Chapter 2

THE CONTEXT FOR THE INQUIRY - WHAT IS AT STAKE

2.1 The Importance of the Inquiry

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

The reform agenda being pursued by the Government has several broad philosophical underpinnings[1]:

- "that people, and businesses, know better than government what is in their best interests;
- that saving and investment, that income and wealth creation, that choice and competition, and free and fair trading, are essential to a vibrant, growing economy, and rising living standards."

The Financial System Inquiry is a crucial part of this broad reform agenda and is central to the achievement of these objectives. This arises because an efficient and stable financial system is:

- central to the workings of a healthy economy;
- critical in facilitating the achievement of the personal goals of individual Australians;
- critical for Australian businesses to continue to flourish; and
- a core ingredient in the larger goal of achieving international competitiveness for the Australian economy as a whole and for the hundreds of thousands 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 on the achievement of the three key objectives set for the Committee, namely that:

- the efficiency of the financial system continues to be enhanced, including through greater competitiveness;
- the stability and integrity of the financial system is maintained; and
- regulatory arrangements are able to respond flexibly to emerging trends in the industry.

---

[1] *Financial System Inquiry*, Senator Jim Short, Assistant Treasurer, AIMA Investment Management Conference, 20 May 1996

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

2.2 The Importance of an Efficient Financial System

Greater financial system efficiency is critical to the growth and development of a competitive Australian-based financial services industry in an increasingly global marketplace. In turn, enhanced efficiency will directly contribute to overall international competitiveness by lowering the relative cost of financial services for all Australian enterprises.

2.2.1 Financial system's role in the economy

The financial system plays a vital role in the economy by:

- facilitating the settlement of payments for goods and services exchanged between individuals, companies and government;
- intermediating between those with funds to invest and those with requirements for funds; and
- managing risk on behalf of individuals and businesses such as through insurance, treasury risk management services and investment management.

While the risk intermediation role is important, it is the efficient provision of the payments and intermediation functions that are integral to a healthy and growing economy. Consequently, these are singled out for some preliminary remarks.

Facilitating value exchange

A critical role played by the financial system in fostering Australia's long term economic growth and prosperity is through the efficient provision of the nation's value exchange system - commonly referred to as the payments system[2].

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[3]. 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 carried out by licensed banks[4]. Looked at another way, Australia's broad money supply is approximately $350 billion and around a third of this is transferred between the banks every day. On a global basis, the value passing through payments and settlement systems daily adds up to some US $6 trillion.

Consumers, businesses, and governments, and hence the economy, are totally dependent on this exchange of value occurring efficiently, accurately, irrevocably and in a timely manner.

---

[2] The payments system is the mechanism by which individuals, businesses and governments are assisted to meet their monetary obligation to others. The mechanism is mostly about the processing of instructions to make payments and the related transfer of value.

[3] Australian Payments System Council and RBA. The figures exclude the settlement of intrabank, Austraclear and RITS transactions.

[4] Building society and credit union Special Service Providers also carry out some settlement activities but on a much smaller scale than the banks.

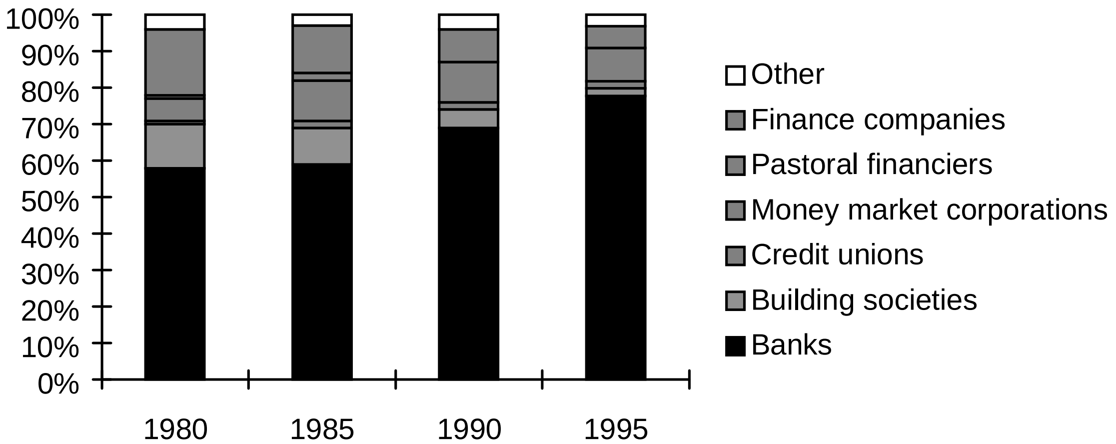
Intermediation between suppliers and users of funds

The importance of an efficient financial system is also emphasised by the relatively high level of involvement of financial institutions in the flow and management of financial assets in the Australian economy. Approximately 65% of the $1,461 billion of total financial assets in the economy are held in financial institutions, which is high by international standards[5]. The remaining 35% of financial assets are **directly** held by individuals or non-financial institutions, mainly in the form of equities, and government or corporate debt securities.

The intermediation function[6] of the financial sector, through which funds are made available to individuals and enterprises, is crucial to economic progress and to the creation of wealth in society. This transfer from suppliers to users of funds occurs principally through **direct intermediaries**[7], namely those involved in borrowing and lending. Direct intermediaries account for over 65% of the total assets of all financial institutions[8].

Of the direct intermediaries, banks play the major role, accounting for some 77% of **directly intermediated** assets. While banks, in total, have increased their share following deregulation, rising from 58% of directly intermediated assets in 1980, most of this growth has resulted from conversion or absorption of non-bank financial intermediaries. The growth and share of these assets across different **direct intermediaries** is shown in Figure 2.1.

Figure 2.1
ASSETS OF DIRECT INTERMEDIARIES (% SHARE OF TOTAL)



Note: Only assets held by the intermediary itself are included, eg. assets of banks do not include assets of their non-banking subsidiaries.

Source: RBA Bulletins.

5 Equivalent level in the US is approximately 57% of total financial assets
6 Intermediation involves the management of the mismatch associated with the different time horizons, risk preferences and size of savers and borrowers.
7 Direct intermediaries are those institutions whose core functions involve borrowing and lending. This sector excludes life insurance and superannuation funds along with other managed funds, including such activities carried out by banks.
8 RBA Bulletins

While the role of financial institutions in the provision of housing and personal finance is important, perhaps even more so is the role played in providing finance to business. Banks again play a critical role, providing $155 billion, or 30% of all funds borrowed by businesses. In particular, they are by far the most important providers of finance to small and medium business and to the rural sector. Banks lend about $50 billion to small business (over 80% of the total)[9] and about $13 billion to the rural sector (over 70% of its requirements)[10]. Lending to the rural sector by the four major banks alone increased from 40% to 58% of total rural sector lending between 1983 and 1995, demonstrating how the major banks have filled the void created by the exit from rural lending of less committed lenders.

2.2.2 Financial sector's importance in its own right

The sheer size and importance of the financial sector in its own right is best illustrated by the economic dimensions of the sector, as summarised in Figure 2.2. The sector directly accounts for over 4% of Australia's GDP, and employs in excess of 300,000 people, or around one in every 26 Australians in the work-force. As at December 1995, assets held in Australia by financial institutions totalled $956 billion[11], equivalent to over twice Australia's total GDP.

In its own right, the financial sector, is of vital importance to the overall health of the Australian economy.

Figure 2.2
FINANCIAL SECTOR ECONOMICS

- Assets of over $900 billion, growing at 6% p.a. since 1990;
- Revenues of approx $30 billion, growing at 5.5% p.a., since 1990;
- Operating costs around $19 billion, growing at less than 5% p.a. since 1990;
- Profit of over $9 billion[12] pre-tax in 1995;
- Approx 11% return on equity of over $50 billion[13] invested in the industry;
- $3 billion paid annually in company tax and of over $10 billion (excluding PAYE), or 6.5%, of the total annual tax take across all levels of government;[14] and
- Employment provided for 313,000[15] individual Australian workers.

---

9 RBA Bulletin, March 1996
10 ABARE, National Rural Finance Summit, July 1996
11 ABS Financial Accounts 5232.0
12 Not including "profit" generated by mutual life companies of approximately $2.5 billion after tax.
13 Not including capital employed by major mutual life companies such as AMP, NMLA.
14 ABS Australian National Accounts 5204.0
15 ABS Australian National Accounts 5204.0

2.2.3 Potential efficiency gains

The financial sector has undergone considerable restructuring since deregulation resulting in significant efficiency gains and customer benefits through reduced interest margins. For example, the efficiency of major banks, as measured by their cost to income ratio, has improved from 72.9% in 1982 to 61.4% in 1995, a 16% improvement. Customers of the major banks have benefited from a 22% reduction in domestic interest spread, falling from 5.0% in 1980 to 3.9% in 1995.

Major efficiency gains can be expected from continued restructuring of the economy and from regulatory and competition policy reform. Westpac estimates that cost savings of roughly $1 billion per annum would result from an average 5% improvement in operating efficiency across the financial sector. In the retail banking industry alone, a recent McKinsey Global Institute study[16] estimates the gains from achieving international best practice efficiency levels to be in the range $1.8 to $3.6 billion per annum.

As the McKinsey study point out, one important way these efficiency gains can be realised is through mergers. Getting competition policy right is crucial to achieving such benefits. Merger constraints that ignore the real and changing competitive dynamics of the market will increasingly affect the achievement of major efficiency gains through consolidation and rationalisation within the industry. In turn, this will prevent consumers and businesses benefiting from a more efficiently structured financial sector.

2.3 Maintaining Financial System Stability and Integrity

The objectives of stability and integrity derive their importance from the special roles performed by the financial system in storing and managing accumulated wealth and in providing the mechanisms for the exchange of value. While maximising efficiency and facilitating a competitive market which encourages choice and innovation are key objectives for the Inquiry, they must not be pursued at the expense of ensuring the stability and integrity of the financial system.

The payments system involves the provision of deposit accounts, from which funds are withdrawn to make payments and into which funds received from payments are deposited. It is imperative that institutions which are the custodians of these deposits be of the highest quality, as any collapse could result in widespread financial loss to the public at large, with major repercussions for the national economy.

The economic disruption resulting from any loss of confidence in the integrity of banks is likely to be more serious than if other sectors of the financial system were to experience problems. Put more simply, the social and economic costs for the economy as a whole of systemic bank failure are likely to significantly exceed the direct costs borne by depositors, other creditors and shareholders.[17]

---

[16] *Growth Platforms for a Competitive Australia,* McKinsey and Company Australia and the McKinsey Global Institute, 1995, pages 99 - 112

[17] A significant disruption to the payments system or a large scale run on a bank that cannot be met would quickly lead to destabilisation in financial flows and ultimately to a sharp contraction in credit to the whole economy. Such a contraction in credit would be particularly harmful to the business sector which will always remain most reliant on bank finance.

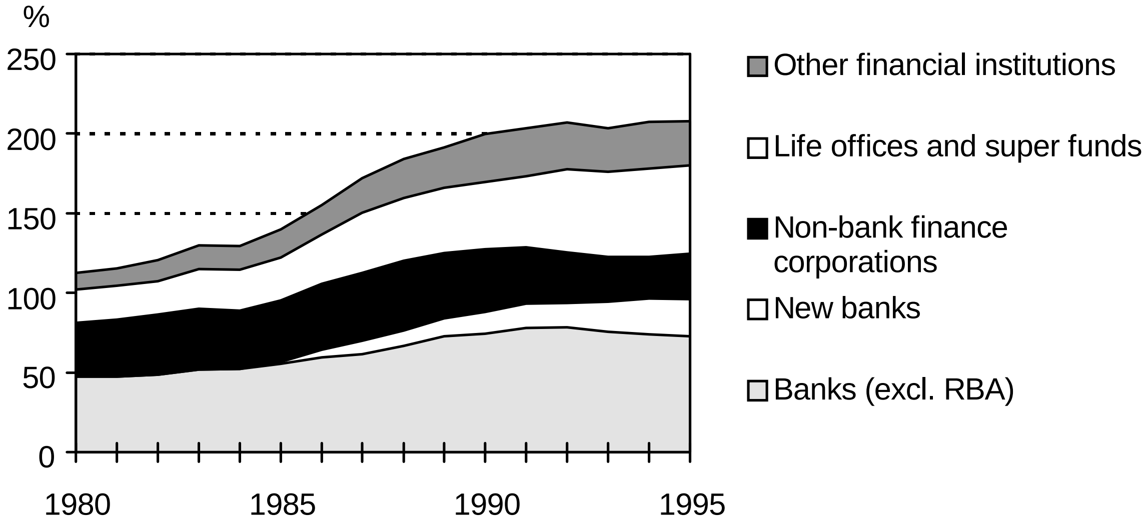
Achieving the delicate balance between enhanced efficiency and competition on the one hand, and stability on the other, however, is a difficult challenge as regulation designed to encourage stability may, if too prescriptive, have adverse effects on efficiency. Achieving this balance is the appropriate key objective for the Inquiry.

2.4 The Need for Flexible Regulatory Arrangements to Encourage Competition, Innovation and Diversity of Choice

The community has much to gain from a flexible regulatory framework that encourages the development and implementation of innovative, resource-efficient ways of providing financial services. The Inquiry faces the challenge of regulatory reform knowing that the financial system of the future will be very different from that of today. Unfortunately, it is difficult to be precise as to how it will develop.

Since the early 1980s, financial system assets have almost doubled in real terms, from 112% to 208% of GDP, with the steepest growth occurring in the post deregulation period of the late 1980s (see Figure 2.3). Continuation of this real growth can be anticipated.

Figure 2.3
TOTAL ASSETS OF FINANCIAL INSTITUTIONS[18]
(AS A % OF GDP)



Source: *The Evolving Structure of the Australian Financial System*, M. Edey & B. Gray, 1996, forthcoming.

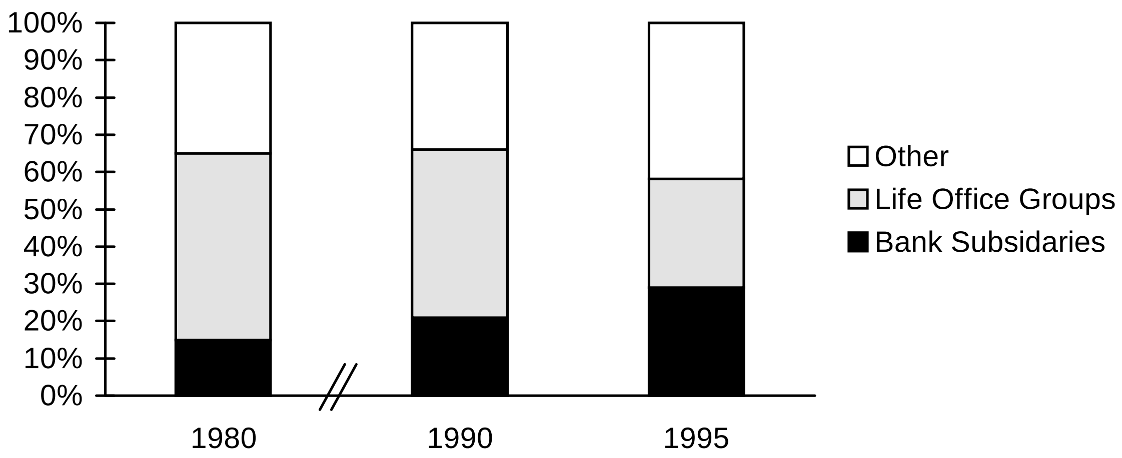
Equally significant has been the change in the composition of this growth and its impact on industry structure.

[18] Assets of financial subsidiaries are included under the appropriate institutional grouping and not under banks. For example, funds management or insurance products offered by banks are included under 'life offices and super funds'.

The greatest growth has occurred in the insurance and funds management sectors, with the assets of life insurance companies, superannuation funds and other institutional fund managers increasing from $26 billion in 1980 to $253 billion in 1995[19], an annual compound growth rate of 16.4%. This growth reflects the high investment returns which were earned by superannuation funds in the late 1980s (which were automatically reinvested) and, to a lesser extent, the increased flow of funds into superannuation, following Government initiatives aimed at encouraging greater private sector savings for retirement.

The insurance and funds management subsidiaries of banks are included in these figures and have been taking an increasing role. The share of bank affiliated funds managers is up from 15% of the assets of fund managers in 1980 to 25% in 1995 (see Figure 2.4).

Figure 2.4
ASSETS OF LIFE OFFICES AND SUPERANNUATION FUNDS
(% SHARE OF TOTAL)



Notes: Represents a breakdown of the life offices and superannuation funds category in Figure 2.3. Figures are as at June and have been estimated according to control by ultimate manager. 1995 figures in banks include State Bank of NSW funds management operations.

Source: "*The Evolving Structure of the Australian Financial System*", M. Edey & B. Gray, 1996, forthcoming and Reserve Bank of Australia.

At the same time, the more traditional activities of banks have also seen strong growth, with assets of bank entities increasing from $57 billion in 1980 to $438 billion in 1995[20], an annual growth rate of 14.6%. Much of this growth, as explained previously, has come from the conversion of money market corporations and building societies into banks.

---

19 RBA Bulletin, Table D5, April 1996

20 RBA Bulletin, Table D5, April 1996. This source is different from the ABS data cited in footnote 10 of this chapter.

Despite the increasing share of net new flows of household savings being channelled into the funds management sector over the last 10 to 15 years, the role of deposit taking institutions, especially that of banks, as providers of safe haven deposits has not diminished. The total value of funds in bank and non-bank deposits was $58.4 billion in 1980 and is $279.6 billion now, representing an annual compound real growth rate of 11.0%.[21] In addition, deposits as a proportion of GDP have also increased over the period, growing from 46.7% to 61.6%.

This demonstrates the community's continuing demand for low risk transaction and short term savings accounts. The fact that long term discretionary savings increasingly may be channelled into superannuation and other managed funds does not detract from the ongoing importance to the community of safe deposit products. As a result, the Inquiry will need to ensure that regulatory arrangements preserve the diversity of choice in the range of investment and savings options available to meet the particular needs of the community, whether for retirement savings or low risk transaction or savings vehicles such as deposits.

The Inquiry will also need to ensure that regulatory arrangements facilitate structural changes that are occurring within the industry. Roughly two thirds of total financial system assets are now controlled by the 30 largest companies, with the majority being primarily banks or insurance companies. In addition, banks and insurance companies are moving beyond their traditional products and into each other's markets. Niche players which do not have their origins in either industry are also increasingly active competitors.

The difficult policy challenge arising from these structural changes, in an increasingly global market, is how to regulate Australian firms that are providing different (or similar) combinations of financial services while ensuring competitive neutrality and institutional flexibility, without compromising soundness and stability objectives. That is, the regulatory framework must provide for both the entry of new players, as well as allowing existing players to adapt flexibly to changing market conditions.

Consequently an adaptable regulatory framework[22] is a pre-requisite if consumers and businesses are to benefit fully from diversity of choice brought about by effective competition between both existing and new competitors.

2.5 The Inquiry's Task

Looked at from the perspective of consumers and business, the Inquiry's task is to deliver regulatory arrangements for the financial system that:

- ensure the efficient provision of financial products and services in a way which best meets the needs of customers, and in doing so benefits shareholders and the economy at large;

---

[21] Occasional Paper number 8 - RBA. Includes all bank and non-bank deposits, including households and businesses. Household deposits in bank and non-bank institutions were $42 billion in 1980 and $202 billion in 1995, a growth rate of 11%

[22] This regulatory framework, however, will need to be framed in a global context. Any notable variance from other OECD countries, could have the potential for Australia to lose valuable business opportunities or even worse, to suffer a loss of international confidence

- encourage competition by minimising barriers to entry in the evolving market, thereby facilitating customer choice among all the various financial services that exist within the financial services industry;

- ensure the stability and integrity of the financial system by maintaining prudential oversight of participants so as to minimise potential systemic risks including to the operation of the payments system and, in turn, to the health of the overall economy; and

- encourage disclosure and the fair treatment of consumers, allowing for freedom of customer choice regarding the riskiness of investments and the return on them, subject to the benefits of disclosure requirements exceeding the costs.

The Inquiry must also ensure that the regulatory framework allows for the balancing of competing aims, such as increased competition and less regulatory intervention on the one hand and the requirement for financial stability and integrity on the other. Similarly, to maintain a healthy and robust financial system capable of evolving and remaining viable in an increasingly global marketplace, there may be times when greater diversity of choice in one sector is not entirely compatible with maximising overall system efficiency.

Future regulation of financial institutions will need to be forward looking to ensure Australia's economies development is not constrained by rigid adherence to overly prescriptive regulation. There also must be a capacity to look beyond sectoral or narrow interests when it comes to intervention in the financial system.

In summary, the Committee has the challenge of designing a regulatory framework which will allow the financial system to perform to its full potential. In a world where change will be constant and where global trends will increasingly promote a more competitive market, the regulatory framework will also need to be conducive to change and innovation. In this way, the success of the Inquiry in promoting the interests of users, and thus a more competitive and stronger Australian economy, will be maximised.