and the ASC should accelerate the process of presenting legislative proposals to the Government.

*Recommendation 7.23:* The Prudential Statement L1 on asset quality should be retained without amendment.

*Recommendation 7.24:* Banks should meet the costs incurred by the Reserve Bank in the discharge of its responsibilities for prudential supervision.

*Recommendation 7.25:* Any costs borne by banks in acting as agent for government should be offset against this fee, or separately reimbursed by government.

*Recommendation 7.26:* The requirement for banks to maintain Non-Callable Deposits with the Reserve Bank at a penalty rate should be abolished.

**Chapter 8: Payments system****Real time gross settlement system**

*Recommendation 8.1:* Only banks and industry based Special Service Providers (for non-bank deposit takers) should be allowed to operate an Exchange Settlement Account (ESA) with the Reserve Bank, and hence have direct access to the clearing and settlement components of the payments system.

*Recommendation 8.2:* Access to Exchange Settlement Accounts for settlement on Real Time Gross Settlement (RTGS) should be limited to a “reasonable” number of regulated deposit takers, who in turn act as agents for other institutions.

*Recommendation 8.3:* Exchange Settlement Account holders should be allowed to manage liquidity on a more flexible and commercial basis than via the current requirement to maintain the Prime Assets Ratio, including the provision of intra-day credit by the Reserve Bank.

*Recommendation 8.4:* Access to Clearing Systems should continue to be limited to regulated deposit taking institutions which can meet scale efficiency hurdles, as set by the Australian Payments Clearing Association (APCA).

### **Access to instruments**

*Recommendation 8.5:* There should be no restriction on access to participation in the payments system by new Instrument providers (other than stored value card issuers), provided such new entrants meet the standards and abide by the rules set by APCA.

*Recommendation 8.6:* Only licensed deposit taking institutions should be allowed to issue stored value cards or electronic “cash” for use in on-line systems.

*Recommendation 8.7:* Any organisation can be a participant in the delivery of payments instructions provided that it complies with agreed rules and protocols.

### **Access to infrastructure**

*Recommendation 8.8:* Suppliers of infrastructure should not be allowed to form alliances with payments system participants to limit competition.

### **Control of clearing and settlement systems**

*Recommendation 8.9:* For greatest efficiency, the systems through which payments clearing and settlement take place should be controlled by the private sector.

## **Chapter 9: Competition Policy**

*Recommendation 9.1:* Competition policy should be applied to the banking and financial sector in an identical manner to its application to other industry sectors.

### **Mergers**

*Recommendation 9.2:* Treasurer approval for bank mergers should be removed from the Banking Act. The Reserve Bank should be responsible for approving all mergers from a prudential perspective and the ACCC should administer competition policy.

*Recommendation 9.3:* The “Six Pillars” policy should be abolished.

### **Trade practices and draft merger guidelines**

*Recommendation 9.4:* When examining a potential merger among diversified financial organisations whose prime business is banking, the ACCC should adopt a broad functional approach to determining who are the market participants, with the focus on the major products and services that are supplied.

*Recommendation 9.5:* The market definition should reflect the dynamic, increasingly fragmented nature of the market and its growing reliance on remotely administered technology for the delivery of products and services. The geographic boundary for the market for financial services should be national.

*Recommendation 9.6:* The ACCC should adopt the Industry Commission's suggested review threshold figures beyond which proposed mergers would be subject to review namely:

- raising the threshold market share for an individual merged firm from the present 40% to 50%; and
- replacing the threshold test in which the post merger concentration ratio for the *four* firms is 75% or more (with the merged firm having at least 15% of the market) with one in which the *three* firm concentration ratio is 75% or more (with the merged firm having at least 20% of the market).

*Recommendation 9.7:* When assessing the extent to which there are any barriers to effective new competition within the financial services market, the ACCC should take full account of emerging trends in the competitive environment.

## **Chapter 10: Consumer and Privacy Regulation**

### ***Approach to consumer regulation***

*Recommendation 10.1:* A national approach should be adopted to the regulation of consumer credit to ensure that it adapts with the market over time. Responsibility should be transferred from the States to the Commonwealth, with a separately constituted financial practices regulator having responsibility for its administration.

*Recommendation 10.2:* In any review of the Uniform Consumer Credit Code, after responsibility has been vested in the financial practices regulator, provision should be made to take account of the full costs and implications for consumers. Putting in place a requirement for Regulatory Impact Statements would be one way of bringing this about.

*Recommendation 10.3:* In any review of the Uniform Consumer Credit Code, after responsibility has been vested in the new financial practices regulator, the following broad reforms should be made:

- Restrictions imposed under the Code should balance the need to protect consumers with that of ensuring credit providers can respond flexibly and efficiently to customer needs.
- Regulatory impact statements should be used to ensure that:
  - regulation under the Code achieves an appropriate balance between user protection and efficiency and equity considerations, and
  - the Code evolves in a way which enables credit providers to adapt to the changing market place.

- Disclosure requirements should have regard for broader efficiency implications, including the costs of compliance.
- Disclosure should emphasise the need for consumers to exercise care and judgement in choosing financial services and assist in this through clear and simple disclosure requirements.
- Where a contract is reopened because it appears to be unjust, relief should only be provided where it can be shown that there has been an intention to deceive a consumer or where a consumer has been significantly and adversely affected as a result of action by a credit provider.

## **Privacy**

*Recommendation 10.4:* Subject to the customer not objecting, financial institutions should be permitted to use information within the group for purposes related to the activities of the group, so as to enhance the efficiency of their marketing activities and their ability to meet customers' needs more effectively.

*Recommendation 10.5:* Customers should not have access to market sensitive or commercial proprietary information or confidential information held by financial institutions on their own behalf or on behalf of others. Customer access should be limited to a bank's holding of information on the customer's address, occupation, marital status, age, gender, accounts with the Bank and the balances and statements relating to those accounts.

*Recommendation 10.6:* The Commonwealth Government should seek to ensure that a national approach is adopted in relation to the implementation of laws relating to the privacy of financial information.

*Recommendation 10.7:* Regulatory impact statements should be used to ensure that:

- any amendment to privacy regulation achieves an appropriate balance between the need to protect the privacy of customers and the ability of financial institutions to offer beneficial services to them; and
- the Privacy Act evolves in a way which enables financial institutions to adapt to the changing market place.

*Recommendation 10.8:* The Privacy Act should be amended to allow positive credit reporting.

*Recommendation 10.9:* The key elements on which any privacy regulation relating to stored value cards should be based include the following:

- Before any new regulation is introduced over and above that available at common law, under the Privacy Act, and under the Code of Banking (and building society and credit union) Practice, a demonstrated need must be established.
- To secure public confidence in the terms on which information is collected and in any use to which it may be put, only licensed deposit-taking institutions should be permitted to issue general purpose stored value cards, as these have proven and reliable standards regarding customer confidentiality.

- Regulatory impact statements should be used to ensure that any regulation achieves an appropriate balance between the need to protect the privacy of customers and efficiency considerations.
- Any additional regulation required should be provided in the EFT Code of Conduct rather than in legislation, as the Code provides greater flexibility to change the requirements if the need arises.

## **Chapter 11: Sectoral and Social Assistance**

*Recommendation 11.1:* Banks should be able to use fees to encourage customer transaction usage that reflects underlying costs.

*Recommendation 11.2:* Where the Government is concerned that the charging of such fees will cause particular problems for some sectors of the community, it should seek to resolve these problems through the provision of subsidies through the budget.

*Recommendation 11.3:* In the interests of efficiency, effectiveness and equity, Governments looking to resolve the financial difficulties faced by farmers should provide programs to assist farmers to address their underlying problems, while leaving it to the rural and banking industries to develop supporting arrangements on a voluntary basis.

*Recommendation 11.4:* In future all proposals which are intended to achieve sectoral or social objectives through the financial system should be the subject of regulatory impact statements as proposed in Recommendation 6.22. These statements should explicitly address the implications for the four criteria identified by the Campbell Committee: efficiency, effectiveness, equity and accountability.

## **Chapter 12: Banks as Agents for Government**

### ***FID and BAD***

*Recommendation 12.1:* The Federal Government should, as a matter of urgency, work with the States to develop alternative fiscal measures to ensure that FID and BAD tax are abolished by the year 2000, so as to achieve greater competition and efficiency in the financial system and greater equity among those making financial transactions.

### ***Financial Transaction Reports Act 1988***

*Recommendation 12.2:* The account opening procedures imposed on cash dealers under the Financial Transactions Reports Act should be amended in accordance with the Senate Committee's recommendation, with cash dealers being obliged to take reasonable steps to satisfy themselves of the identity of signatories to an account.

*Recommendation 12.3:* A proportion of the costs incurred by cash dealers in complying with account opening procedures and all the costs of reporting substantial, suspicious and telegraphic transactions should be reimbursed from the additional tax collected.

*Recommendation 12.4:* If this is not done, the costs incurred by banks should be credited against the fees payable for their prudential supervision. (See Recommendation 7.25).

*Recommendation 12.5:* All the costs incurred by deposit-taking institutions in connection with administration of the Tax File Number system should be reimbursed.

*Recommendation 12.6:* If this is not done, the costs incurred should be credited against the fees payable for their prudential supervision. (See recommendation 7.25).

*Recommendation 12.7:* The costs incurred by banks and other deposit-taking institutions in responding to official requests for information should be credited against the fees payable for their prudential supervision.

## **Chapter 13: Australia as a Regional Financial Centre**

*Recommendation 13.1:* The Inquiry should strongly recommend to the Government that the removal of financial transaction taxes and the overhaul of other taxation measures are urgently required if Australia is not to lose the opportunity to establish itself as a regional financial services centre.

## **Chapter 14: Role of the Reserve Bank**

*Recommendation 14.1:* The Government should act as quickly as practicable to ensure that the Reserve Bank competes on an equal basis with commercial banks.

*Recommendation 14.2:* All banker to government services should be put out to tender.

*Recommendation 14.3:* The Reserve Bank should retain responsibility for both monetary policy and the prudential supervision of banks (and other deposit-taking institutions).