Chapter 14

SOME ASPECTS OF THE RESERVE BANK'S ROLE IN THE FINANCIAL SYSTEM

14.1 Commercial Activities of the Reserve Bank

Issues relating to the Reserve Bank's commercial activities are discussed in detail in the ABA Submission to the Inquiry. It is not proposed, therefore, to undertake a further detailed analysis in this Submission.

In April 1995, the Competition Principles Agreement executed by Australian Governments undertook to introduce a number of nation-wide reforms to competition policy. Included among these was the achievement of:

> "competitive neutrality between government and private business activities".

In June 1996, the Australian Government issued a policy statement on competitive neutrality. This requires competitive neutrality arrangements to apply to designated Commonwealth businesses, including the Reserve Bank. Key issues identified which have a bearing on competitive neutrality include:

- the adoption of appropriate organisational structures, such as corporatisation, for significant business activities. While not explicitly required, corporatisation usually involves the establishment of a separate legal structure;
- taxation neutrality, where this can be achieved in a cost-effective and administratively simple manner;
- debt neutrality, by subjecting organisations to similar borrowing costs to those faced by private sector businesses;
- the requirement that all organisations engaging in significant business activities will be required to earn commercial returns at least sufficient to justify the long-term retention of assets in the business, and to pay commercial dividends (ie. equivalent to the average for the industry) to the government from its commercial activities;
- regulatory neutrality, where appropriate; and
- the need for agencies to meet "appropriate financial targets for specified business activities" so as to ensure that prices charged reflect full cost attribution for these activities.

Having regard for the above criteria, there are several areas of concern relating to the commercial practices of the Reserve Bank, including:

- The Reserve Bank does not provide its commercial services through a separate organisational or legal structure. This limits the scope to assess the extent to which its commercial activities are cross-subsidised by its non-commercial activities.

- It is not known whether the Bank sets “appropriate financial targets”, so as to ensure that its prices are commercially determined, but it is believed to undertake a full costing.

- While the Bank does provide a payment to the Government, this appears to bear no specific relationship to normal returns on capital, nor the tax obligations, which the rest of the banking industry meets.

- The Reserve Bank does not pay FID or BAD tax.

- The Reserve Bank does not have depositors or borrow in commercial markets and thus does not need to pay market rates for funds. This appears to be reflected in cross-subsidisation from its non-commercial income generating activities (eg. exchange rate intervention, note issue) and can be viewed as an implicit subsidy associated with Government ownership.

- The Reserve Bank is not subject to the regulatory requirements which apply to commercial banks, and therefore does not carry the compliance and other costs associated with this. This includes capital requirements, PAR, the 1% NCD requirement, and other such requirements.

Westpac considers that it is fundamental to fair competition that, to the extent possible, the Reserve Bank competes on equal terms with commercial banks. This will require the above concerns to be addressed in a way that satisfactorily puts the Reserve Bank on a competitively neutral footing.

In this regard, the Competitive Neutrality Policy Statement indicates that the Government wishes to introduce competitive neutrality arrangements to various non-Government Business Enterprises, including the Reserve Bank on a progressive basis, according to a timetable to be determined during 1996-1997.

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.**

14.2 Integration of Monetary and Supervision Policy

There are significant reasons why monetary policy and the prudential supervision of banks should remain integrated. This issue arises because of the suggestion that a single regulator might be established with responsibility for prudential supervision and the possibility that this might not be the Reserve Bank. In Westpac’s view, such an outcome:

- would be counter to efficient prudential policy, and thus to economic efficiency and stability;

- may contribute to payments system instability at some future time; and

- would have some impact on the Reserve Bank's ability to discharge its monetary policy responsibilities effectively.

Economic efficiency is critically dependent on financial system integrity. A loss of confidence in banks could lead to a contraction in lending, with adverse consequences for economic growth. It is therefore essential that the Reserve Bank, as lender of last resort to the financial system, should be in a position to respond promptly to a liquidity crisis. This would be difficult if there were a single regulator which was not the Reserve Bank, as the Reserve Bank would need to satisfy itself that the exercise of its lender of last resort responsibilities was justified.

If responsibility for monetary and supervision policy were separated, the Reserve Bank would have to “shadow” regulate financial institutions, thereby raising the overall cost of regulation.

Through the provision of exchange settlement accounts, the Reserve Bank plays an integral part in ensuring that the payments system operates efficiently. Its supervision of banks facilitates this role and many of the prudential requirements banks are required to observe for depositor protection purposes also have important implications for the integrity of the payments system.

Prudential supervision also enhances the discharge of the Reserve Bank's monetary policy responsibilities through financial markets by providing it with a good understanding of the activities of players in those markets, and particularly banks. In a rapidly changing market place, this is of particular importance.

Separation of monetary policy and prudential supervision would therefore both increase the risk that liquidity support would be less timely when needed and risk impairing the discharge of the Reserve Bank's other functions.

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