

September 6, 1996  
Mr Greg Smith  
The Financial System Inquiry  
C/- Treasury Building  
Parkes Place  
Parkes ACT 2600  
Australia

Dear Mr Smith,

Please find attached the submission to the Financial System Inquiry from the Australian Friendly Societies Association.

AFSA is the peak body for Friendly Societies across Australia and represents some 80 Friendly Societies ranging from some very small societies to the very large like IOOF of Victoria.

The submission is divided into two sections:

Policy Approaches, which details our recommendations to the inquiry; and  
Research Report, which analyses the financial system and develops the thought process we went through in developing the Policy Approaches.

We are keen to assist the inquiry and if you require any further information or clarification do not hesitate to call.

Yours sincerely

Martyn Pickersgill  
**Executive Director**

**Friendly Societies**  
**FOR ALL OF US**

**Australian Friendly Societies Association**  
**Submission to the**  
**Financial Systems Inquiry**

**POLICY APPROACHES**

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## **GLOSSARY**

ACCC.....	Australian Competition and Consumer Commission
AFIC .....	Australian Financial Institutions Commission
AFSA .....	Australian Friendly Society Association
ASC.....	Australian Securities Commission
ASX .....	Australian Stock Exchange
ATO .....	Australian Taxation Office
CFS .....	Council of Financial Supervisors
DTI.....	Deposit Taking Institution
FIC .....	AFSA proposed Financial Institutions Commission
FS.....	Friendly Society
FSI.....	Financial Systems Inquiry
ISC .....	Insurance and Superannuation Commission
LISA.....	Life, Investment and Superannuation Association
RBA .....	Reserve Bank of Australia
SSA.....	State Supervisory Authority

## INTRODUCTION

This submission has sought to provide a broad and systemic view of the financial system. With such scope, it becomes easier to identify the interactions within the financial system that lead to the creation of externalities and market failures. Using a neo-classical view, the rationale for any government interest in the financial system stems from the existence of market failure. As history attests, there have been significant market failures within the financial system. This provides an important rationale for government, via the FSI inquiry, to examine the financial system.

After reviewing the classes of institution and the broad product categories this submission has outlined a logical structure to the regulatory overview of the financial system, which seeks to be efficient and yet practical. (There are undoubtedly impediments to developing a purist approach.) The submission has sought an arrangement that groups institutions together on the basis of their historical legacy of supplying the similar type of financial product.

The financial system is primarily a product of its history. This has resulted in a particular focus on the banks, with a secondary focus on other parts of the system. Since the de-regulatory period sparked by the Campbell Inquiry, there has been a tendency for greater national integration of the financial system, development of multi-product financial conglomerates and an increased rate of change. The late 1980's also saw some significant weaknesses emerge in financial institutions despite the existing prudential framework. Projecting these developments forward raises the serious possibility of increased risk to the financial system growing inefficiencies from impediments such as the lack of uniform national management for some classes of institution such as Friendly Societies.

It is necessary, therefore, to have a 'vision' of an efficiently structured financial system for the future. Such a financial system serves to meet the broad social goals of the community. The most significant issue to be decided here would be the future role of long-term and intermediate term savings vehicles. These vehicles are the products of government policy designed to serve wider social goals, and serve to correct a general myopic perception on the part of economic agents; these vehicles fail to provide enough for retirement.

The detailed and carefully envisaged structure of these vehicles will heavily influence the future shape of the financial system. Provided that there is a good understanding of the financial system's direction, it is possible to examine the management (ie. regulatory) issues associated with the financial industry.

The submission provides a broad indication of the future 'look' of the financial system, and an idea of how it might be regulated efficiently. This leads to a series of policy recommendations. The submission then addresses issues concerning the ensuring of a 'level playing field' - including taxation and the vestiges of regulation. Finally, it examines issues associated with competitive policy, ensuring that the financial players are fairly matched, and that no one group

is receiving an unfair advantage. The level playing field discussion and the competition policy point to some more recommendations that require analysis by the FSI.

Using a football analogy, this submission attempts to explain why the game is being played, and what it should resemble - if it is to properly achieve social goals. The Financial System Inquiry decides the rules for the umpire, then builds the playing field, ensuring that all players attend the right venue and have or not hidden advantages such as a propensity to ignore the rules.

The following diagrams graphically show AFSA's views from an economically pure model to a practical solution, taking into account the complexity of change required to implement the economically pure model.

Table 1 is inserted to classify financial institutions and the products and services they supply.

Table 2 is inserted to detail the various financial institutions and their regulatory framework.

Table 3 is inserted to show the AFSA model for regulation of the financial system.

**Table 3. Financial institution by type of regulator (proposed)**

The institutional type to be covered by each regulator is listed in the following table.

Overall Regulators*
Australian Securities Commission
Australian Stock Exchange
ACCC

\*All institutions are overseen by the above regulators where relevant

Regulator	Market failure concern	Institution
<b>Central Bank</b>	Deposit protection	Building Societies
“	“	Credit Unions
“	“	Banks
“	“	Reporting Bond dealers
“	“	Authorised money market dealers
“	“	Centralised Borrowing authorities
<b>Financial Institutions Commission</b>	Solvency, prudential oversight	Mortgage managers
“	“	Securitisation Cos
“	At least liaison	GiroPost
“	“	Finance companies
“	“	Pastoral finance companies
“	“	General financiers
“	“	Merchant/Investment banks
“	“	Investment companies
“	“	Unit and investment trusts
“	“	Funds managers
“	“	Trustees and trustee companies

“	“	Stockbrokers
“	Liaison role	Actuarial, accounting etc
“	Solvency, prudential oversight	Arbitrators & speculators
“	“	Non-life insurance
“	“	Friendly Societies
“	“	Life insurance
<b>Superannuation Commission</b>	Deposit protection	Superannuation funds and other long term vehicles
<b>ASX</b>	Protecting the stock market & its functioning	Stockbrokers in particular
<b>ASC</b>	Corporate governance and law enforcement	All institutions
<b>ACCC</b>	Market functioning	All institutions

## 1. THE FRIENDLY SOCIETIES: FOR ALL OF US

Friendly Societies have a long tradition of caring for their members, while running a business; and taking a broader interest in the welfare of society at large. Friendly Societies were first formed in the early 1800's by groups of workers as a means of collectively insuring against the vagaries (contingencies) of life such as sickness, death, unemployment, etc. The Societies also provided special assistance to members in unusual and difficult circumstances.

The community has since taken on the lion's share of these responsibilities with the growth of the modern welfare safety net, and this, to some extent, undermined the broad appeal of Friendly Societies. As Australia moves towards the late 1990's, we exist in the most 'economistic' of times. Economic frameworks underpinning the world of work and production have a singular focus on the role of the social welfare-maximising individual and the profit-maximising business enterprise. These in turn are overseen by governments increasingly keen to reduce the public sector role. The impression one gains of the economy as a whole is of businesses concentrating on purely business-related activities, with all other matters left to the individual or the state. The sterility of characterisation will have a damaging impact on the options for improving the quality of our society and thereby the quality of people's lives.

By contrast, the Friendly Societies have been successful as businesses that seek to maximise the social benefit of their members (customers), while pursuing reasonable profit (or surplus). The mere existence of the societies serves as proof that businesses can be simultaneously profitable and socially responsible. In these qualities they may be mutually self-reinforcing. The existence of the societies and the wide variety of other institutions in the financial markets (and elsewhere) serve as a reminder that there is more to business than making a dollar.

A sound analysis of the financial system and its functions, therefore, needs to identify the context of that system within the broader landscape of modern society. As Beveridge states: "it is impossible to make a good society in Britain or anywhere else, by a simple combination of state action and the pursuit by the individual of his individual interests, ... a third type of action is needed. You need state action; you need pursuit by the individual of his personal interests; and you need voluntary action; social progress to improve not only your own conditions but the society in which you live. Voluntary action means action not controlled or directed by the state means in effect, a private enterprise for social progress". (Lord Beveridge, Speech to the House of Lords, 22 June 1949<sup>1</sup>) Ironically, Lord Beveridge had recommended that Friendly Societies play a significant part in the provision of the British social safety net - an option not taken by the Government of the day.

Yarrow et al<sup>2</sup> noted that Friendly Societies have broad appeal. They reflect libertarian values of self-help, individual responsibility and voluntary action, while their co-operative structure appeals to those who see the importance of collective response and social solidarity. According

to Yarrow *et al*, the nineteenth and early twentieth century saw millions of people in the UK making use of Friendly Societies.

In recent years, the universal social safety net (via welfare payments) has come under increasing strain as the public sector sought to align revenues and outlays. The Friendly Societies, however, have contributed to reducing the burden on the public purse by providing a means by which those who choose can self-insure. This contribution has removed the burden from the public sector, freeing resources to go to more needy causes. This positive externality, resulting from the d

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<sup>1</sup>. Cited in Yarrow, G. and Lawton Smith, H. (1993:1)

<sup>2</sup> Yarrow et al (1993:1)

of individuals to provide for their own future without impost on the state, still has a role in modern society. According to the economic theory which underpins modern policy analysis, such positive externalities should be encouraged by the government to the point where the marginal cost equates with the marginal benefit. It remains to be seen if there is a practical means of realising the theoretical benefits behind such externalities.

Were such theoretical implications to be implemented, the Friendly Societies would expand their activities while strengthening their complementary contribution to the existing social welfare system. By definition, this allows government resources to be re-allocated to lower income groups in the social welfare system. Ideas would need considerable exploration at a practical level, but discussing them in a theoretical manner does reveal the powerful interaction between the financial system and the social welfare system.

Savings at any level form a significant part of the financial system, and any measures to do with the social safety net may have significant spillover implications (savings vehicles) for the financial system. Design of the financial system, its regulation, taxation and management should take into account the role and function of savings vehicles in the social safety net, and those institutions that play a significant role in linking the two systems. Some savings vehicles may have cross-effects where they generate positive externalities in the social security system but at the cost of 'distortions' in the financial system. Such benefits and costs need to be traded off 'at the margin'. Friendly Societies played a significant historical role in this area, which modern economic analysis suggests will continue into the future.

## 2. FRIENDLY SOCIETIES: THE BACKGROUND

Australia's Friendly Societies<sup>3</sup> presently have a membership base of 1.2 million people and assets worth nearly \$10 billion. During 1995/96, they approximately \$180, 000, 000 in taxes. More than three quarters of their members are aged over 50 years. During the last ten years, the Friendly Societies grown substantially; primarily through the investment management product known as Friendly Society bonds. The Societies operate as mutuals controlled by members. The range of products is indicated below.

### Description of Products

Their traditional areas of service provision for Friendly Societies have been in the following categories:

- Sickness/Death/Disability/Accident Benefits
- Education benefits
- Unemployment benefits
- Funeral Benefits
- Assurance (Endowment etc.)
- Health Insurance Funds
- Flexible Assurance
- Approved Deposit Funds
- Permanent Building Societies
- Pension schemes

Friendly Societies also provide services such as retirement villages, residential mortgage loans, commercial mortgage loans, cash card facilities, interest-free cheque accounts, financial planning services, and dispensary services.

### What makes a Friendly Society Unique?

Friendly Societies have a unique management structure. The very existence of this management structure is definitive, and only Friendly Societies, as financial institutions, operate under a "Benefit Fund" structure.

Friendly Societies have defined products, where every product is matched by its own specific benefit or investment fund. Each benefit fund has its own account, and manages and owns its assets independently of the other benefit funds operated by the society. The use of such 'firewalls' between benefit funds as a means of providing 'damage control' for any Society. Should one benefit fund get into trouble, the problems are quarantined such that it would be difficult for the problems to spread into other funds and threaten the Friendly Society as a whole. Management is provided by a management fund that draws income from fees levied on the 'benefit' funds in return for management services.

### The distinction between DTI's and Friendly Societies

It is vital to draw a distinction between the funds management activities of Friendly Societies and the deposit-taking activities of banks, building societies and credit unions. Friendly Societies invest funds on a "best endeavours" fiduciary basis. By contrast, building societies and credit unions are financial intermediaries and on-lend money borrowed from depositors. They are obliged to return the original amount deposited, plus interest to the investor.

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<sup>3</sup> AFSA Annual report (1996:6)

However, because Friendly Societies currently offer “capital stable”-type products and allow investors to withdraw funds before maturity, investments in Friendly Societies can look like deposits to the investing public. In reality, Friendly Societies more closely approximate the role provided by Life Insurance companies.

### The Friendly Society Industry Structure and Statistics

Friendly Society Gross Total Assets: Total Distributions by State and Size, as at June 1995

	NSW	VIC	QLD	SA	WA	Total
Total Assets (\$m)	637.5	7952.3	295.6	752.1	85.8	9723.3
Distribution by state (%)	6.6	81.8	3	7.7	0.9	100
FS Distribution by size						
Less than \$10m	6	11	6	1	9	33
\$10m but less than \$100m	3	7	8	3	2	22
\$100m but less than \$1000m	2	4	-	2	-	8
\$1000m and more	-	3	-	-	-	3
Total	11	25	14	6	11	67

Source AFSA Annual Report, 1996.

About 80 - 85% of the industry's assets are managed by Friendly Societies in Victoria. However, there is now a national financial market place and, consequently, the membership of the societies may come from any state, and the assets of the society may be located in any state. The industry is also heavily concentrated in Victoria. The ten largest societies account for 89% of the assets and 78% of the members overall.

Like other state-based financial institutions, Friendly Societies have reacted to the changed financial environment by diversifying their activities - often through subsidiary companies. Some Friendly Societies in Victoria and South Australia engage in financial intermediation. This may be indirectly through ownership/control of, or association with, building societies or credit unions in those states. Many Friendly Societies have also taken on fee-based activities through subsidiaries, including investment and retirement advisory services, travel and insurance services.

### **Contribution to the Community<sup>4</sup>**

Friendly Societies have a long and distinctive history of assisting Australians to protect themselves against the vicissitudes of life. During the mid nineteenth century in Australia, Friendly Societies were teaching Australians the benefits of mutual self help through the pooling of members' resources to provide care times of sickness and retirement. The saving and investing of members' funds was another important goal of the Societies.

Today, with the increasing complexity of life's financial and political fabric, the Friendly Societies continue their quiet but highly effective mission of self help a corollary of this long-standing mission, Friendly Societies contribute over \$2 million annually towards various community activities. These include:

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<sup>4</sup> Source AFSA 1996 Annual Report

<p>Ausfest, Bendigo</p> <p>Aged Accommodation</p> <p>Alcohol Education Program for Youth</p> <p>Ambulance Service Victoria</p> <p>Association for Blind Babies</p> <p>Association for Deaf Children</p> <p>Association for Handicapped Children</p> <p>Apex</p> <p>Adelaide Central Mission</p> <p>Asthma Foundation</p> <p>Australian Sports Medicine Federation (SA Branch)</p> <p>Australia Day Parade Victoria</p> <p>Boatsafe Victoria</p> <p>Bushfire Appeal</p> <p>Cancer Research</p> <p>Anti-Cancer Foundation</p> <p>CANTEEN support for teenage children cancer</p> <p>Catholic Charities Appeal</p> <p>Crippled Children's Centre</p> <p>Childminding</p> <p>Children's Week</p> <p>Children's Ward, Gosford Hospital</p> <p>Children's Hospital, Adelaide</p> <p>Community Health Program</p> <p>Community Nurses</p> <p>Delmar Homes for Infants</p> <p>Diabetes Outreach Australia</p> <p>Drug Arm Queensland</p> <p>Guide Dogs Appeal</p>	<p>Heart Foundation</p> <p>Home Maintenance/Assistance Co-operative</p> <p>Kindergarten Parents Association of Victoria</p> <p>Life. Be In It</p> <p>Motivational Education Programs for Youth</p> <p>Melbourne Moomba Festival</p> <p>Metropolitan Fire Brigade</p> <p>Metropolitan Ambulance Service</p> <p>Neighbourhood Watch</p> <p>Night Rider Buses, Melbourne</p> <p>Operation Paradox</p> <p>Pre-natal video Welcome to Life</p> <p>Parenting videos for parents of school-age children</p> <p>Royal Children's Hospital, Queensland</p> <p>Royal Alexandra Hospital for Children, NSW</p> <p>Royal Children's Hospital, Vic</p> <p>Red Cross</p> <p>Senior Citizens Week</p> <p>SA Wheelchair Basketball Team</p> <p>Street Kids Programs</p> <p>Tunarama Festival</p> <p>Victoria Police Bands</p> <p>Wheelchair Sports</p> <p>Numerous other schools, clubs and kindergartens</p> <p>SIDS research</p> <p>Swinburne University</p> <p>St. Vincent De Paul</p> <p>Sports Arts and Recreation Council Foundation</p> <p>Spastic Centres</p>
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## List of Friendly Societies

<p><b>New South Wales</b>  Grand United Friendly Society  Hibernian Friendly Society  IMB Friendly Society  Independent Order of Oddfellows  Independent Order of Rechabites  Manchester Unity Friendly Society  Newcastle Friendly Society  Protestant Alliance Friendly Society  United Ancient Order of Druids Friendly Society</p> <p><b>South Australia</b>  Friendly Societies Medical Association  Independent Order of Rechabites  IOOF of South Australia  Lifepan-Manchester Unity Friendly Society  Savings and Loans Friendly Society  United Ancient Order of Druids</p>	<p><b>Victoria</b>  Amicable Friendly Society  Australian Friendly Society  Australian Paper Employees Friendly Society  Australian Scholarship Group  Australian Unity  Druids Friendly Society  Foresters Friendly Society  Geelong UFS Dispensary Friendly Society  Grand United Order of Free Gardeners  Heritage Friendly Society  Irish National Foresters  IOOF Australia Group  Independent Order of Rechabites  Lifepan Friendly Society  Melbourne Jewish Friendly Society  Mutual Friendly Society  Norwich Union Friendly Society  Over 50s Friendly Society  Permanent Friendly Society  Stateguard Friendly Society  St Patrick's Friendly Society  Transport Friendly Society  United Dispensaries Friendly Society  Vic &amp; Tas Friendly Society  VPA Friendly Society</p>
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**Queensland**

AIFS  
Ancient Order of Foresters  
AUSDEF  
CPS Friendly Society  
Community Benefits Association  
CUA Members' Benefits Society  
Grand United Friendly Society  
Hibernian Australasian Catholic Benefit  
Friendly Society  
Independent Order of Rechabites  
Manchester Unity Independent Order of  
Oddfellows  
Noosa District Hospital Friendly Society  
Over 50s Friendly Society  
Public Service Family Benefit Society  
Queensland Friendly Societies Pharmacies  
Association  
QPS Friendly Society  
Queensland Teachers Union Health Society  
Total Care Friendly Society of Queensland

**Western Australia**

Ancient Order of Foresters  
Australian Natives Association  
HBF Friendly Society  
Homeowners Friendly Society  
Independent Order of Rechabites  
Independent Order of Oddfellows  
Manchester Unity Friendly Society  
Protestant Alliance Friendly Society  
United Ancient Order of Druids Friendly  
Society  
Victoria Park Friendly Societies Pharmacy

### **Friendly Society: Regulatory Background & Circumstances**

Friendly Societies presently operate under the supervision of different state authorities. Each state has its own Friendly Societies Act. These range from the Act in Western Australia to the 1992 Act in Queensland. As would be expected, standards vary from State to State. From 1 January 1997, it is expected that Friendly Societies will operate under the Friendly Societies Code of the AFIC scheme. This will ensure that legislation and standards are consistently formulated across the States. This does not imply, however, that the codes will be uniformly administered.

### 3. THE FINANCIAL SYSTEM: ROLE AND OBJECTIVES

Society objectives supply the “effectiveness” benchmarks against which the performance of the financial system should be judged. Sound economic analysis derived from a neo-classical economic framework - begins with the assumption that the task is to ‘maximise the welfare of the society’ where welfare refers to the happiness of the community. Thus, an efficient financial system should help maximise the happiness of society; ie. it should further the objectives of society.

Despite some innate complexity, the objectives of society could be summed up as follows:

- To allow individuals to achieve their fullest level of development at the personal level;
- To allow individuals to form communities as they see fit;
- To protect the rights of the individual and of groups from others;
- To provide a democratic political structure;
- To provide the maximum quality of life with the available resources;
- To provide for the maximum economic standard of living given the available resources;
- To protect, develop and sustain the cultural and social fabric of society;
- To protect and sustain the weakest members of the community and other dependent entities; and
- To protect the rights and opportunities of future generations.

From these social objectives, it will be necessary for the FSI to derive a range of performance benchmarks which should be met by an efficient financial system and against which various policy measures, regulations and other government interventions should be evaluated. These performance benchmarks should include at least, the following:

- *ceteris paribus*, the financial system should optimise/maximise competitiveness and performance incentives between and for all participants;
- *ceteris paribus*, the financial system should strike the optimum balance between cooperative and competitive behaviour by participants;
- *ceteris paribus*, the operation of the financial system should not undermine any other social objectives such that a sub-optimal social welfare outcome is recorded;
- *ceteris paribus*, the financial system should operate at a lowest financial cost;
- *ceteris paribus*, the financial ‘game’ should be played on a ‘level playing field’;
- *ceteris paribus*, externalities should be cost-effectively internalised;
- *ceteris paribus*, the security of the whole financial system should be ensured;
- *ceteris paribus*, the interface between the financial system and other components of society and the economy (retirement incomes policy, tax, social safety net etc) should be neo-classically efficient;
- *ceteris paribus*, the regulatory structure should enhance the achievement of the above goals;

These multiple objectives are served by a financial system that emerges from interactions between a broad taxonomy of financial institutions. These financial institutions have evolved to meet the constraints (regulatory and real) of their environments, while seeking to secure the objectives established in their respective charters.<sup>6</sup>

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<sup>5</sup> . We could debate the distinction between effectiveness and efficiency here but for the sake of simplicity we have decided to assume the two words are synonymous

These objectives are fulfilled by the provision of a series of products to the market place. In a perfect market (as defined in economic text books<sup>6</sup>), the objectives are achieved by the operation of the 'invisible hand' without government intervention. In the real financial market place of the 1990's, the 'invisible hand'<sup>7</sup> interferes with the operations of the 'invisible hand'. In other words, while the hand guides resources to the efficient allocation, the elbow is dislodging other efficient allocations. As customers seek out these financial products, in an unregulated or distorted market place, various externalities generated that - generally speaking - result in unwanted transactions<sup>9</sup> which reduce the overall social welfare (by lowering economic output, undermining goals etc).

In order to propose a regulatory framework, we need to understand the specific products which have emerged in the market place to meet customer demand. The nature of the products will provide clues to the likely inefficiencies inherent in the financial system, and which are the rightful target of government intervention.

It should be possible to classify the 'products' of the financial system by their characteristics and the manner in which they compromise or complement the operation of an efficient market place. The system of classification could group products according to their characteristics and whether they generate a similar set of externalities. Products with similar characteristics and externalities may consequently require similar regulatory management.

The products of the financial market will be subject to technological evolution, changes in marketing, contestability, international competition, etc. The system of classification could assist in identifying the impact of trends on the products, the externalities and hence the regulatory framework.

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<sup>6</sup>. Some financial institutions are profit maximisers and some, such as Friendly Societies have a mix of social and financial goals. Even supposedly 'pure' profit maximisers are seldom as single minded as textbooks may convey. Particularly where 'management' has respite from shareholders other objectives such as power and prestige are commonly present.

<sup>7</sup>. See Russell and Wilkinson,

<sup>8</sup>. Thanks to Michael Jacobs for this intuitive and apt metaphor (The Green Economy, 1991)

<sup>9</sup> On the positive side they can result in free lunches and windfall gains for others

## 4. POLICY FRAMEWORK FOR THE FINANCIAL SYSTEM

### 4.1. Financial System Policy Framework

The financial system is such a richly diverse and complex structure that the first task of any policy analysis is to map the basic dynamics and structure using various economic (and other) tools. It is easy enough to state the objective, but harder to achieve it, because a systemic view is required of the operations of the financial system.

In Chapters 1, 2 and 3 of the AFSA Financial Systems Inquiry Research Report we have provided some background on the participants - and where they are likely to behave 'inefficiently' - as well as the key products, and where they are likely to behave inefficiently. As already noted, this provides the rationale for structuring the regulatory framework in a task-oriented and efficient manner. Table 1 (page 8) provides a list of the financial institutions that 'inhabit' the financial system. It indicates the type of 'product' that each institution creates. Table 2 (page 9) cross matches products and regulators. Table 3 (page 10) provides an outline of the proposed regulatory framework, taking account of the need to group institutions by product and to match regulators to groups of institutions.

Concentrating the regulatory framework upon the products of the financial system serves as an economically logical approach to identify the appropriate regulatory structure. The historical reality, however, is that the existing regulatory structure grew out of the problems of the past, and was therefore focused on the financial institutions, primarily the banks, and then the 'non-banks'. This historical legacy may take some considerable time to fade. In the meantime, there is a 'pure' economic argument for focusing regulation on the products in such a manner that the regulators are indifferent to the particular institution. Thus it would be a regulator to manage all deposit-taking products. This approach would be more compatible with a conglomerate style financial institution, but unlikely to be practicable for some considerable time since it requires institutions to manage their funds in the style of a Friendly Society; ie with separate funds for each product. While this approach is more secure, reducing information asymmetries and risk, it is also more costly in management terms. Over time management costs fall, it may become more feasible.

A practical alternative is to group financial institutions by product type and then provide one regulator to oversee each product. When grouping institutions by product type, we imply that they should be grouped by the type of product with which they have been associated on an historical basis, rather than the more recent developments in terms of conglomeration. Thus the central bank looks after banks and other deposit-taking institutions. Basing the classification on a historical focus is appropriate, because it is likely that each institution is dominated by the habits associated with its founding product. Such cultures influence the production function of institutions for many years, providing some continuity in the behavioural responses that regulators are observing. Since most financial institutions still belong to distinct classes it is possible to separate them by product class in order to provide a regulator for each of the main categories of product/institution. Thus the proposed practical approach only requires an evolution in the existing arrangements, to begin to accommodate the move to conglomeration.

In the future, the emerging financial conglomerates (whether small or large) are likely to be more homogenous, and hence will require a greater focus on product, rather than the institution. The Friendly Society structure probably provides some future clues to the appropriate risk management structure of financial conglomerates. Classifying the regulators by product will assist them to move from an institutional focus to product focus, and hence to deal with the fully fledged financial conglomerates they are likely to meet over the coming decade.

The difficulty with this 'economic' approach is that it fails to ask about the 'vision thing'. That is, what does society want to obtain from its financial markets? Economists, the idea of asking about the 'vision' of the financial system is difficult, because it suggests that the existing financial system product is a sub-optimal market outcome. There is a prevailing tendency to see markets as optimal by default, even though this flies in the face of recognised economic theory. Yet clear by logical deduction that if there are market failings, then the eventual outcome is likely to be sub-optimal - to some degree at least - thus opening up opportunity to ask about the 'vision' for the financial system. The presence of market failure reduces the inherent contradiction in economic logic of asking a strategic direction for an industry that is, in essence, a collection of market places.

The prevalence of the invisible elbow<sup>10</sup> in the financial markets suggests some considerable role for government regulation, and hence the need for a combination of an efficient market. Without the 'vision', there is no target against which to aim the regulatory framework. Hence, before creating a regulatory ou the government, the community and the industry need to be satisfied that they know what the industry should look like.

To some extent, Australia's political system has already provided a 'vision'. While most of the system is a product of the free interchange of customers suppliers, certain parts (specifically the long term savings component) is a creation of government policy. This component is receiving an increasing volume funds relative to other sections of the market. In addition, there are also other arrangements, such as Friendly Society/life insurance bonds which seem to creation of government. These products will heavily influence the operations of the industry for decades to come.

#### **4.2. Future Structure of the Financial System**

The Financial System Inquiry terms of reference specifically exclude discussing retirement incomes policy, and yet this policy is fundamental to the future of financial system, the efficiency of the financial system and the method by which we ensure the financial

system remains efficient. For this reason, it is essential that any analysis of the financial system should provide a clear indication of the expected roles of long-term savings products, intermediate term savings products, short term savings products and others.

By revealed preference, it would seem that Australia's political system prefers a financial system that comprises the following products (as discussed in the Australian Financial System Inquiry Research Report):

- The Domestic Payments System
- The International Payments System
- Financial intermediation
- Long term savings system
- Financial system risk reduction and management services
- Non-financial system risk reduction and management services
- Information services
- System management services

All these products, with the exception of the long term savings component and the system management component, are largely market-driven products. The preferences of the community with regard to market-driven products will (or should) be reflected in the respective regulatory arrangements. The system management services are largely uncontroversial, receiving broad support as a necessary component of any financial system.

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<sup>10</sup>. The invisible elbow is explained in the AFSA Financial System Inquiry Research Report as the corollary of the invisible hand. Where there are large externalities there is large invisible elbow offsetting generally speaking efficient resource allocations by the invisible hand with inefficient resource allocation

The long term savings products are relatively new but appear in principle to have wide community/industry/government/specialist support, subject to a range of caveats being satisfied. The principles apparently include:

- the concept of compulsory superannuation is accepted;
- compulsory superannuation is necessary because people will not save sufficiently for retirement;
- the system is funded by government and hence should not provide favourable benefits to those who have high incomes, but the same benefit to all;
- the system should not shuffle savings from other vehicles, but should generate new savings from those who would otherwise not save;
- the system should be secure and extremely reliable,
- the system should not overly distort the financial system;
- there should be competitive neutrality between providers.

These caveats have an impact on how the superannuation system works and how the financial system will respond to the growth of the long-term savings product. This latter implication is crucial for establishing a 'vision' of the financial system. These caveats, as stated, will influence the shape of other financial markets. The caveats are changed, they will also influence the shape of other financial markets. The caveat on reducing benefits to high income earners may well do considerable funds out of super and into other areas. Likewise, for example, the compulsory nature of the superannuation measure may effect low income earners by reducing the discretionary balances they hold in DTI cheque accounts.

The caveats we have identified seem to be broadly accepted. There are others that are more controversial. In particular, the caveat that superannuation for members should have choice

has only recently arrived. Whether it comes to be accepted is yet to be determined. This caveat could have the effect of redistributing funds from one provider to another. This is acceptable if it is due to competitive forces, but it is not efficient if it's caused by bumps in the level playing field through lack of competitive neutrality. Pursuit of such a caveat should not be considered in isolation, but analysed as part of the overall mix of caveats required for an efficient long term savings system.

When we know what caveats will guide the long term savings system, we can then describe the resulting financial system. These caveats are still being determined and may not be known for some time. To devise a basic outline of the long term savings system, we will assume that the basic premise of the system is compulsory superannuation vehicles seeking to capture the funds acquired compulsorily from all income earners. The tax incentive is structured so that the benefits are distributed between all income earners, irrespective of income levels.

Using the above superannuation model, we can pin down two parts of the financial system. The long term savings vehicles are at one end and the short term deposit taking institutions are at the other. The tax-advantaged 10 year bonds are less attractive than superannuation, but occupy a position in the range of savings that falls short of the time duration that is attached to superannuation. While the life and friendly bonds have been moved onto an equivalent basis, there appear to have been little considerations of their overall positioning in the savings system relative to the DTI and the superannuation options. When examined in a continuum, which is graphically shown in Diagram 3, the savings option provided by Friendly Society and life insurance bonds, appear to fit into the gap between superannuation and short term savings. They look as though their advantageous tax status is an attempt to fill a gap in the savings opportunities along the line the Fitzgerald report recommendations, as cited by the Index Group:

Introduce a new type of tax advantaged savings vehicle ‘applicable to a range of life-cycle purposes’ (ie not just retirement income).<sup>11</sup>

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<sup>11</sup> Indecs (1995-234) State of Play 8.

The reality is that the existing situation has emerged by accident. This raises the next key point in any 'vision' of the financial system. What type of savings vehicles should exist in the gap between superannuation and short term savings? Should these vehicles have tax benefits? And if so, in what form? How should they focus on delivering tax benefits to all income groups without becoming a vehicle for tax reduction by high income earners? How does such a system of vehicles cope with the OECD (1994) view that tax incentives cannot raise the savings rate<sup>12</sup>? What should be done about existing vehicles? How should collective investments be treated? Should they be in categories for longer term products or in categories for other products like unit trusts?

It is clear, despite the questions above, that the intermediate term savings category has a definite structure in terms of the 10 year bond arrangement. The existing discrepancy between the life and friendly bonds will be eliminated by July 1997.

This 10 year bond vehicle emerges as the obvious candidate for an intermediate term saving framework, subject to various constraints relating to the need for horizontal and vertical equity. The relationship between this vehicle and others - and, in particular, the tax treatment of savings - in this intermediate category needs careful attention. The tax structure needs to be brought into line with the perceived requirement for a savings vehicle in this area so that there is consistency between the different options. Additionally, the tax structure needs attention where the investment income is taxed in different hands and where the investment vehicles receive a different tax level due to the methods by which expenses are brought to account.

All of these issues are subject to discussion by the Treasury review of the taxation treatment of life insurance and Friendly Society life insurance businesses. To complete this review, the Treasury will need to arrive at a view about the economic value of intermediate term tax advantaged savings vehicles. Similarly, to achieve a vision of the 'efficient' structure of the financial system, the Financial System Inquiry will have to form a view of the role played by intermediate tax-advantaged savings vehicles - as well as the role played by superannuation.

The state of play with respect to the life insurance bonds and the Friendly Society bonds is expected to be determined in a forthcoming review report. The position of the AFSA, supported by the LISA, advocates a dual system. That is those who choose to remain in, or adopt, the 10 year bond under present arrangements can do so. The alternative option available to investors is that the 10 year rule should be replaced by a 20% tax on friendly bond income in the hands of the manager, with policy holders being taxed at their marginal rate, at the point of realisation, with a rebate or imputation credit to avoid double taxation.

Assuming that the AFSA and LISA proposal is adopted, the future shape of the financial system should look like Diagram 4.

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12. Indecs (1995:229) citing the OECD (1994) Taxation and Household Savings Survey

### **4.3. FUTURE REGULATORY FRAMEWORK**

The future regulatory framework of the financial system should be a hybrid system that groups financial institutions according to the type of products they historically used. Each of these groupings is then regulated by one regulator. In the case of institutions regulated by the proposed Financial Institutions Commission (FIC) the need was to cover the non-DTI's, non-Super fund institutions with one regulator to reduce the numbers of regulators.

In the breakdown in the following table, we have allocated each institution against a regulator.

The central bank has been given the responsibility for the deposit-taking institutions which largely cover retail financial intermediation. These institutions represent the core of the financial system, providing the means by which domestic and international payments are made. They also provide retail-level financial intermediation which must be protected against the damaging risk of bank runs. There seems to be little reason to focus only on the banks, when modern technology should facilitate the central bank to provide coverage of the smaller institutions as well. In the light of recent collapses, the cost of intervention would seem small against the benefits of avoiding future collapses by even small deposit-taking institutions.

The central bank also manages monetary policy, and the DTI's have a central role in that process. Additionally, there would appear to be synergies between domestic and international payments system and the deposit-taking institutions oversight role. Finally, the central bank has a major role in monitoring the financial risk reduction service providers for early signs of trouble. This role is shared with the proposed Financial Institutions Commission, and it is envisaged that the regulators would work in partnership.

The ISC has been split into two functions. The superannuation component has been split off to become a separate organisation in recognition of the scale and significance of the task it has to manage. The nature of the risks to superannuation, as well as the public and private investment in its success, warrant the creation of a separate regulatory agency to focus exclusively on this concern. The insurance role is likely to provide a distraction.

Table 3. The Proposed Regulators and Regulated.

Overall Regulators*
Australian Securities Commission
Australian Stock Exchange
ACCC

\*All institutions are overseen by the above regulators where relevant

Regulator	Market failure	Institution
<b>Central Bank</b>	Deposit protection	Building Societies
“	“	Credit Unions
“	“	Banks
“	“	Reporting Bond dealers
“	“	Authorised money market dealers
“	“	Centralised Borrowing authorities
<b>Financial Institutions Commission</b>	Solvency, prudential oversight	Mortgage manager
“	“	Securitisation co's
“	“	GiroPost
“	“	Finance companies
“	“	Pastoral finance companies
“	“	General financiers
“	“	Merchant/Investment banks
“	“	Investment companies
“	“	Unit and investment trusts
“	“	Funds managers
“	“	Trustees and trustee companies
“	“	Stockbrokers
“	Liaison role	Actuarial, accounting etc
“	“	Arbitrators & speculators
“	“	Non-life insurance
“	“	Friendly Societies
“	“	Life insurance

<b>Superannuation Commission</b>	Deposit protection	Superannuation funds and other long term vehicles
<b>ASX</b>	Protecting the stock market & its functioning	Stockbrokers in particular.
<b>ASC</b>	Corporate governance and law enforcement	All institutions
<b>ACCC</b>	Market functioning	All institutions

The insurance component has been proposed to become a part of the Financial Institutions Commission in reflection of the scale of the insurance industry in Australia. The Friendly Societies have been nominated to come under the Financial Institutions Commission, and under Commonwealth legislation, due to a significant scale, strong insurance background and product range. Where Friendly Societies or insurance companies put forward superannuation

products, these will be regulated by the Superannuation Commission. Similarly, if these companies started a bank, it would be regulated by the central bank.

The Financial Institutions Commission is a renamed AFIC under Commonwealth legislation. It has a new focus which is to cover the broad sweep of financial corporations that fall outside of the central bank, insurance and superannuation commissions. This area has information service products, financial risk reduction (insurance products) and wholesale financial intermediation products under its regulatory framework. The organisation has become fully national with no bodies. The financial markets are national and there is no justifiable efficiency gain in duplication at the state level - and potentially some efficiency losses. The adoption of a Commonwealth level regulatory base also facilitates an arms-length relationship between regulator and the regulated. The financial system is the first Australian industry that is truly national, due to the advances in information technology.

The existing arrangements have provided for a Council of Financial Supervisors, where the regulatory bodies should meet to confer on their task. The development of this organisation is welcome, because someone has to take a broad overview. We have suggested that the Council should be chaired by the Treasury because it is not part of the financial institutions family. The Council should not close off the options for regulators to pursue other paths of communication, but it should be a formal alternative for the airing of views about the overall direction of the financial system, and reporting to the relevant ministers. The Council should include among its ranks the ACCC, the ASC and the Australian Stock Exchange (which is a de facto private sector regulator).

It is expected that the roles of the ACCC, ASC and ASX should remain broadly unchanged.

The system has been designed such that regulatory institutions are expected to stray into each other's 'turf', but in a co-ordinated way - with the lead regulator in an industry offering the leadership role in forming multi-regulator teams to review regulated bodies. The multiplicity of regulators are expected to engage in friendly competition to uncover, report on and understand the functioning of the financial system. The multiple regulators provide a means by which bad new routes to the top of the decision-making tree. The competitive nature of the structure should improve the efficiency of what would otherwise be bureaucratic structures with an inbuilt tendency to lag behind real world developments.

It is felt that financial institutions which travel the conglomerate track should be required to put separate and different product lines into different vehicles. This facilitates regulatory oversight, though it should not hamper administration, nor economies of scale or scope. Indeed, the approach is very much in line with the team-based flat structure management style which has become fashionable.

The above scheme represents an ultimate objective for the regulatory framework. It is not likely to be achieved in the short term. The Financial System Inquiry will need to paint a picture of the intended final outcome of the regulatory framework if efforts of different agencies are to be coherently organised directed in pursuit of efficiency.

#### **4.4. COMPETITIVE NEUTRALITY**

In the opening discussion about the future policy framework of the financial system, we noted the issue of tax differences causing similar savings products to produce different outcomes. It is considered essential that an efficient financial system should apply the same regulatory and tax environment to like products irrespective of the originating institution. This ensures that like products will be competitively neutral in the marketplace. Products should not be able to gain an advantage on like products on the basis of regulations, taxation or any other aspect of government policy. This is another reason for Commonwealth legislation to set the standards for the industry. Each state will tend to set slightly different standards and to interpret them differently, when compared with a national body.

The focus of competitive neutrality should be on the products rather than the institutions. Regulating multi-product institutions ensures that similar products in different regulatory environments will have different opportunities in the market place. Regulating the product supports competitive neutrality, while allowing institutions to move as they please through different markets.

Three areas emerge as needing attention in terms of competitive neutrality:

- Taxation approaches to different financial instruments;
- Different regulatory approaches for similar products (eg. Friendly Societies and life companies);
- Different State jurisdictions in regulatory management
- the tendency of co-operative institutions to become banks, suggesting some benefit from banking regulation.

#### **4.5. COMPETITION POLICY**

The task in competition policy is to ensure that the market has sufficient players to prevent monopolistic or monopsonistic practices. This differs from problems dealt with under 'competitive neutrality' which refers to the state of the playing field, and the extent to which the 'playing field' should be allowed to influence the game played by different players. Competition policy takes the playing field for granted and seeks to ensure that all players are competing at the appropriate time.

One of the key debates in this area is the nature of financial institutions and the extent to which they exhibit economies of scale and economies of scope. Settlement of this argument will determine the future of bank mergers. Another area to be covered under competition policy lies in ensuring there is an opportunity for investors to become new players in the financial markets, whether as banks or other institutions. The entry or threat of entry (contestability) is a crucial element in keeping existing players 'up to the mark'.

## 5. POLICY RECOMMENDATIONS

This section provides a series of broad recommendations. This Policy Recommendation section is intended as a summary of the policy recommendations that arisen from a broad analysis of the financial system conducted in the Research Report.

### 5.1. Financial System Structure Policy Recommendations

#### General Policy Recommendations

This section contains recommendations that seek to improve the financial system as a whole.

#### GP1. The Future of Long Term Savings Vehicles: the role of superannuation

The Inquiry should address the issue of the impact of superannuation on the financial system. This should go some way toward clearing the air about efficiencies/inefficiencies caused by the existence of superannuation in its present form. This in turn will assist in reducing future requirements for the government to change the system, beyond those that flow from the inquiry itself.

The Inquiry should also address the perceived financial system inefficiencies flowing from the superannuation system and recommend policy options. In particular the impact of the present framework in moving funds around (the savings of high income earners) without significant value adding for the economy should be rejected. Rather, the administration of the long term savings system should focus on raising funds from the non-saving low income earners, on the empirically based assumption that this is correcting market failure, providing a net gain to overall savings, and hence to the financial system. The resulting superannuation framework can then be optimised to fit efficiently into the savings system. Once this occurs, financial market players will be able to establish their plans for long term development of their businesses, with the comfort of knowing that the plans will not be undone by ad hoc responses to ‘friction’ caused by inefficient, eventually unsustainable arrangements.

#### GP2. The Future of Long Term Savings vehicles: the role of RSA’s

One of the best examples of ‘friction’ is the demand by banks for RSA’s. The inquiry, as part of its brief for identifying the form of an efficient financial system will need to ensure that such proposals are assessed on an economic efficiency basis. The UK experience is not relevant to this debate since the RSA product has been recommended will not be attractive to the superannuation policy holders, vis a vis their existing arrangements. The RSA product is expected to be feasible in terms of developing market interest because of its low rate of return and its late entry to the market place. Consequently the RSA will not attract savings in other areas as is being anticipated, and thus it will have limited influence over the structure of long term savings vehicles.

While the option of RSA's may have some appeal for the banks, what is really required is an efficient long-term solution that provides a working structure of savings options in which all financial institutions can engage on an equal footing. The RSA's are accessible by the Friendly Societies but they are unlikely to be exploited. Intermediate term vehicles are more likely to affect the future shape of the financial system.

### **GP3. The future of intermediate term savings vehicles**

The Inquiry should make a recommendation with respect to the future viability of intermediate term savings vehicles. The role of superannuation is established and is causing a significant impact on the financial system as the flow of funds to super vehicles increases. The existence, or otherwise, of intermediate-term savings vehicle will be a further significant influence over the flow of funds through the financial markets. Such a vehicle must be structured to ensure that it increases net savings (and the quality of savings<sup>13</sup>) at a cost that is less than the benefit, minimises subsidies to high income earners who would have saved anyway and provides a means of locking in of savings for at least a 10 year period. Such a vehicle would have a direct impact on other savings vehicles presently available. A straightforward statement by the Inquiry of the efficiency of this option and its economic viability would allow an increased degree of certainty into future financial market development of savings vehicles.

### **GP4. The role of housing in the financial system**

Housing represents a tax-advantaged savings vehicle. Relative to other vehicles, housing draws excessive quantities of investment funds from Australian savers in excess of what would be expected in an efficient market, because of its tax exempt status. While this may encourage a greater level of saving (in the same manner that superannuation improves the savings rate amongst low income earners), it also distorts the financial system. This reduces the quantity of funds available for other types of investments - and ultimately to other industries, while biasing financial system business to the housing-focused DTI's at the expense of other financial institutions.

The purely economic solution is to tax housing. This is politically so unacceptable that it will never be seriously considered. By contrast, when the financial system is looked at as a whole, the superannuation vehicle and the housing vehicle could be regarded as partly offsetting each other. The financial system needs a suitable compromise solution to the impact of the housing distortion, that takes into account the other distortions/policy creations that exist in the system - which are unlikely to change while the costs of mis-allocation continue to mount.

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<sup>13</sup>. It could be argued that Australia needs 'quality' savings. That is it needs a 'bedrock' of long term, reliable savings that will not disappear, such as government savings are likely to do. In theory a sustainable savings strategy will enable a faster, more sustainable rate of economic growth. The need for a 'bedrock' of sustainable savings is even more important when the highly cyclical nature of the Australian economy is taken into account. Such a 'bedrock' allocation facilitates a government draw down during recessions and slows the growth rate during the subsequent expansion.

#### **GP5. The role of inflation and taxation in distorting savings patterns**

Likewise, a similar permanent response needs to be found for the problem caused by the lack of an inflation-adjusted tax arrangement for deposit income. The problem will undermine the deposit savings vehicle, biasing savers towards short-term credit as a savings option. The interaction between this major saving problem, and the others already described, needs to be unravelled in the context of defining an efficient financial system - given certain political realities.

#### **GP6. The 'hodge-podge' tax and regulatory structures for different savings vehicles**

The Inquiry should examine the broad sweep of tax structures and regulatory structures underpinning all financial products. The inquiry should make recommendations to rationalise these arrangements on a basis consistent with an efficient nationally-based financial system. At the same time, the Inquiry should base its recommendations on the expected 'tax structure' (income tax-based but with modifications), rather than the preferred 'pure' tax structure (expenditure taxes, no savings taxes).

#### **GP7. Access conditions of financial institutions to all product markets & conglomerations**

The trend towards conglomeration in financial markets poses difficulties for regulators. The focus in financial market regulation should be on providing a regulatory regime for similar financial institutions that offer similar financial products.

Thus a 'pure' bank should be paying the same regulatory fee, and facing the same regulatory/tax structure as a bank owned by a life office. This implies that an appropriate corporate vehicle is necessary - and indeed it is recommended that, for risk management purposes, a separate corporate vehicle be established whenever institutions get keen to build a new business around a new product. Thus a bank which wanted to create a Friendly Society product would need to set up or buy a Friendly Society outside its normal corporate structure. Economies of scope and scale should not be compromised since the parent structure contracted to provide consumer database services, for instance, to all of its subsidiary structures.

#### **GP8. A 'vision' for the financial system**

Using the above 'principles', the Inquiry should be able to put forward a view of the likely long-term, efficient structure of the financial system in terms of product categories and broad categories of differing types of institutions. The identification of such a structure should form the focus of the development of a regulatory system.

#### **GP9. Timetable for reform**

The Inquiry will need to specifically state that the management of the financial system is a process not an objective. Proposed reforms will be more likely to emerge rather than have the 'big bang' effect noted in the early 1980's. Thus the Inquiry should prioritise its suggested reforms and provide a realistic timetable which it expects change can/should be achieved.

## **Specific Policy Recommendations Recommendations that specifically relate to Friendly Societies.**

### **SP1. Intermediate term savings vehicle: The future of the 10 year bond**

The Friendly Societies consider the notion of a tax advantageous intermediate term savings vehicle to be an important component of the savings system. Such a vehicle will allow the savings system to develop a more balanced range of structures that meet a range of savings needs. The combined effect of the long intermediate term savings product will be to act as a counterweight to the tax advantages provided to housing. The ten year bond arrangement appears to be a product that will suffice as an intermediate term product. It is necessary that the Inquiry reaches a view on the efficiency of this product - given the commitment held by insurance companies and Friendly Societies.

### **SP2. Long term Savings Vehicles: The Future of RSA's**

The provision of RSA's is not likely to have a significant impact on the financial industry. As a general principle, the product should be available to be offered to all institutions - where they have placed the product under the control of a suitable prudential regime. The prudential regime should be identical for each product type irrespective of the offering institution. The proposed arrangement - whereby each institution relies on its existing regulatory framework to protect deposits - suggests that the RSA will evolve along similar lines, but in violation of competitive neutrality. The same product at different institutions will have different regulatory and hence cost structures, implying that a competitive advantage may be given to some players. The emergence of the RSA requires specific policy proposals/principles with respect to the desired interaction between existing and proposed products, in order to ensure an efficient financial system.

### **SP3. The access of Friendly Societies to providing other products via subsidiaries**

As a general principle, each financial institution should be able to provide any product - subject to an appropriate vehicle being developed that carries the particular product. Under a system where we are regulating by groups of financial institutions that have similar products, it is necessary that institutions wishing to enter the market should set up under the same regulatory framework. Thus banks need to establish a life company to offer life products and building societies would need to establish a Friendly Society to offer Friendly Society products. It ensures that each product is competitively neutral with respect to its regulatory structure. This will maximise competition for the supply of each product opportunity given the regulatory arrangement.

## **5.2. Prudential Regulation Policy**

### **General Policy Recommendations**

#### **GP10. Recommend a competitive multi-regulator model**

The proposed regulatory system comprises three regulators covering three different classes of financial institutions/products. Whilst the FIC is expected to cover a diverse range of institutions this is only because of the impracticality of creating a regulator for each institutional type. The FIC could be seen as a mini-regulator. It is not equivalent because the 'popular' mega-regulator proposal, is likely to be more bureaucratic; it is likely to 'hide' serious policy disputes within its structure rather than bring such issues into the public arena, and is equally likely to be less motivated in performing relative to the proposed competitive regulator system. The proposed system has at least three regulators who compete with each other to be doing their jobs well.

A multiple regulator system provides for a range of regulators as outlined in Table 3 in the executive summary. Each product regulator will tend to overlap areas covered by other product regulators. owing to the conglomerate nature of many financial institutions. Such situations should be co-ordinated by the diffi

regulators amongst themselves. It will also ensure that each regulator seeks the optimal level of information, lest other regulators uncover poor supervision, hindering some spur to competition. Other regulators such as the ASC will examine the industry from their own particular perspectives. The CFS provides a forum for the regulators and for Treasury to look at the financial system as a whole - thus ensuring that systems deficiencies are 'owned' by all regulators including the Treasury.

#### **GP11. Preferred regulatory structure**

The preferred regulatory structure is as follows:

- RBA to supervise all deposit taking institutions;
- Superannuation Commission to supervise all superannuation products - and hence relevant institutions;
- Financial Institutions Commission to supervise all financial institutions (including insurance, excluding deposit-taking institutions under RBA covers absorbing the insurance arm of the ISC);
- AFIC to be absorbed into the Financial Institutions Commission; and
- State based regulators to be replaced by a single Commonwealth regulator.

#### **GP12. Regulators should focus on saving the 'deposits' or equivalent**

The principle governing central bank regulation was to focus on protecting deposits, rather than saving the institution. This minimises the moral hazard associated with regulation designed to safeguard the financial system. This principle should be applied to all institutions covered under the multi-regulator system, respect to the supervision of financial products.

#### **GP13. Regulators should be based around similar institutions/similar products**

It is recommended that future regulators be focused on similar institutions offering a specific class of products. Thus entities that offer deposit products at a low level should be under central bank supervision with respect to those products. This also implies that each class of product should carry its own capital adequacy load, reserves etc. Similarly, the life insurance products of a bank should be offered by an appropriate corporate vehicle supervised by the ISC or relevant regulator. The benefit is that different classes of product should end up on different balance sheets, allowing the regulator to focus on the relevant balance sheet.

If conglomerates place the different products on the same balance sheet, then each regulator will have to take a broader interest in products not under its regulation, in order to safeguard those that are. This is where different regulators would need to establish teams and formal co-ordinating mechanisms increase the costs of regulation for everybody. Such measures would be more administratively difficult, reflecting the greater complexity and information asymmetry of such multi-product balance sheets. By providing some degree of separation, as friendly societies already do, between different classes of product so that they are effectively being offered by different types of financial institution, whilst being owned by the same conglomerate, will reduce risks.

Different products classes which are linked through common ownership structures that provide a cross-over between regulators, will likewise benefit from being scrutinised twice from different perspectives; since regulators will not want to leave their fate to each other. The administrative impact of supervising products linked by ownership reflects the greater complexity, and risks, associated with conglomerates. Such administration costs should be minimised by the formation of combined regulatory teams in appropriate circumstances.

In simple terms, if each regulator focuses on its own class of financial institution and associated products, as well as any other products that threaten to underwrite the products under its supervision, the overlapping competitive nature of the regulatory system should bring forward earlier, rather than later, any problem areas.

#### **GP14. Regulations should be based on Commonwealth legislation and management**

The financial system has evolved under both the State and Commonwealth jurisdictions. In previous decades, financial institutions were limited, at least to some extent, by geography. Recent changes in information technology have lowered the cost of doing business across geographic distances. This means that financial institutions based in one geographic location can reach into, and contest markets, in far off locations. Where different states either have different regulations or apply the same regulations differently, interstate competitors can take advantage of local competitors suffering a regulatory handicap. The local regulators can react to these incursions. These incursions reflect the growing national integration of financial markets caused by development of ever cheaper and better communication/information technology.

Under a regulatory system which allows local variation, it can be expected that competitors will exploit opportunities. Indeed, arbitrating of regulatory systems already common practice for international taxation management. Financial system players are already being handicapped by variations in the regulatory environment between different states, because the system is under the operational control of different entities. The tougher the competition, the greater the likelihood that 'dips and hollows' in the regulatory playing field will be used to win market share, rather than focusing on satisfying customer requirements. The overriding need for competitive neutrality in an efficient system, it is unlikely that the Australian financial system can be efficient unless it has centrally administered regulators. The Friendly Societies want to

be regulated under national legislation by a single national regulator ('one umpire, one rulebook').

The central regulators will need to speak 'with one voice', and provide a consistent interpretation of the rules under which all institutions operate. The central bank regulatory experience has avoided the problems of multiple jurisdictions and its experience needs to be followed for all financial system regulation. A useful metaphor for the existing system lies in the changes required for the NCSC framework. This framework failed, in part, because of the differences between enforcement agencies.

An equivalent would be for each state to create multiple police forces to enforce one set of laws. The reality of law enforcement is that the operational transfer of legislation needs to be agreed by the enforcing body; else confusion will ensue. At present, we have the curious circumstance that companies are managed under a national body while important parts of the financial system are managed at state level. The state enforcement of AFIC based regulation will cause regulatory variation leading to distortions in the financial market. The distortions are likely to cause reduced wealth creation and slower economic growth as economic agents exploit holes in the playing field rather than real economic opportunities.

It is recommended that the Financial Institutions Commission be established to absorb the insurance arm of the ISC in addition to the AFIC bodies. The FIC also absorb the state-based bodies into one, single, Commonwealth regulatory agency, thus bringing it into line with the ASC.

#### **GP15. User-Pays Regulation**

AFSA believes that it is a function of Government to pay for the supervision of the financial system. Experience in "user pays" system to date indicate that bigger payers receive the better "service". User pays can create a distortion and a "protection" mentality, especially when financial institutions have sought change, or convert to another type of institution.

It is to be expected, however, that the Inquiry will recommend user-pays regulation for the entire industry. This development should be welcomed as a means of ensuring the industry is efficient: i.e. costs are matched to outputs. The successful implementation of a user-pays regime requires the following:

- identify the true costs of regulation for each type of regulator;
- establish efficiency benchmarks for the regulator;
- establish an industry-regulator committee to review regulatory imposts;
- establish a regular 'RBA Bulletin' style journal for each regulatory institution in the same manner as already demonstrated by the RBA; and
- divide regulatory costs between the regulated in a 'efficient' manner - probably based on the degree of output from each source, with perhaps a and variable component.

Based on the above principles, we recommend that existing anomalies in the user-pays pricing structure should be eliminated and replaced by an efficient framework.

### **Specific Policy Recommendations Recommendations that specifically relate to Friendly Societies**

#### **SP4. Regulate Friendly Societies under the FIC framework**

It is recommended that Friendly Societies should be regulated by the same body that also regulates insurance companies. Insurance companies and Friendly Societies have the same products and hence are direct competitors. Under existing government intentions, the Friendly Societies will be regulated by the FIC and the insurance companies will be regulated by the ISC. This is likely to lead to regulatory-based distortions in the operation of the insurance market, and a direct example of the type of inefficiencies that the FSI should be correcting. Sellers of like products should have the product regulated by the same regulator.

We recommend that the insurance providers should have their products regulated by the Financial Institutions Commission. The ISC Insurance Division should become part of the FIC. Thus all Friendly Societies would be included under the FIC framework, where they could compete on a level playing field with insurance companies.

If the FIC framework is not adopted, then, whatever the chosen style of regulation, the insurance companies and Friendly Societies should be regulated under the same regulator.

#### **SP5. Regulate Friendly Societies at a Commonwealth level**

The Friendly Societies are presently subjected to different regulatory frameworks in each state-based corner of the national financial market. Under the current scheme, the state-based regulators will be required to apply an identical set of nationally based regulations. This was the same means by which the now-defunct National Companies and Securities Commission worked (or failed to as the case may be). The approach is an intellectually elegant means of achieving uniformity in policy outcomes in a federated state. Unfortunately, it is based on a mistaken premise that identical legislation implies that the enforcement will be identical. It does not logically follow that identical legislation leads to identical enforcement. The identical enforcement can only be provided by a uniform enforcement agency that has one chain of command. Multiple 'command chains' implies multiple standards of enforcement, which implies 'de facto' multiple regulatory frameworks with multiple cost structures reflected in a

very bumpy playing field. Efficiency in the financial sector requires single Commonwealth-based regulators.

#### **SP6. Friendly Societies should be charged user pays fees reflecting the scale of their operations.**

Friendly Societies are presently paying significant user-pays regulatory fees. These fees are significantly above those imposed on other institutions supplying similar products. The setting of fees should reflect the principles previously outlined. In the interests of competitive neutrality it is necessary that user-regulatory fees be harmonised across the sector to reflect the costs of the appropriate regulatory institution if, in fact, the user pays system is adopted.

### **5.3. PRODUCT REGULATION POLICY**

#### **General Policy Recommendations affecting the financial system as a whole**

##### **GPI6. Approach to Consumer Protection Product Regulation in general**

Product regulation for financial products is of crucial importance to maintaining market efficiency. The information asymmetries associated with financial products leads to a natural imbalance between the consumer and producer with respect to understanding of the product. This information asymmetry provides an incentive for product suppliers to compete for customers by using misinformation about product performance. While such an approach is obviously a short-term strategy, it places a competitive financial pressure on all other financial institutions who seek to conduct themselves with probity.

It is in the interests of all 'honest' institutions to ensure a highly informed market, since it prevents misinformation being used to gain market share by 'dishonest' institutions.

The protection of consumers from information asymmetry problems is a necessary part of ensuring an efficient market. Another, and perhaps dominant component is sustaining or increasing the intensity of competition amongst financial service providers. It is clear that there is a 'consumer backlash' against larger financial institutions. The small institutions have not experienced the same level of negative consumer reaction. Rather, the smaller institutions benefited by gaining customers from the larger institutions. This reflects apparent management 'dis-economies' of scale in financial institutions. Tolerating these 'dis-economies' by management can only be due to the absence of effective competition between players at the large end. A first principle of effective consumer protection in financial markets must be to sustain competition. This must also be supplemented by government efforts to improve the efficiency of the market.

Friendly Societies have taken a special interest in the welfare of their customers. The competitive position of Friendly Societies is undermined when mini-product standards are breached. What remains to be discussed is the exact form of such regulations. An optimal disclosure regime would maximise market confidence and therefore output and wealth creation.

In simple terms, high quality product disclosure information is good for market efficiency, competition, the financial system and the economy in general.

The following principles should apply to product disclosure information:

- Ensure effective competition.
- Product information regulations should acknowledge the imbalance of information between consumer and producer in the manner in which regulations are framed. The pressure should be placed on the producer to apply appropriate disclosure standards.
- The standard of disclosure should be a minimum requirement, written in user-friendly language.
- It needs to be simple, succinct and consistent across all financial products reflecting the key parameters, relevant to the consumer, of any financial product.

- Similar financial products should be required to meet the same disclosure requirements - rather than, as presently applies, having to meet a diverse set of different requirements which also serves to confuse customers.
- Product disclosure standards should be regularly tested by the relevant regulator (the ACCC in conjunction with the prudential regulators).
- There should be a funded consumer advisory group regularly convened to oversee the application of the required principles, in conjunction with relevant regulators. The group should prepare an annual report.
- Beyond basic standards the application of consumer protection legislation/measures should be focused on concentrating on those institutions that have a poor record of consumer complaints.
- An index of consumer complaints should be prepared in order to indicate trends in this category, as well as problem areas.
- Consumer protection legislation will need to be rationalised into one national uniform code reflecting the status of the financial sector as a national industry; ie. one where competition takes place across national boundaries.

**GP17. Role of state based consumer credit laws; replace with Commonwealth consumer credit code**

The credit code, which has been developed by careful negotiations between Australian governments, is intended to replace a variety of state-based credit arrangements. The single uniform code is a necessary corollary of having national financial markets. It will reduce consumer confusion, and prevent competition from gaining a regulation-based competitive advantage. The consumer code should be nationally implemented by a national body.

**GP18. Problems with the consumer credit code**

The following problems have been identified with the credit code. They include:

- high cost of implementation for small credit providers;
- overly prescriptive nature of the code;
- interpretative difficulties due to the ambiguous nature of the proposed legislation;
- draconian penalties for breaches of the code;
- likelihood of different interpretations being made by different courts for the same piece of legislation;
- the difficulty of having different legal jurisdictions acknowledging each other's rulings when courts are of similar standing - resulting in different rulings for the same issue in each state and territory - which implies the need for a national legal jurisdiction;
- difficulties with amending the credit code, since eight different states and territories must agree;
- the credit code has no central body tasked with its development and deployment. This ensures that it will not be guided to serve the best interests of any stakeholders.

The proposed solution to the above difficulties is to provide a national body (ACCC) to administer a revamped credit code under national legislation.

#### **GP19. Transfer privacy legislation to the Commonwealth jurisdiction**

Each of the states and territory, as well as the Commonwealth, have enacted privacy legislation. NSW is promising to introduce a new Privacy Bill in 1996. A difficulty for the financial sector is that the different jurisdictions cause administrative difficulties. As for other state based legislative codes the financial sector have to face a range of different approaches causing duplication of effort, 'bumps and hollows' in the level playing field and compliance difficulties. It is suggested that a national approach, which is administered nationally, is required for different jurisdictions.

#### **Specific Policy Recommendations Recommendations that specifically relate to Friendly Societies**

##### **SP7. Approach to product regulation and Friendly Societies**

Friendly Societies recommend the adoption of a national approach to the regulation of product standards in the financial industry. They also support the adoption of a single national body for the implementation of the product regulation. This body should be the ACCC.

##### **SP8. Commonwealth control of privacy legislation**

The Friendly Societies recommend Commonwealth control of privacy legislation, under the oversight of a single national authority.

## 5.4. COMPETITIVE NEUTRALITY

### General Policy Recommendations affecting the financial system as a whole

#### **GP20. Tax structures, in principle, should be the same for like products**

Tax structures are crucial to the costing of financial products. Taxes can also alter the realised return in the hand of the investor. Yet because of an incoherent approach to managing the financial system, similar products can be taxed in different ways under Australia's present arrangements. Clearly taxation arrangements can have a major effect, undermining the competitive neutrality that ought to exist between similar financial products. It should be a clear principal, implemented by the joint efforts of the CFS to ensure that tax distortions between similar products are eliminated.

#### **GP21. Tax structures between different states**

Differing tax structures between different states can also distort the competition between similar products put forward by different institutions. While the circumstance would see all state taxation measures harmonised across Australia, thus ensuring competitive neutrality, this is unlikely in the short to medium term given the emphasis on state sovereignty.

The governing principle in this area should be that state taxation measures should be targeted in such a manner that they do not discriminate between similar products from different institutions. This should not be difficult within a state, but may be more difficult where taxes apply to local products that does not apply to imports. At this point it would seem sensible (in the absence of a coherent national approach) to rely on competition between state jurisdictions to resolve taxation measures that undermine local products. Pressure from the CFS would also be useful in preventing differences in state-based taxes from interfering with competitive neutrality - particularly within a state where taxes may be causing market distortions.

#### **GP22. The methodology of taxing financial products**

The taxing of financial products has evolved on an ad hoc basis. It is obvious that different vehicles are being taxed in different ways, with unknown consequences for the efficiency of the financial system. Taxes can be levied at the time of deposit (superannuation), taxes can be levied when investment income is earned by the manager of the invested funds, taxes can be levied when the interest is passed to the investor or when the capital is returned to the investor, taxes may be levied at all in the case of housing, or subject to an imputation scheme in the case of shares. All of these imposts are acting to distort the flow of funds around the financial system while exacting transaction costs - and shaping the structure of the financial system. The solution to this problem is not necessarily obvious and will require further research. The broad principle is clear: that taxes across all savings vehicles should be non-distorting, or have a net effect of being non-distorting, as best can be judged.

#### **GP23. Regulatory structures in principle should be the same for like products**

Competitive neutrality requires that regulatory structures should also be identical for similar products. This implies that there must be one set of rules enforced by one umpire (one rule)

book, one umpire) if the Australian economy is to have an efficient financial system and economy. This is going to be an emerging trend as the Australian economy becomes more nationally integrated. It will put enormous pressure on the State authorities as their economic jurisdiction is reshaped by the national economic winds of change. This will be a difficult task for Australian governments to face. The FSI will have to lead the way in this matter.

#### **GP24. Regulatory and tax structures, for like products, should be the same throughout Australia**

Regulatory and tax structures provide critical 'infrastructure' too support the level playing field. While it is clear that they should be the same for similar products it is also clear that they should be the same across Australia for similar products - if the best economic outcome is to be achieved (a first-best result). If there is an absence of an identical national response, particularly for taxes, the second-best outcome should be identical tax and regulatory structures, where each state chooses their own levels. Thus states would impose the same taxes but choose a level of tax that suits them. This is unlikely to be achievable except over the very long term, though there is nothing wrong with establishing the principle.

**GP25. Tax and regulatory structures should be determined to support an efficiently designed financial system**

The shape of the financial system, the tax arrangements and the regulatory arrangements have all tended to develop in a separate manner. The new structure of the regulatory framework should be able to provide for a more integrated approach to the development of the financial system. This process may not yield benefits for many years but it is hoped that eventually the overall strategic development of the financial sector could be handled with some greater sense of direction.

**GP26. State based taxation of financial institutions should be uniform and nationally based**

As a general principle the taxation of financial institutions by state government should be conducted in a uniform manner such that the method of taxation is identical across the country though level may vary. While this goal is probably the most difficult to achieve under a Federal system, the process needs to start early, so that the benefits can be examined by the Financial System Inquiry inquiry, and the goal of uniform state-based taxation written into the long-term vision for Australia's financial system

**GP27. Commonwealth taxation policy uniform across similar product types**

Likewise, it is clear that Commonwealth taxation should be uniform across similar product types. Given that this issue is at the discretion of the government of the day, it is necessary to ensure that a broad set of principles is outlined to guide government taxation increases.

**GP28. Issues to do with state taxes**

The following lists some key issues revolving around state taxes which should be settled by a uniform state-based approach to taxation.

- the revenue raised by state taxes is relatively small compared with costs associated with collection
- the relevant legislation is complex and requires costly outside advice
- electronic transfer is complicating the taxation process
- different state tax regimes can apply to the same transaction
- lack of uniformity will undermine efficient delivery and processing
- time consuming nature of reforms when applied to seven state/territory tax systems.

While some of the above will be difficult to improve in a Federal structure, they point to some long-term issues that will need to be confronted in the interests of efficiency.

**Specific Policy Recommendations**

**Recommendations that specifically relate to Friendly Societies**

**SP9. Friendly Societies are competitive equivalents of Life insurance companies**

Friendly Societies should be classified principally as being competitors with life insurance companies. Under present arrangements, life insurance companies are regulated by the ISC whilst the Friendly Societies will be regulated by AFIC. This is not likely to create a level playing field between the similar producers of these organisations.

#### **SP10. Friendly Societies & Life insurance companies need the same regulatory framework**

The principle of competitive neutrality requires that Life Insurance companies and Friendly Societies should have the 'same umpire and the same rule book'. It is recommended that Friendly Societies and the Life Insurance companies should come under the same regulator. The first best outcome would be for the Life Insurance companies and the Friendly Societies to be regulated by the proposed FIC. Failing this the Friendly Societies should be regulated by a Commonwealth agency that also regulates the Life Insurance companies.

#### **SP11. Friendly Societies should be taxed in the same framework as Life insurance companies**

Following the previous recommendation, that since Friendly Societies and Life Insurance companies belong to the same class of financial institutions, it is a logical step to ensure that taxation arrangements between the two groups are harmonised. This process has already begun with respect to the taxation of Friendly Society/life bonds. The process should continue, and the Friendly Societies should be included in any discussions about future taxation of the insurance sector. Taxation arrangements are structured to affect like products in a similar manner then taxation will be harmonised by definition.

#### **SP12. Friendly Societies and Life insurance companies should be competing on Australia-wide 'level playing field'**

It is recommended that the Friendly Societies and the Life Insurance Companies should be competing on a 'level playing field' that is nationally based.

#### **SP13. Commonwealth regulator required.**

The level playing field for insurance products of any group, but in particular, Friendly Societies and Life Insurance Companies, should be administered by one Commonwealth regulator.

#### **SP14. Regulatory fees**

Friendly Society fees for regulation should be pro rata on size of the institutional assets, as should those applying to the Life insurance companies.

### **5.5. COMPETITION POLICY RECOMMENDATIONS**

#### **General Policy Recommendations affecting the financial system as a whole**

#### **GP26. The approach to mergers and acquisitions policy**

The Friendly Societies observe that there is a need for greater competition between the larger financial players. The prospect of mergers between large players in the financial system has the following deleterious effects on the efficiency of the financial system:

- Distracts management attention from increasing market share by satisfying customers;
- Provides deeper pockets for merging institutions to buy or influence more market share rather than compete;
- Increases the market power of remaining institutions lessening the need for competitive effort;

- Through reductions in competitive effort mergers lead to reductions in corporate fitness when it comes to competing in international markets - h mergers do not lead to international expansion - they are more likely to mitigate against international expansion.

The price to be paid for these effects will show up in a more costly financial sector, where the cost of output is higher than that which would have prevailed in a fully competitive model. This has effects, amongst others, in reduced investment and lower returns to saving. The existing suite of large players should be maintained. Cross-over mergers between the life offices and the banks should also be prevented. Efforts by each type of institution to create their own ban office should be regarded as healthy developments to force down costs. The inquiry should address this issue since it goes to the heart of efforts to improve efficiency of the financial system.

### **GP27. The role of conglomeration**

Conglomeration is probably an unstoppable trend in the financial markets. To the extent that it deepens competition in the financial markets, it is to be welcomed. The dangers of conglomeration are more likely to be apparent in the regulatory sector. Here it is important that regulators focus on the adequacy with which type of product is protected, taking sufficient interest outside of their designated products to cover other relevant issues, either independently or in conjunction with other regulators. Conglomerates should be required to maintain a degree of separation between products, with specific reserves aligned to every product. The customer information, IT processing and other core functions can be integrated.

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**Friendly Societies**

**FOR ALL OF US**

**Australian Friendly Societies Association  
Submission to the  
Financial System Inquiry**

**Research Report**

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## **Preface**

This research report by the Australian Friendly Societies Association (AFSA) provides a background to the AFSA submission to the Financial Systems Inquiry. The FSI has been set up by the Howard Government to examine the efficiency of Australia's financial system, following the Campbell Inquiry of 1980 (deregulation of the financial system).

Chapters 1 and 2 set up a view of the financial system and its role in a manner consistent with neo-classical economic thinking (otherwise known as "Think"). They also outline the various financial institutions that comprise Australia's financial system - examining in particular where they generate market and externalities.

Chapter 3 identifies the products and the issues of concern in the existing market arrangements.

On the basis of these chapters, the AFSA submission outlines several policy recommendations, which enable a broad systemic approach to the present problems in the Australian financial system. This section represents a simple beginning to identifying the issues and trends relevant in each area. We anticipate that time, this list will expand.

As a result of the analysis in chapters 2 and 3, we have however identified:

- a structure for the financial system,
- the role and structure of the regulatory framework
- locating impediments to the efficient operation of the financial system.

These have been included in the AFSA submission.

Conclusions have been documented in detail within the AFSA submission, and in essence point to the apparent need for an intermediate-term savings vehicle to effect a greater balance between long-term savings strategies (such as superannuation), medium-term savings (such as friendly society bonds) and short-term vehicles (such as bank accounts).

## Chapter 1. The Objectives of the Financial System:

### 1.1. Introduction

Society objectives supply the “effectiveness” benchmarks against which the performance of the financial system should be judged. Sound economic analysis derived from a neo-classical economic framework - begins with the assumption that the task is to ‘maximise the welfare of the society’ where welfare refers to the happiness of the community. Thus, an efficient<sup>14</sup> financial system should help maximise the happiness of society; ie. it should further the objectives of society.

The Financial Systems Inquiry (FSI) has been empowered to investigate the ‘efficiency’ of the financial system -

‘Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system.....’<sup>15</sup>

Efficiency in a neo-classical context implies that the arrangements chosen to regulate the financial system should be in accordance with the broad objectives of society, reflecting societal preferences in the adopted trade-offs between competing goals.

The financial system should be seen as a significant sub-system in the economy, which in turn is a structure for delivering innumerable goods and services to the community, (subject to the requirement that other social goals are met). Where there are competing social objectives that are dependent on the regulatory structure, the FSI will need to find the appropriate balance that gives the maximum expression to social preferences.

Despite some innate complexity, the objectives of society could be summed up as follows:

- To allow individuals to achieve their fullest level of development at the personal level;
- To allow individuals to form communities as they see fit;
- To protect the rights of the individual and of groups from others;
- To provide a democratic political structure;
- To provide the maximum quality of life with the available resources;
- To provide for the maximum economic standard of living given the available resources;
- To protect, develop and sustain the cultural and social fabric of society;
- To protect and sustain the weakest members of the community and other dependent entities; and
- To protect the rights and opportunities of future generations.

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<sup>14</sup>. We could debate the distinction between effectiveness and efficiency here but for the sake of simplicity we have decided to assume the two words are synonymous.

From these social objectives, it will be necessary for the FSI to derive a range of performance benchmarks which should be met by an efficient financial system and against which various policy measures, regulations and other government interventions should be evaluated. These performance benchmarks should include, at least, the following:

- *ceteris paribus*, the financial system should optimise/maximise competitiveness and performance incentives between and for all participants;
- *ceteris paribus*, the financial system should strike the optimum balance between cooperative and competitive behaviour by participants;
- *ceteris paribus*, the operation of the financial system should not undermine any other social objectives such that a sub-optimal social welfare outcome is recorded;
- *ceteris paribus*, the financial system should operate at a lowest financial cost;
- *ceteris paribus*, the financial 'game' should be played on a 'level playing field';
- *ceteris paribus*, externalities should be cost-effectively internalised;
- *ceteris paribus*, the security of the whole financial system should be ensured;
- *ceteris paribus*, the interface between the financial system and other components of society and the economy (retirement incomes policy, tax, social safety net etc) should be neo-classically efficient;
- *ceteris paribus*, the regulatory structure should enhance the achievement of the above goals;

In the next sections of Chapter 1, we briefly examine the significance of the above benchmarks. It should be noted that each benchmark has been qualified by the expression 'ceteris paribus' ('all other things being equal'). The use of this Latin expression is crucial, because in a complex system such as the financial system, there will always be several goals - often competing with each other. Thus, it is not wise to pursue one goal to the exclusion of others, otherwise the overall outcome (in economic shorthand: welfare maximisation) will not be achieved. Each benchmark is qualified in order to ensure that the emphasis is on achieving the right balance.

## 1.2. Optimise Competition

This benchmark implies that the financial system should be structured such that financial markets reflect the maximum amount of competition - subject to the caveat that the goal of maximum efficiency is achieved.

The best example of this is the stock market where the Australian Stock Exchange is owned by the stockbroking firms. The stockbroking firms compete with each other for business, but co-operate sufficiently to ensure that the Stock Exchange provides a viable forum for their business activities. In the context of the financial market, we would expect to see that competition is maximised between brokers for the conduct of the business, with sufficient co-operation to sustain the existence of the Exchange - which after all, is the foundation of the broking market. Competition implies the absence of cartels, monopolies, price fixing, market

power and examples of where businesses may seek to 'rig' markets for their own benefit. Nevertheless, it should be very clear that pursuit of competition should not undermine the ability of the financial system to evolve into more efficient forms as opportunities permit.

### **1.3. Optimal Balance between Competition and Co-operation**

Normally, when markets are discussed, it is in the context of promoting competition. However, some social objectives can be better served (ie. more efficiency) by co-operation between otherwise competing agents. This notion of co-operation is sometimes overlooked in public policy with unfortunate consequences. Establishing the balance between co-operative and competitive behaviours is not a simple task, since it is feasible, for example, for anti-competitive behaviour to be dressed up as efficiency-enhancing co-operation.

Conversely, it would be very easy for an overzealous regulator to deem efficiency-enhancing co-operative behaviour as anti-competitive. The stock exchange is the most prominent example of self-organising and efficiency-enhancing co-operation. The arrangement could feasibly be used to reduce competition (enhance competition, and it would be up to the regulator to ensure that the socially optimal outcome (balance) was achieved. Accelerating trends in the information technology and the need for good information infrastructure may be examples of where enhanced co-operation will be required to set technical benchmarks, such as those used in the computer industry.

### **1.4. Avoid Sub-optimal Social Outcomes**

Many now perceive the pursuit of market-based cost efficiency as synonymous with reducing the level of social amenity. The reality of the neo-classical definition of efficiency in economic terms is that where a sub-optimal social welfare outcome is the result of market practices, the market cannot be efficient. For example, a life insurance company which pursues new business to the detriment of social consequences (such as taking money from clients who have limited means and do not need the product) may increase sales, but undermine other goals such as protecting the weak. This sort of market is by definition inefficient, since it produces negative impacts requiring 'cleaning up', and hence offsetting any benefit achieved by increased sales.

The appropriate approach is - to paraphrase the Salvation Army - 'hard-headed and soft hearted'. Bank closures in rural areas are an example of where pressures would seem to indicate the need for branch reduction, yet the social consequences appear to be significant. An alternative approach may be bank operating to provide a service centre staffed by a representative of each bank, thus achieving banks' cost-reduction goals - yet meeting important societal goals such as the need for face-to-face service, provision of jobs, etc).

As a corollary, efforts to regulate the financial system must consider the explicit tradeoffs between social and other objectives and thereby recommend changes to strike the optimal balance between profit margins and serving the community at large.

In answer to the question whether businesses have social responsibilities, neo-classical analysis must respond with an emphatic yes. In a recent magazine editrix Company Director, American social researcher Madelyn Hochstein was quoted as saying that “business does not feel that the issue of picking up the slack responsibility.”<sup>16</sup> Such a view suggests that the only constraint on business is ‘black letter’ law. Self-serving arguments such as these ignore the negative welfare outcomes of businesses which take actions conflicting with social preferences. What is gained in output growth or lower costs could be offset by reductions in social welfare<sup>17</sup>. In the same manner that charities should never pursue their social work to the detriment of their financial accountability, so should financial institutions pursue financial performance while remaining cognisant of social impacts and responsibilities. It is neo-classically inefficient for business to “take care” of business while ignoring all ‘social’ preferences.

In some circumstances, the industry regulator may be required to establish the acceptable social mores or norms to which the relevant industry should adhere. Present trends that confine regulators solely to ‘market outcomes’<sup>18</sup> necessitate that governments must legislate the full suite of social standards for an industry. The reality is, however, that society is governed both by laws and less tangible social norms. Social norms cannot be legislated in any practical manner. If these norms are to be effectively achieved/maintained, then they need to be asserted by the industry and its regulator(s).

### **1.5. Operate at Lowest Cost**

Over the years, the financial system has evolved to supply services and goods to customers. In an efficient market place, prices are set at the lowest possible level given a sustainable return on investments. It follows that the financial system should deliver products at a competitive price which allows a risk-adjusted rate of return to invested capital. This should reflect the price of capital as determined in markets with a competitive interaction of demand and supply.

‘Competitive’ implies that the market conforms, as far as practicable, to the standards for well-functioning markets. These signify many buyers and sellers, free entry and exit for new and old market players, good market information and inability for any one participant or group of participants to affect the market price. Such markets exclude the possibility of monopolies, oligopolies or any other distortions. Of course, in some industries, increasing economies of scale preclude the possibility of there being many players. In such circumstances, increasing tendencies towards oligopoly on the grounds of economies of scale would require increasing market intervention by regulators to ensure that market outcomes remained optimal.

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<sup>16</sup>. Quoted in Company Director, July 1996, Vol. 12, No 6, page 15

<sup>17</sup>. It is feasible to believe that output itself may suffer from a single minded focus ‘doing business’ since customers are likely to seek to do business with organisations that reflect their social preferences as well as providing competitively priced services.

<sup>18</sup>. ‘I know that regulators are proposed in a number of these privatized areas but those bodies are generally limited to ensuring market outcomes are achieved.’ Tom Sherman, former head of the National Crime Authority, Speech to the ‘Ethics in the Public Service, Fifth International Conference, Hilton Hotel Brisbane, 5-9 August, 1996.

<sup>19</sup> These standards are laid out in any economics textbook

A classic example is the electricity grid. Any gains in terms of economies of scale may thus be offset by increasing costs resulting from increased regulation, a loss of economic efficiency resulting from enhanced market power and higher barriers to the entry of challengers. Finally, absence of domestic competition may result in poor competitive fitness on the part of the monopoly/oligopoly incumbent(s) making them unable or unwilling to attend to new opportunities internationally or domestically.

The work of Michael Porter in the *Competitive Advantage of Nations*<sup>20</sup> points to the potential of competition to train businesses in becoming more effective market players. Porter dismisses the adage that 'bigger is better' and replaces it with the idea that 'stiff competition is a better training environment'. This may be particularly true of large corporations which have entrenched hierarchical management systems. Such management systems are considered inefficient by modern management experts<sup>21</sup> and hence are likely to find that newly competitive markets are hard work. The management of such corporations can respond in two ways - they can alter the shape of the management pyramid (which is difficult), or they can seek refuge in mergers (to achieve 'deeper' financial reserves) or they can forestall the inevitable decline.

### **1.6. Level the Playing Field**

The expression 'level playing field' became a cliché during the 1980's. Yet the essential value of the level playing field approach is still critical to an efficient financial system. All markets tend to contain a basic infrastructure of regulations which supports the playing of the 'game'. The concept basically suggests that competing players in the same market place should not be afforded differential advantages as a result of being favoured or disfavoured by the regulatory infrastructure. That is, the regulations should be neutral with respect to their impact on the competitiveness of financial institutions. No one player should be able to achieve a competitive advantage as a result of being different from, or operating under, a different regulatory jurisdiction. An efficient market requires that all players in a similar market are equally advantaged, or disadvantaged, by the regulatory infrastructure.

However, the principle of competitive neutrality does not imply that the regulations should level the capacity of players. Rather, it should be ensured that all players, irrespective of their size or capacity, should play by the same rules on the same 'level playing field' for the same game. Equality of opportunity - rather than equality of capacities or outcomes - is the area of emphasis.

This issue may be particularly important in financial markets where players often tend to operate in several different financial markets simultaneously. Thus, a company may operate a life insurance business. The life insurance business should not be able to gain a competitive advantage over 'pure' life insurance companies, or over other companies in the fact that it has a banking parent from a different regulatory regime.

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<sup>20</sup>. Porter, M. (1990), *The Competitive Advantage of Nations*.

<sup>21</sup>. Peters, T. (1987), *Thriving on Chaos*, MacMillan, London.

### **1.7. Internalise Externalities**

Many market places tend to generate externalities which cause negative and positive effects on other variables in the social welfare function of society. If externalities are sourced in transactions that result in costs and benefits being incurred by the other parts of society as the result of dealings between private parties. For instance, insider trading generates information which suggests that the market is not 'level'. This encourages some players to withdraw, reducing economic output. These information externalities can be especially powerful in the financial system.

Another example of a negative information externality is panicking depositors. Once the information about such private transactions gets around, other depositors are forced to act. Where a market generates a positive externality, the society is likely to want more of those transactions to take place. Transactions generate positive externalities should be subsidised by the taxpayer. In the absence of claims for subsidies from financial institutions, it's a safe bet that there are few positive externalities in the sector!

It can be assumed, thus, that we are dealing mainly with the impact of negative externalities where agents not associated with the private transaction suffer losses. In this instance, the appropriate response is to internalise the externality where it is cost-effective to do so. This may take the form of regulating the transactions in order to reduce the negative effects that are involved. An example may be the issuing of 100% home mortgages, which may unduly expose an entire class of informed borrowers to the risk of default. Since information is expensive, it is not infeasible that some borrowers will be unaware of the default risks on 100% mortgages leading to high levels of social distress. The regulatory or other form of the internalisation mechanism will be determined by the particular circumstances. The externality however must be internalised, subject to costs not exceeding benefits, if welfare maximisation is to be achieved.

### **1.8. Ensure System Security**

The 1980's and 1990's have seen a resurgence of interest in freer markets and reduced government intervention. The financial markets, however, are still subject to intense efforts to ensure that the system does not break down, wreaking extended consequences to the 'real' economy. The significance of this system security task has not receded - despite the push for freer markets.

Ideally, an optimal balance should be found between the need to secure the financial system and the dynamic benefits of a free market. It is a fundamental goal of the financial system that security be maintained while minimising any loss of performance incentives for the market players. These system security provisions need to 'co-evolve'<sup>22</sup> with developments in the financial markets in a way that surprises are minimised. The system security framework must have a built-in ability to identify disturbing trends, classify their significance and take timely requisite action. Recent events such as the Barings collapse in 1995 indicate that disruptive changes may arise more quickly than can be coped with by the existing system.

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<sup>22</sup>. Where systems co-evolve it means that the evolution of one party responds to the evolutionary changes in another party and vice versa. Thus wolves attack weaker deer, causing the deer to evolve to be stronger, in turn forcing the wolves to evolve enhanced skills. See Waldron M (1992) Complexity

### **1.9. Efficient interface between the financial system & other sub-systems**

The financial system exists in close relationship with other systems both economic and social. The financial system interacts with the taxation system, various industrial sectors, small-scale businesses, legal systems, political systems, etc. These other systems also contribute to achieving the goal of welfare maximisation. It follows that different systems should not inefficiently impinge on the performance of others. Taxation is a necessary part of the apparatus of a welfare maximising society. Therefore, the interface between the financial system and the taxation system should seek to jointly maximise the welfare output. Within a context that tax must be paid, tax structures should nevertheless not impede nor distort the efficient operation of financial markets.

### **1.10. Regulatory Structure should enhance achievement of the above goals**

The regulatory framework should assist the achievement of the above goals. The regulatory system is a necessary part of achieving maximum benefits from the financial system. The regulatory system serves multiple purposes, ranging from prudential supervision to competition policy. These services are needed to ensure that the system produces an optimal level of output.

In the absence of services, problems concerning monopoly, instability and other undesirable outcomes would surely emerge. **The key issue for the inquiry is to optimise the structure of the regulatory system such that it leads to a net increase in output and adopts a risk-averse approach to the management of the financial system.**

Naturally, it is paramount that the system survive, rather than that it should have maximum ability to explore new but potentially dangerous directions. Conversely, if the pace of change continues, the regulatory structure will need to be able to modify itself in response to changes as they occur.

### **1.11. Financial System Objectives: Conclusion**

These multiple objectives are served by a financial system that emerges from interactions between a broad taxonomy of financial institutions. These financial institutions have evolved to meet the constraints (regulatory and real) of their environments, while seeking to secure the objectives established in their respective charters<sup>23</sup>.

These objectives are fulfilled by the provision of a series of products to the market place. In a perfect market (as defined in economic text books<sup>24</sup>), the objectives are achieved by the operation of the 'invisible hand' without government intervention. In the real financial market place of the 1990's, the 'invisible hand'<sup>25</sup> interferes with the operations of the 'invisible hand'. In other words, while the hand guides resources to the efficient allocation, the elbow is

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<sup>23</sup>. Some financial institutions are profit maximisers and some, such as friendly societies have a mix of social and financial goals. Even supposedly 'pure' profit maximisers are seldom as single minded as textbooks may convey. Particularly where 'management' has respite from shareholders other objectives such as power and prestige are commonly present.

<sup>24</sup>. See Russell and Wilkinson, (1979).

<sup>25</sup> Thanks to Michael Jacobs for this intuitive and apt metaphor (Jacob (1991)) The Green Economy

dislodging other efficient allocations. As customers seek out these financial products, in an unregulated or distorted market place, various externalities generated that - generally speaking - result in unwanted transactions<sup>26</sup> which reduce the overall social welfare (by lowering economic output, undermining goals etc).

In order to propose a regulatory framework, we need to understand the specific products which have emerged in the market place to meet customer demand. nature of the products will provide clues to the likely inefficiencies inherent in the financial system, and which are the rightful target of government intervention

It should be possible to classify the 'products' of the financial system by their characteristics and the manner in which they compromise or complement operation of an efficient market place. The system of classification could group products according to their characteristics and whether they generate a similar of externalities. Products with similar characteristics and externalities may consequently require similar regulatory management.

The products of the financial market will be subject to technological evolution, changes in marketing, contestability, international competition, etc. The system of classification could assist in identifying the impact of trends on the products, the externalities and hence the regulatory framework.

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<sup>26</sup> On the positive side they can result in free lunches and windfall gains for others

## Chapter 2. Financial Institutions and their Products

### 2.1. Introduction

#### Taxonomy of Financial Institutions

In this chapter, we examine each of the broad categories of financial institution in order to understand the nature of the products they supply within the financial market places. In Australia, the financial system appears to consist of the following institutions that provide products to the market place:

- Permanent Building Societies;
- Credit Co-operatives/Unions;
- Authorised Money Market Dealers;
- Finance & Pastoral Finance Companies;
- General Financiers;
- Life Insurance companies;
- Merchant Banks;
- Friendly Societies;
- Banks;
- Investment Companies;
- Unit & investment trusts in general;
- Non-life insurance;
- Pension funds/funds managers;
- The Central Bank/Reserve Bank of Australia (RBA);
- Insurance and Superannuation Commission (ISC);
- Australian Financial Institutions Commission (AFIC);
- Australian Securities Commission (ASC);
- Australian Competition and Consumer Commission (ACCC);
- Council of Financial Supervisors (CFS)
- Stockbrokers;
- Stock exchange;
- Actuarial, accounting, auditing, information providers, and assessors;
- Trustees and trustee companies;
- Mortgage originators;
- Arbitrators/speculators;

- Merchant/Investment Banks/Money Market Corporations.

Some of these institutions may exist solely because of the regulatory environment, and hence externalities. Other institutions exist as a function of demand for or partially internalised services and would exist even within an unregulated market. It is taken for granted that:

- the legal system,
- the taxation system,
- the social security system,
- the retirement system, and

other systems also exert pressure and influence over the manner in which financial marketplaces function. They can enhance or reduce efficiency. For a moment, the following analysis focuses exclusively on each of the financial market players, their products and the associated costs, benefits and risks.

### **Product Benefits/Costs**

This section provides a brief overview of the product types generally associated with such institutions. This indicates the service (benefit) provided to the financial market and/or the community. The costs of the service are also indicated where these diverge from the normal, i.e. appearing to be out of line with expected benefits or generating negative (or positive) externalities.

### **Product Risks and externalities**

#### **Risks can be located at two levels.**

- There are the private risks associated with choices by suppliers and purchasers. This risk is beneficial in the sense that it forces otherwise disinterested parties to contemplate the risks that are taken on by their transactions, and hence forcing them to consider the 'efficiency' of their choices.
- The other risk type, associated with most products to a greater or lesser degree, are the risks due to events outside of the control of one or all parties. Yet, these risks are also controllable, if tackled in a systemic fashion.

For instance, earthquakes are obviously beyond the control of the central bank, but the collapse of financial institutions is not necessarily beyond RBA control. The collapse of financial institutions is, however, beyond the scope of small players to control, although players should seek to factor in such risks (including the efficacy of RBA oversight) when they are costing products. If RBA control is weak, then the costs of production will rise and output will fall.

The risks of financial instability from, say, runs on the banks are caused by the information externalities associated with the service of providing a depositor money. If a product has significant negative, this can lead to serious impacts on other transactions, creating the risks that can only be controlled systemically and not by single agents.

## **2.2. Permanent Building Societies**

### **2.2.1. Product Benefits/Costs**

Established in the 1840's, Building Societies are co-operatively owned and managed by a board elected by their members. The building societies grew out of the same co-operative movement that facilitated the genesis of friendly societies and credit unions<sup>27</sup>.

Building Societies are regulated at the state level. The specific style of the management structure suggests that these organisations have a broader range of interests than simply maximising profit. The societies were formed to lend funds from members and other lenders to housing borrowers. They are effective deposit-taking institutions governed by a co-operative structure. The other types of building societies known as Terminating or Cooperative Housing Societies similarly institutions for lending deposits to home buyers. Star Bowkett Societies are also co-operative societies which lend deposits to home buyers - they operate under a different rule structure - allowing no interest on deposits or loans, and selecting borrowers by ballot. While the building societies have expanded to become 'full' service financial providers, it remains clear that they were formed as deposit-taking institutions, and still largely retain that role.

It is claimed that, relative to banks, building society loan costs are higher in part, because of the different regulatory environment. The building societies presumably want to see this regulatory infrastructure rationalised so that all deposit-taking institutions operate under the same umbrella.

Clearly, financial institutions evolve and are altered. Thus, it is necessary to be careful in classifying institutions for regulatory purposes, because of the tendency to evolve different products at different stages of the lifecycle. For the purposes of this analysis, investment in human capital (resulting from specialisation in a particular business niche) implies that organisations which began commercial life as building societies, for example, are likely to retain that central feature for many years. Indeed, it is unlikely that a profitable activity will be given up, once it is an established part of business culture - owing to the sunk investment, the adverse nature of investment decision-makers, and the difficulties with establishing new lines of business. For this reason, it would seem fair to characterise financial institutions by their primary business activity, which, in the case of building societies, is the taking of deposits.

### **2.2.1. Product Risks and externalities**

The risk profile of building societies should be the same as that of any deposit-taking institution. The only differences in this instance will be due to variations in the character of the borrowers (probably home buyers and personal loans) and the depositors.

## **2.3. Credit Co-operatives/Unions**

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<sup>27</sup> Carew, F. (1989:85) *Fast Money 2*

### **2.3.1. Product Benefits/Costs**

Credit Unions or cooperatives make loans and take deposits from their members. These loans are generally advanced for personal and housing purposes. They are direct competitors with the building societies and banks. Credit unions like building societies have focused their efforts on the retail level. They have explored automatic teller machine (ATM's) technology at a rapid pace. Like building societies, credit unions market themselves as friendlier, more informal and more helpful than the banks. Their management structure is similar to those of the building societies.

### **2.3.2. Product Risks and externalities**

The credit union, much like the building society, must be seen as a deposit-taking institution. As a result, while offering other services, a credit union's risk profile will mainly centre around its core business activity (ie. taking deposits and making loans for specified purposes).

## **2.4. Friendly Societies**

### **2.4.1. Product Benefits/Costs**

As mentioned earlier, the friendly societies emerged during the 1840's along with building societies. Finance writer Edna Carew describes them as being founded by

'groups of workers who made small periodic contributions to a common fund which could be used when needed for funerals, sickness and so on. Friendly societies predate modern social services such as pension schemes and retirement benefits. They were formed on the basis of group interests such as craft or religion. Now friendly societies operating in each State offer benefits such as funeral or sickness insurance, hospital cover and sometimes<sup>28</sup> (sic) retirement benefits through savings and investments.<sup>29</sup>

In essence, friendly societies are co-operative managed insurance companies. The significance of co-operatively managed institutions, relative to shareholder managed institutions is that the organisation can generally be expected to expend less emphasis on profits with a greater emphasis on service. Friendly societies are assisted in this role by their smaller and flatter management structures, relative to those of major companies. A similar analysis applies to building societies

Friendly societies are to the life insurance companies what the building societies/credit cooperatives are to the banks. While it could be argued that friendly societies have moved closer to the role of financial intermediaries via long-term retirement savings devices, it is clear that insurance remains the core business activity. Insurance companies - whether run co-operatively or by the shareholders - while having some element of prudential risk, do not share the character of deposit-taking institutions where a 'run on deposits' can threaten the financial system and the real economy in general. Insurance operations normally reserves that cover their anticipated outgoings. Runs on insurance companies simply imply that the flow of premiums dries up.

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<sup>28</sup>. ASFA report author's note - The use of the word "sometimes" is incorrect. Nowadays friendly societies in each state offer retirement benefits.

<sup>29</sup>. Carew, E. (1988:104) *The Language of Money*. Allen and Unwin. Wellington. London and Boston

## 2.4.2. Product Risks and externalities

The product risks associated with services provided by friendly societies can be characterised in two ways.

- Firstly, there is a risk that the contract will be breached, or that the parties to the contract do not understand it clearly enough.
- Secondly, there is a risk that the friendly society will default on its liabilities.

In either case the damage can be contained to the immediate parties to the contract - with perhaps only a small spillover (externality) into other areas. In a run, the 'fear' spreads to other parties, generating an externality that is very damaging to other transactions.

## 2.5. Mortgage originators

### 2.5.1. Product Benefits/Costs

Mortgage originators service and/or originate loans for housing purposes. They are effectively supplying funds to the housing borrowers. These funds are provided to the mortgage originator from the mortgage manager. The service is effectively a loan product provided to the public at large. The costs of these loans are apparently somewhat less than those of funds supplied by banks. The reasons for these differences are the subject of debate. They may be due to the absence of regulatory constraints that drive up the cost of bank-based deposit institutions; or it could be because the bank margins on housing loans were excessive.

The product provided by mortgage originators is a loan which, at first glance at least, would suggest that the institution could qualify as a deposit-taking institution. The institution, however, does not source its funds directly from depositors from the mortgage manager. This poses a different type of risk.

### 2.5.2. Product Risks

Mortgage originator-based loans do not have the same risk profile as loans directly tied to deposit-taking institutions. Loans to mortgage originators are wholesale funds, therefore the risk of recall is different. It is clear that the prudential supervision of deposits will not be relevant to this particular institution or products. Indeed, it is more likely in this instance that the risks flow in the reverse direction. Major default on mortgages (collapse in the housing market leading to UK-style default problems) could threaten the mortgage originator, and in turn the mortgage manager.

## 2.6. Mortgage Managers

### 2.6.1. Product Benefits/Costs

Mortgage managers bring together a wholesale supplier of funds on the one hand with a mortgage originator on the other. The mortgage manager takes a commission on the transaction business generated. The mortgage manager is effectively a business that lives on its deals. Its service is to provide an entrepreneurial bringing together of deals that wouldn't otherwise exist. Its benefit is the ability to arbitrage markets, gain new business, and force down prices.

## **2.6.2. Product Risks and externalities**

If the manager 'goes under' either through problems in the managerial company, or through a flow back from mortgage defaults, the impacts could be confined to the immediate clients of the manager. Presumably, the manager could be replaced by a joint agreement between the originator and the wholesale funds supplier. The only caveat to this would be the risk that default problems in one originator would flow back through the manager and be seen to affect other originators serviced by the same manager.

This may be a significant risk, if all originators are bundled into the same wholesale funds market portfolio. If each originator is separately identified, the risks of default crisis spreading to other players is limited. Separated originators also act to ensure that neither the originator and/or the manager can disguise a bad batch of defaulting mortgages among good bundles from different originators. This serves as a discipline for the mortgage originators and managers. In the event that a default problem develops, the ultimate risk problem will be borne by the supplier of wholesale funds.

## **2.7. Securitisation companies/wholesale fund suppliers**

### **2.7.1. Product Benefits/Costs**

The securitisation company can take individual mortgages (or groups of mortgages) and bundle them up for sale or security against funds supplied by wholesale fund suppliers. The securitisation company supplies an investment product as their basic service. The benefit to the financial markets is that a formerly illiquid commodity is rendered into a liquid product which can be more easily sold and priced. The risks to the securitisation company depend upon the contract governing the relationship between securitisers and the wholesale fund suppliers. Where the securitiser still has some responsibility or connection, it will bear a portion of the risk. Otherwise, all the risk passes completely to the wholesale funds supplier.

The wholesale funds supplier - whether it is a trust, superannuation fund or any other vehicle for delivering large scale investments - is, in essence, a lender of investment funds. This product is as vulnerable to the issue of default as any other lender. The difficulty is that the wholesale fund supplier must rely on the judgements of the intervening agents with respect to the quality of the underlying assets (and the management of those assets).

There are two ways of looking at this. The system could be seen as the ultimate flat management structure where the small size of each component is highlighted and focused on its particular task - and hence more effective. Alternatively, the chain of management, based on a series of contracts between the parties and the management of each group, is only as strong as its weakest link.

The prime skill thus becomes the monitoring and development of loan portfolios. This skill has been developed over a long period by other housing lenders and institutions. The emphasis on loan monitoring, and the requisite depth of skills, may not be adequate in this circumstance where relatively inexperienced players are involved. This suggests that the risk for wholesale fund managers is higher than for comparable organisations such as building societies. They should

getting a premium on their funds for this risk which (all other things being equal) should result in somewhat higher interest rates for home borrowers using service - relative to what would have existed in an efficient market.

### **2.7.2. Product Risks**

The suppliers of wholesale funds to the mortgage originators and managers have the most to lose from the problems in defaulting mortgage bundles. Security will also be lost if they are still connected to the products they created. These are normal risks run by commercial operators. The primary danger lies in the risk of loan defaults spreading beyond the original contracting parties to become a systemic or near systemic problem.

The wholesale fund suppliers are at risk in this regard only if they have become too exposed to one particular product. Diversification is the best defence here. Limits on the amount of funding committed to housing. Wholesale fund suppliers, faced with a major loan problem, could face a risk of clients' loss of confidence and withdrawing money. This is more controllable than a public run on a bank, but the risks are there, nonetheless. The withdrawal of money will require a rapid sell-off of assets where it was retail or even other wholesale funds managers withdrawing support. Where it's a case of superannuation members exercising choice, this may be more difficult, although the rules that slow down withdrawals will give management some time to stabilise the situation to make it worse in the absence of sufficient outside scrutiny).

From this discussion, it would seem that there are some systemic risks associated with the supply of wholesale money to the mortgage market.

## **2.8. Banks**

### **2.8.1. Product Benefits/Costs**

The banks form the original linchpin of the modern financial system. Their services as deposit-takers are well known. In the past, banks used to issue their own currency as well. Through the multiplier mechanism of deposit-taking activities, they have been central to money creation, even in the absence of powers to issue their own currency.

In addition, the banks have provided the core components of the payment systems through cheque-clearing and other services. For this reason, the banks have been the central focus of regulatory efforts. Other institutions have since joined their ranks as deposit-taking institutions and have become capable of providing payment system services. It is also clear that there should be a continuing pathway by which new institutions can be formed and develop into banks.

### **2.8.2. Product Risks**

The product risks of associated with banking services take two key forms:

- the risk of depositors creating a run on a bank that is perceived to be failing; and

- the risk of a bank failing to meet its payment system responsibilities.

These prime risks are significant because they create self-sustaining information externalities. If a small group of people fear for their deposits (lifetime savings in the case of superannuation funds) and are able to take action to withdraw those funds, they are likely to do so. This private transaction affects other people who are influenced to do the same - producing a 'crowd' effect. This further impacts on all other parties who have dealings with the bank. In the absence of information to the contrary, the existence of such a negative externality forces people to recover their deposits before the 'supply' runs dry. The payments system implies that a bank is unable to meet its obligations to other banks or people and groups making claims on the bank. This would also have reverberations on other parts of the financial system. Once again, what would appear to be a normal commercial failure in any other industry, can rebound through the banking sector into the real economy.

This problem does not appear in other industries, because the number of contractors with whom a company can deal is limited. The loss of one order or one debt, while costly, does not lead to the large-scale collapse of other businesses. In the case of banks, the loss here can cause a serious chain-reaction of business closure, withdrawal of funds, reverse money creation and other effects.

The Australian economy has also developed more regional characteristics where small institutions have a large impact on a community (such as the Pyral Building Society in Geelong) which is not inside the span of existing banking prudential requirements. Secondly, in the information age, information travels faster. People are alerted more quickly and negative information externalities can have a more rapid and proportionately large impact.

## **2.9. GiroPost**

### **2.9.1. Product Benefits/Costs**

GiroPost is a deposit-taking service being developed by Australia Post. While it is managed by Australia Post, the deposits are not held by the postal service - they are sent on to the participating banking institutions. These institutions simply use Australia Post as an agency service. The facility that has been developed is an effect, a multibank service centre. This model may have application in country areas where bank branches are being rationalised.

### **2.9.2. Product Risks**

The product risks are the same as for any deposit-taking institution. The risk, nevertheless, lies with the institution holding the deposits, rather than with Australia Post. Australia Post, however, does risk becoming the intermediary between customers and the deposit holder. Subject to the deposit holder being accountable for its prudential standards and Australia Post being accountable for its statements as a service provider, this product is in the same risk category as other deposit-taking institutions.

## **2.10. Finance Companies**

### **2.10.1. Product Benefits/Costs**

The finance company emerged as one of the first technological challengers to Australia's banking regulations in the 1950's. The finance company raised money debenture and note issue methods. The money was principally passed on in the form of higher-rate personal and home improvement loans. During the 1980's finance company moved on to leasing finance which was an attractive product in the high inflation environment, and was where bank de-regulation had removed much of their edge over personal loan availability. The actions of these companies in engineering their way around regulatory constraints can be seen as a precursor to mortgage originators. These companies present the ultimate challenge to regulation of negative externalities in the financial system.

### **2.10.2. Product Risks**

The product supplied by finance companies in the 1950's would appear to have been less of a risk because it raised its money from the professional money market in the manner of mortgage originators today. These professional suppliers would have had some understanding of the risks that were being taken and had some ability to monitor performance in the professional market.

This is where the wholesale fund suppliers and mortgage originators can be distinguished from the professional investors. The trustees of superannuation funds, for example, may not have the same skill level as professional investors. On the other hand, a professional funds manager should possess the same capabilities as the professional investor in the finance companies. At the same time, the scale of the finance company market was likely to be relatively small and professional suppliers would have some ability to diversify their portfolio. The housing market for today's mortgage originators is huge by comparison, thus making it relatively easy to be overcommitted. This makes it difficult to avoid when things are doing well, and difficult to sell out of when things are going badly. It is likely that the ultimate sources of funds for the 1950's finance companies were not the 'mum and dad' investors providing their lifetime savings, but professional investors seeking a good return for a higher risk.

The modern finance company should probably be regarded as an entrepreneurial, retail financial market opportunist. It needs to live with its own risks if it is to be effective. This is so long as the finance company does not take funds from highly risk-averse investors, as a large percentage of the available funds or underwrite cover of an information asymmetry, for investment in high-risk markets. Given that the finance companies disclose the riskiness of these activities to prospective investors, they probably provide a positive information externality to the market place by identifying mispricing and other abnormalities.

## **2.11. Pastoral Finance Companies**

### **2.11.1. Product Benefits/Costs**

Pastoral finance companies have faded from the Australian financial scene. Although they still exist, their holdings are small, and it is not anticipated that they will ever recover. They were the 'victims of an uneven playing field'. In two decades of spectacular financial innovation, and de-regulation, however they failed to respond.

to change, and other financial groups now offer more attractive services to their clients<sup>30</sup>. Lewis and Wallace describe these companies having provided sea funds for the rural sector, working capital for the rural sector and cheque deposits. In effect, they were banking services to the rural communities.

### **2.11.2. Product Risks**

The sector largely borrows from institutions like banks and the short term money market. It on-lends to the rural sector. If it were of substantial size interaction between the rural asset base represented by loans to rural related clients and the professional money market lenders would require particularly ca management due to the cyclicity of rural activities. Most rural lending is now handled by the banks who have the benefit of placing rural loans within a br portfolio that diversifies risk.

## **2.12. General Financiers/Intra-group financiers**

### **2.12.1. Product Benefits/Costs**

Based on the approach taken by Lewis and Wallace, we have classified the general financiers within the same category as the finance companies. They la borrow from professional sources for on-lending to a mix of businesses for leasing purposes and some retail lending for the purchase of products. Intra-g financiers are regarded as being extensions of the corporate groups that they are largely set up to serve. They are ignored as a finance category by ever (including the RBA and Lewis and Wallace) since they are extensions of corporate treasures.

### **2.12.2. Product Risks**

The product risks associated with intra-group financiers are largely tied to the fate of their parent companies. In a sense, they are borrowers rather than len and hence do not attract prudential regulation. General financiers suffer from the same risk profile as finance companies.

## **2.13. Merchant/Investment Banks/Money Market Corporations**

### **2.13.1. Product Benefits/Costs**

The merchant banks which have also sought to call themselves investment banks appear to occupy the same niche in the wholesale financial markets as provided by the finance companies in the retail financial markets. Established in Australia in the 1950's, merchant banks have thrived on a movable feast of opportunities. Originally formed to financially engineer themselves around the regulations which prevented banks from engaging in certain types of act merchant banks have generally exploited any new, emerging, and therefore risky, opportunities.

Likewise, older activities - which have a decreasing risk perception, due to increasing market exposure - have generally moved on to be financed by the k more risk-averse organisations. The merchant/investment banks<sup>31</sup> provide the following range of services according to Carew:

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<sup>30</sup> Lewis and Wallace (1993:218)

- fee-based advisory work particularly in company terms;
- trading in money, securities and financial futures activities in specialist markets;
- arranging longer term finance for company expansion;
- providing working capital;
- arranging project finance;
- advising clients on foreign exchange cover;
- advising on mergers and takeovers;
- portfolio investment management services;
- underwrite corporate and semi-government issues of securities;
- operate unit trusts in cash, property and equity;
- arranging offshore finance;
- advising on mergers and takeovers.<sup>32</sup>

Merchant banks are 'risk lovers' - they pursue risk and seek to manage it more effectively, such that it becomes profitable. They tend to congregate in the n activities which more conservative players are overlooking (often because they have steady income from existing activities). The riskiness of cash flow merchant banks makes them more willing to pursue new opportunities shunned by others. This provides the opportunities for large profits and large losses.

### 2.13.2. Product Risks

The risk of large losses is not a concern for the Financial System Inquiry if those large losses do not cause significant negative externalities. The loss Australian merchant banks during the late 1980's were a tolerable and probably necessary spring-cleaning of the financial system, following the termination of lending policies. These losses did not create risks to the financial system in the same manner created by weaknesses in the deposit-taking institutions. The rapid departure of Barings Bank likewise did not cause too much of a problem for the international or British financial system. From empirical experience would appear that merchant bank products do not tend to create the negative externalities that are the concern of financial system managers and regulators.

The risk of systemic danger from merchant banks appears to be further offset by the fact that the majority of merchant banks are owned by large financial institutions which stand behind their bumptious offspring. This, however, has its negative side, since serious weakness in a merchant bank may cause damage to the parent. The effect of the Tricontinental experience on the former State Bank of Victoria is instructive. The DTI's with an interest in merchant banks and risk-taking offshoots need to carefully manage their exposure - and the regulators need to carefully oversee such exposure. On balance, the large parent should a benefit to merchant banks since their presence adds another layer of complexity, making it easier to control a problem emerging from a merchant bank.

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<sup>31</sup>. Classified as money market corporations in statistics according to Carew, (1991:111).

<sup>32</sup>. Carew (1991:111)

## **2.14. Life Insurance companies**

### **2.14.1. Product Benefits/Costs**

Life insurance companies offer promises of compensation, in the event of an unexpected personal event like death, injury, loss of work or certain events retirement, in return for regular premiums. These regular premiums provide a means of building reserves that cover the expected payout stream to claimants. reserves are invested in appropriate financial instruments. The product provides the service of allowing people to cope more effectively with risks of life general.

### **2.14.2. Product Risks**

The product of the life insurance companies is the same as that produced by the friendly societies. The product seems unlikely to generate negative external for reasons argued in the discussion about friendly society products: there is unlikely to be a run on a life insurance company for an insurance product. Ins there would be a cancellation of policies and a drying-up of premium income. This suggests that the likelihood of a negative externality associated with a product from this source is small. The cost will largely be borne by the parties to the contract.

The difficulties arise when a product approaches the boundaries between insurance and deposit- style products. Superannuation is the product that most fits ambiguous state. Carew aptly describes super as: rather like a bank account-cum-special type of life insurance<sup>33</sup>

The statement illustrates the confusion. In retrospect, it is easy to see superannuation policies emerging from the life insurance industry to provide retiree income, as an extension of sickness and death benefits. At the same time, the product possesses the characteristics of an extended lifecycle savings system - a term deposit-based product. Thus superannuation occupies a hybrid position between the different product markets of deposit-taking institutions and insurance (risk reduction).

Owing to the difficulty of making withdrawals, it is more difficult to have a run on superannuation. As discussed, however, it is not inconceivable that deposits could switch funds and thus induce a crisis of confidence over time. This requires careful monitoring.

The other risk is that a major fund mismanages its funds and undermines the retirement plans of thousands of members. While this may seem like a long shot would be a major blow to the large number of people concerned - and a major cost to governments to repair the damage. Such an event is small compared to a bank run, but significant enough to undermine general confidence in a very important asset. Like the family home, losses on superannuation funds may in

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<sup>33</sup> Carew (1988:233)

reductions in confidence and real expenditure that flow through the economy. While such an event is hard to contemplate, it should be noted that the weakn in the western world's banking systems through the 1991-92 recession would also not have been contemplated in 1988.

It is also likely that in the absence of a disaster, people have underestimated the risks involved in this area. Special measures may be needed for this product.

## **2.15. Investment Companies**

### **2.15.1. Product Benefits/Costs**

Investment companies have a source of investable funds (often their own) that they use to invest in whatever assets they can identify. These companies effectively individual agents roaming the markets looking for opportunities in their chosen area of expertise. They carry their own risks and hence are the beneficiaries or losers from their own decisions.

### **2.15.2. Product Risks**

Unless such a company has included its reach to source funds from a wide range of 'mum and dad' investors, it is unlikely that the collapse of such a company could do much damage - except to those who are immediately involved. Thus, it would appear that there is very little need for additional regulation beyond which is normal for such corporate entities, since the negative externalities, at least with respect to the financial system, are limited.

## **2.16. Unit & Investment trusts**

### **2.16.1. Product Benefits/Costs**

The unit trust collects the investments of many small investors, and pools the proceeds to create a larger pool of money. This greater pool of money provides a return better than each of those received individually by the investors. The unit holders' funds are placed in a trust under the care of a trustee who non-passes management to a management company.

## **2.16.2. Product Risks**

If the product fails, then the likely losers are the unit holders. While it is not inconceivable that unit holders could panic about rumours of a collapsing trust damage is likely to be confined to the small number of investors. Although characteristically similar to a bank run, the scale of loss is limited because the spread of investors is small, and the underlying investments are not normally loans which would have to be recalled. It would be unusual for the collapse of trust to create a free-ranging negative externality with systemic consequences.

## **2.17. Non-life insurance**

### **2.17.1. Product Benefits/Costs**

The general insurance industry provides risk reduction services for areas other than protecting the individual. These services cover loss of personal items, fire insurance, etc. The task is to mitigate the risk of loss through pooling premium income into reserves so that these can cope with the expected stream of loss. The product provides a valuable service in supporting industry investment in particular, and enabling the effective flow of loan funds to new projects.

### **2.17.2. Product Risks**

There is no apparent systemic risk from general insurance. Ineffective performance leads to a drying up of investment income. Disputes over contracts may be a serious consumer issue for the public and industry in terms of information asymmetries, but this is unlikely to cause major negative externalities that threaten other transactions or the financial system. Pervasive information asymmetries may lead to a reduction in output - all other things being equal.

Some recent events are having an apparent effect on the insurance industry. While it is hard to imagine general insurance companies causing a major systemic impact, it should be noted that Hurricane Andrew in Florida and other unanticipated weather events have been reported as placing insurance companies under intense pressure. In the case of Florida, the government legislated to force companies to provide risk cover to residents' houses after Hurricane Andrew. This has debilitated insurance company reserves (pers. comm). The effect has been to make parts of Florida difficult to insure - with subsequent knock-on effects for the economy and investment. Investments are difficult to finance under normal circumstances, and the absence of insurance can only exacerbate those concerns.

Should climate change prove a serious threat, we can expect more classes of industry (by geographic location or type) to become greater insurance risks - with consequent risks for investment as well as creating issues for the regulatory system. This risk from the greenhouse-induced effect may seem reasonably slight but it should warrant some attention by the Inquiry.

## **2.18. Pension funds/Superannuation funds**

### **2.18.1. Product Benefits/Costs**

These funds were classified by Carew as retirement funds that were paid out to pensioners in the form of pensions rather than lump sum payments. Funds v made lump sum payments were considered to be superannuation funds<sup>34</sup>. Such a distinction probably reflects the thinking of the mid 1980's.

Since then, superannuation has been provided with incentives to pass out returns in the form of annuities and pensions, thus bringing it closer to the definition pension fund. In essence, the pension fund is identical to the superannuation fund, since in Australia, both are likely to be structured to take advantage o benefits in this area. The funds represent the pooled savings/deposits of 'mums and dads' which provide income 'insurance' in retirement.

### 2.18.2. Product Risks

These long term savings vehicles have the following series of product risks:

- the risk of losing the investment monies that have been built up over decades, and upon which people have come or will come to depend;
- the risk of funds being destabilised by investors switching to other funds;
- the risk of funds managers and trustees being insufficiently accountable to investors;
- the risk that poor information will cause problems as different stakeholders react in accordance with their own self-interest - investors vs trustees vs funds managers, advisers vs trustees etc.

These risks do not remain confined to the parties that are directly involved. At the very least, a major problem will call into question the e superannuation/retirement system. The only guarantee is that somehow, Murphy-like, a serious problem will begin to emerge somewhere. Certainly, this hap to all classes of financial institutions at some point! The difficulty is not that the problem fund emerges, but rather that the system designed to ensure that effectively managed and dealt with at the earliest possible stage, may not in fact be effective. Such problems need to be dealt with swiftly, in detail, at transparently as possible.

Losses of confidence may be the most *likely* negative externality from bad transactions in the superannuation system. The most *damaging* negative extern may be a 'run' (ie. the switching of investments from one fund to another) by investors on a superannuation fund perceived to be at risk. The difference bet this fund and a bank in similar difficulties is that the bank run will happen faster, and will also cause loans to be recalled. A superannuation fund in si difficulties will need to recall funds from managers, necessitating a sell-off in assets. This may have consequential effects for the market. If the sell-off is enough, the market consequences will be diminished and the superannuation fund could quietly be wound up.

The negative externalities associated with a problem superannuation fund would seem to be less than those with banks (deposit-taking institutions) because o nature of 'loans' made by the fund and the slowness with which deposits could be removed. There is a potential for some problems, however, and we w expect that the regulatory measures will need to be carefully considered.

## **2.19. Funds Managers**

### **2.19.1. Product Benefits/Costs**

Funds managers provide professional funds management services allowing trustees to contract out their responsibilities to a panel of fund managers. These companies are often closely associated with major financial institutions and other market players, and are well placed in terms of market information, to price their services.

These companies earn their income via fees. The fees, and how they are structured, will be significant in determining the managerial style adopted by fund managers. While funds management is not a new concept, it would seem that the present existence of funds managers owes a great deal to the creation of a superannuation system. This suggests that the type of mistakes that will be made in this sector are also likely to be novel. While losses are inevitable, it is in the interest of the financial system as a whole to provide a means by which the funds manager can be alerted to dangerous circumstances - perhaps through 'model' - without the industry needing to learn from real-life mistakes.

This is a relatively young sector, with large responsibilities, and stiff competition, forming a recipe which may lead to considerable over-confidence.

### **2.19.2. Product Risks**

The risk in this industry is that a fund manager will lose a portion of their portfolio, causing a significant loss of invested funds. The use of several funds managed by the same trustees is a necessary risk management device. The funds manager is in the front line of any poor performance by the investment. Spread investment funds between several funds managers ensures that no one manager should be able to bring down the entire super fund. This also reduces the risks investors will panic and swap into other super funds.

Given the relative newness of this financial institution it may be necessary to conduct some modelling of the funds managers, trustees and investors to determine situations through which losses may occur. An issue warranting particular attention is the tendency of funds managers (due to the built-in incentives) to follow the crowd rather than developing individual strategies. This collective tendency led to the building boom in the late 1980's and could theoretically happen to fund managers.

It would be necessary for the regulator to monitor such collective behaviour and issue appropriate warnings. Such collective behaviour is common in financial markets (and others) and can result in large losses. It is in effect an information externality which is generated when everyone agrees on the world view, and no one can afford to be out of the market due to the risk of under-performing in some particular sector.

Funds managers are not directly vulnerable to a 'run' by investors because they are buffered by the super fund itself. The super fund trustees are not 'fill-inform' investors likely to withdraw money on poor information. If they did withdraw money, it is also likely to be in a considered manner that does not excite the market and exacerbating the problem to be solved. The problem of 'runs' is largely confined to the superannuation funds themselves.

## **2.20. Trustees and trustee companies**

### **2.20.1. Product Benefits/Costs**

Trustees and trustee companies represent a particular class of financial player. These players have enormous weight placed on their competence and integrity. They effectively act as managers for hire, standing in for the owners or other investors who have surrendered their powers of control for a range of various reasons. The trustee has become particularly important with the rise of the superannuation funds. The volume of funds under the control of trustees has become significant and will continue to grow if trends continue. The calibre of trustees will become a significant issue.

### **2.20.2. Product Risks**

The normal relationship between service supplier and customer is guided by their incentive to find suitable choices that maximise the benefit to all parties. The risk with trustees is that they are not known to the customers, and customers have no way of ascertaining their ability or of measuring their performance, except by various measures of fund performance.

While this used not to be problematic when trustees were utilised only by relatively informed market participants, it has potential to cause difficulties with 'mums and dads' being drawn into the system. This large class of investors are not skilled in identifying good trustees; they do not meet the trustees and hence unlikely to be able to exert any pressure over performance issues. Under such circumstances, the trustees and their advisers are likely to form a very tight controlled 'club' which will have a dangerous tendency towards 'group-think'.

Trustees will require monitoring, probably by regulators, in order to prevent the generation of inefficient behaviour patterns.

## **2.21. Stockbrokers**

### **2.21.1. Product Benefits/Costs**

Stockbrokers provide a service which supplies, buys and observes the sale of shares. This service enables them to be well placed to operate on behalf of clients. The services they provide have been around for sufficiently long to observe a range of events from boom to busts. While stockbrokers have come and gone, sharemarkets have risen and fallen, and broking customers have benefited and lost - there has been an absence of major events from this sector that have caused lasting damage to the real economy. This market in fact provides a useful barometer of possible economic direction, without necessarily dragging the economy with it.

### **2.21.2. Product Risks**

The risks from this service would appear to be largely borne by the customer and the broker - based on past experience. There are limited externalities which from this transaction that cause impacts on other transactions. The most significant is a positive externality, in that the market can signal future directions for the economy, providing other markets with forewarning. Occasionally, the market can signal a down-turn which may be taken to be a 'negative' externality, but in reality is more often a judgement, rather than a cause.

Some danger arises when the stockmarket gets caught up in a self-fulfilling spiral of prices such as the run up to the 1987 crash. Such events, in the past, largely affected professional players directly and the real economy indirectly. In the future, with a larger proportion of Australia's assets in super funds, the risk of a market spiral will be spread further. The regulator (of super funds) will need to offer guidance in this area and ensure that a wide range of views are present in front of funds managers and trustees. The central bank has set a good example of providing suasion at key points.

If there is a significant risk in this service, it lies in the dangers from asymmetric information - an example being insider trading where certain parties may be able to profit while the majority misses out. These activities are damaging to the market and do require regulation by a regulator as well as by the stockbrokers themselves.

### **2.22. The Stock Exchange**

#### **2.22.1. Product Benefits/Costs**

The stock exchange provides the market place within which shares can be traded. This is a service as much as any other. It can only be achieved by co-operation and by a continual vigilance on the part of members to promote the interests of the market above the interests of any individual member. Conversely regulatory authorities will need to ensure that the stock market serves the broader interest of the community. That is, it should be a place for the efficient allocation of capital between different shares, and a mechanism for the efficient pricing of capital. The stock exchange should act as a barometer of the health of companies and the economy in general.

#### **2.22.2. Product Risks**

This service, collectively provided by the stockbroking community for themselves, has positive spin-off benefits for the broader society in terms of improved information about corporate performance, better information flows and more efficient resource allocation. It can also have some negative spin-offs for so-called bubbles where the stockmarket engenders speculative bubbles that have little to do with the efficient pricing of capital. These occurrences lead to economic loss where capital is mis-allocated, even temporarily.

The existence and reality of the negative events needs to be acknowledged and their costs considered. This does not imply a heavy regulatory hand, but rather the relevant authorities exercise powers of persuasion to encourage the market to 're-think' its direction. The market may conclude that its direction is correct the persuasion is unheeded. Alternatively, the market may take a second look and conclude that there are greater grounds for doubt.

The direction of markets is often determined by purely subjective decision-making. Good analytical data deployed to counter some firmly held views may cause the market to re-evaluating its approach. The regulator should look to widen the terms of debate and provide an information resource which reduces the incidence of 'over-enthusiasm' by taking a good look at the numbers.

## **2.23. Actuarial, accounting, auditing, information providers, and assessors**

### **2.23.1. Product Benefits/Costs**

Standard economic analysis has relied upon the perfect provision of information services to completely inform market players. Thus, by logical deduction, there can be no 'free lunches' because all opportunities and risks, by definition, have been eliminated (ie. taken up).

The reality is, however, that information is extremely imperfect and expensive to procure. This leaves all market participants struggling to position themselves. Without information, they cannot position themselves in the market, and yet the amount of information required to obtain, analyse, and formulate implications is endless and self-perpetuating. This is, in essence, a never-ending process that severely inhibits the ability of markets to find an efficient outcome. Thus individual agents, and for the market as a whole, the provision of information can significantly improve efficiency, eg. improve the quality of life and raise the standard of living through increased wealth.

The information gathered by individual agents is to assist their particular purposes - which may not assist the market. This is why a prime function of the regulator is to supply market-specific data and analyses, which may not be in the interests of participants to supply. For the individual agent, information can be the difference between a profitable and unprofitable deal. The opportunities for significant efficiencies are large, which warrant an ongoing expansion in investment in this sector by both the private and public sectors.

For any market to function efficiently, it is necessary that an optimal balance is struck between private and public service provision. That is, in any market there is probably a unique mix of public and private goods (services) that need to be provided if the market is to achieve maximum efficiency. If private services expand to a certain level and provision of public services has not maintained equal pace, it is likely that there will be a diminishing return on the continued expansion of private investment.

Of course, this is not an argument for winding back private investment; rather, it is an argument for expanding public investment in order that the overall growth is not retarded. Both the public and private components have a necessary stake in the continual, optimal upgrading of their information investment, in order to continue to improve the efficiency with which the market, as a whole, delivers its services.

### **2.23.2. Product Risks**

Increasing provision of information at higher speed ensures that risks can be reduced. Indeed, increased information leads to positive spin-offs for the market through improved efficiency (caused in part by reduced risks). The reality, though, is that the information provided by commercial suppliers is designed to serve their profit-oriented purposes. While the information may not be slanted as such, it may be that it is not the whole story. The role of regulator is to fill in the gaps of information provided by commercial suppliers, and to ensure the overall story is as complete as possible - and broadly known in the market place.

Provided that there is a source of impartial information, it is in the interests of all information providers to acknowledge its role for the sake of their credibility. In the absence of a regulatory oversight of the information driving the market, it is not necessarily commercially sensible for an information provider to take an interest in the wider story when its profits are at stake. Auditing of super funds might be an example. In the absence of a regulator prepared to conduct tests, it can be in the short-term interests of some auditors to give in to pressure from clients. Yet when there is a risk of the regulator intervening, it is a lot easier for the auditor to 'do the right thing' because they can point to the dangers of being caught out.

### **2.24. Arbitrators/speculators**

#### **2.24.1. Product Benefits/Costs**

Arbitrators and speculators have a reputation akin to that of the African vulture. This type of market player serves a very useful market function. In the pursuit of their own interests, they in fact provide a valuable service to the market. Their entrepreneurial instincts, opportunistic attitude and highly developed expertise with risk enables them to pursue mis-pricing and inefficiencies in the market, which they seek to exploit to their own gain.

Of course, the inefficiencies that they exploit can either be market-created or regulation-created. An opportunist is indifferent to the distinction between the two since both types of opportunities will only last so long as the more conservative sectors of the private sector, and the public sector in general, have not appraised of the gap in the market. The service provided by an opportunist is to push the market and the regulator to examine more closely their present operations and to consider the danger/opportunities of what has been uncovered.

It is these opportunists who are largely responsible for the accelerated rate of innovation in the financial markets. Their activities have led to new products increasing the output of the system and they have also exposed flaws in the regulatory framework. In consequence, they have changed the 'dominant paradigm' and will continue to do so. Moreover, they expose badly priced commodities through taking positions that even the market considers wrong, but which eventually turn out to be prescient (naturally, few tears are shed when speculators lose out!).

Financial innovation and financial information, in short, are created by the activities of innovators.

### **2.24.2. Product Risks**

The speculator is a valuable component of the financial system, helping to keep it healthy. By the same token, the risks of this 'service' is that it can also cause damage where speculation undermines important public benefits, or leads the market into 'bubbles' and other excesses.

The role of regulators and market managers such as the stock exchange is to keep up with speculators and monitor the extent to which their activities are beneficial to the overall goal of maximising welfare. This does not imply impeding speculators, but inquiring as to whether they have, for instance, uncovered a flaw in the regulatory approach. Modifications to that regulatory framework provide a means of deflecting the energies of speculators into more socially-productive directions.

It is difficult to conceive of a situation where, in the same manner as a bank run, speculators can lead the entire financial system into trouble. However, it is feasible that speculative activity could contribute to a high risk situation, either through a catalytic effect, or through exacerbating an existing trend by buying speculative options around a market bubble. The speculator needs to be watched carefully for positive and negative externalities.

### **2.25. Reporting Bond Dealers**

#### **2.25.1. Product Benefits/Costs**

The reporting bond dealers were created in 1984 to deal directly with the central bank in respect of government securities that had a term to maturity longer than one year. This institution was created by the central bank on the basis of the bond dealers who had already formed a market. The benefit of this move was to 'fund' encourage secondary market trading in bonds<sup>35</sup>. This assists the central bank to achieve its objectives in monetary policy and sustaining government financing provides a means of influencing the market, obtaining market information and is based on the power of governments' huge demand for borrowed money.

#### **2.25.2. Product Risks**

The service provides, by revealed preference of the central bank, positive externalities for the management of the financial system. If it fails in this task, the central bank would, presumably, need to resort to other means to achieve public policy objectives. The risks are that the intervention creates more costs than it benefits. The absence of public complaints could be an indicator that most participants are relatively happy with the arrangement, and that the costs do not exceed the benefits.

## **2.26. Authorised Money Market Dealers**

### **2.26.1. Product Benefits/Costs**

The authorised money market dealers provide a service to the central bank in its efforts to control the money supply. They act as a conduit for central bank effort to tighten or decrease liquidity by absorbing or releasing funds as required to maintain their own positions - in a market where the central bank sets the parameters. This market is an artificial creation designed to exploit the central bank's monopoly control of currency, and the market power of government to enforce monetary policy. It is an example of direct government intervention intended to offset the negative externalities commonly associated with a perfectly free financial system.

### **2.26.2. Product Risks**

This system works as long as the central bank is always able to deliver and receive funds. The central bank control over this system is so strong, that it is hard to conceive of a crisis emerging from within the system of authorised money market dealers. Rather, problems are more likely to arise from outside the system in other areas. It is for this reason, in the management of monetary policy risks that the central bank needs both the authorised money market dealers as well as the prudential supervision of banks and other deposit-taking institutions. Indeed, it is clear that the role of deposit taking institutions in creating money places them in a special arrangement with the central bank (and its charter) which requires specific prudential management.

## **2.27. Centralised Borrowing Authorities**

### **2.27.1. Product Benefits/Costs**

The centralised borrowing authorities were formed in response to the Campbell Committee report. State agencies were grouped together to form authorities that would seek funds on the open market for all constituents. It is credited with bringing greater liquidity to financial markets for semi-government securities<sup>36</sup>. The huge government backed borrowing agencies served to key purposes in the financial system: they provided an alternative to holding Commonwealth debt, particularly when supplies of Commonwealth debt became low and they provided an alternative source of liquidity for the market. These were beneficial developments for the financial system as a whole.

### **2.27.2. Product Risks**

The risks associated with these institutions must be judged as very low - given the government guarantee. This does not imply that they are vulnerable to catastrophic loss. If the issuing authority and its government do not manage their finances correctly, they can suffer in the market place. Such large authorities on the way do not significantly increase the risk for the financial system. Instead, collectively they do provide a good service in offering more liquidity, and a diversification of product range.

## **2.28. The Central Bank/Reserve Bank of Australia (RBA) and other regulators.**

### **2.28.1. Product Benefits/Costs**

The central bank is the public policy anchor of the financial system through its management of the domestic payments system and the prudential supervision of money creation process via deposit taking institutions. The absence of a central bank would not impede the existence of the financial markets, but its omission would see a higher level of volatility, leading to frequent exaggerated upswings and down swings - with their attendant costs for resource allocation and efficiency.

This is based on the observation that upswings and downswings in the market can be self-fulfilling prophecies, based on asymmetric information, in the absence of a player with deep pockets, who is dedicated to advancing the interests of the market as a whole. In the presence of a player who is prepared to lean against the market at key times, the level of volatility should fall. This is not to deny that there are costs to intervention but simply to state that there are costs owing to a lack of intervention as well. The central bank must steer between doing too much and doing too little - with plenty of room for reasonable people to disagree.

### **2.28.2. Institutional Responsibilities and Product Risks**

Responsibilities<sup>37</sup> are determined by the Reserve Bank Act (1959) requiring it to ensure that its monetary and banking policies contribute to the stability of the financial system and the welfare of the people. The Banking Act 1959<sup>38</sup> requires the RBA to protect the deposits of Australian banks, regulate bank lending, regulate interest rates and influence asset holdings. Finally, the Financial Corporations Act provides the means for the RBA to monitor and control the activities of registered NBFIs. It also manages the Commonwealth borrowing program in conjunction with the Treasury, and issues paper currency.

The risks with the RBA service is that the service provider either gets it wrong or does too much. The reality of a constantly evolving financial system, compared with the previous static version (pre 1980's for example), requires that the regulatory framework should either put in place measures that are systemically correct or seek to progress measures as times change.

In a similar vein, the range of existing regulators including the ISC, the ASC, the ACCC, AFIC and the CFS could all be analysed in the manner pertaining to the RBA above. The point of this exercise is to establish their bureaucratic charter, and to examine how these interact with the various players in the financial system. From this hypothesised interaction, we can begin to ascertain where our regulators are performing well, and where they are likely to require reinforcement.

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<sup>37</sup>. Carew (1996:281)

<sup>38</sup>. Carew (1996:281)

### Chapter 3. Industry Products: Market Failures, Externalities, Present Problems & Trends

#### Introduction

As a result of the broad overview in Chapter 2, we have classified the products of each service provider into a structured schema. From reviewing the a taxonomy of financial institutions, it would seem that the financial system produces the following broad product categories:

- The Domestic Payments System
- The International Payments System
- Financial intermediation
- Long term savings system
- Financial system risk reduction and management services
- Non-financial system risk reduction and management services
- Information services
- System management services

Some financial institutions produce products in more than one category while others only operate in one sector. Tables 1, 2, and 3 in the AFSA submit executive summary list the products engendered by each financial institution. An example will be the shorter term investment products that can be offered by institutions in the insurance business. These products are not really insurance-based but instead, resemble deposits. Risk reduction institutions, because of their experience in handling money and investments can easily move into this area. Likewise, deposit-taking institutions can move into insurance-style products because of the additional marginal cost - given the existing investments in deposit taking infrastructure - is small, relative to the potential benefits.

There may be a tendency for financial conglomerates to emerge, enabling one institution to operate in distinctly different markets such as insurance and depository taking. This complicates the problem of regulation, because it means that there will be different types of regulation required within the one conglomerate. In the past, this problem was solved by the strong focus on banking as the core of the system, as well as other rules which prevented amalgamations between different institutions. The financial efficiency has led however to some crossover activity between different institutional types. There may be more of this in the future. A regulatory framework will need to take account of this trend.

The significance of approaching the financial system from the perspective of the products is that the system is complex and difficult for any one person to assess as a whole. By focusing on the products, we can identify where benefits, costs and externalities are produced, as well as where market failure may impact on the efficient functioning of the system. From this, we can begin to evaluate the perceived problems, market trends and, hence, the effectiveness of the existing regulatory framework.

### 3.1. The Domestic Payments System

#### Relevant Institutions

This service/product is used primarily by deposit-taking institutions. Deposit-taking institutions are the most likely to provide such services as an offshoot from cheque deposit facilities. Thus, this product includes banks, building societies and credit unions. The regulatory framework should allow new institutions to join payment systems, provided that they meet agreed standards, thus encouraging competition and innovation.

#### 3.1.1. Definition

The domestic payments system comprises the currency as well as various means by which economic agents settle their accounts with each other. The domestic payments system includes bank cheques, exchange settlement funds and many other types of 'money'. When the payments system is mentioned, immediately thinks of the banks because historically they played a central role in allowing people to pay and be paid - in the secure knowledge that the bar system will not fail. The domestic payments system should be seen as a service that facilitates the payments for goods and services.

We have included the currency in this definition, even though it may not necessarily be included normally. The currency is a means of direct payment that is part of the payment system as a whole. Cheques and credit cards are simply substitutes for cash delivered by hand. The currency has its own requirements in terms of needing risk management. These requirements are different from those identified for all non-currency payments, since the financial system as a whole is involved rather than the two agents who exchange cash and the note issuing authority.

The two components (currency vs non-currency payment systems) will need separate handling and regulation.

Gloster notes, with respect to the non-currency payments system, that:

Besides being largely invisible to conventional accounting reports, payments between parties with accounts at separate financial institutions have a peculiarity that sets them apart from most other economic services. In essence they comprise single indivisible services supplied jointly by two suppliers to two customers. The relative costs of the two suppliers and relative benefits of the two consumers vary according to circumstances that are not necessarily matched. Payments services are provided by a diverse group of suppliers in competition with one another. They are obliged to determine the point where competitive proprietary matters and cooperative agreements begin, while being answerable all the while to regulatory authorities. (Gloster cited in Davis and Harper (1991:184))

Gloster goes on to classify four forms of the domestic payments system<sup>39</sup>. The distinctions are:

- Payments where they are viewed as final and complete at the time they are made. These can then be divided into two categories:
  - Small value on the spot payments

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39. Davis, K & Harper, I (eds). (1991:126)

(Examples include electronic point of sale payments system and authorised credit card transactions. These are ordinarily retail payments where verification is carried out by phone or through the use of limits. The payments are normally guaranteed by institution. There appears to be little risk attached, except where this quintessential retail system is used for wholesale payments.

- High value on-the-spot payments that may need to be timed to avoid disrupting the financial system

(Examples may include large tax payments to the government. Gloster notes the existence of the BITS system and Austraclear. draws attention to the need to decide upon an appropriate arrangement for high value clearance systems and points to the risk it that need addressing. In particular, the requirement for establishing inter-institutional limits as a precursor to establishing prud requirements. He draws specific attention to the relatively risk-less Swiss system that only transfers funds when cleared fund available - other transactions are queued until funds are provided.

- Payments that are an order to pay at some future point - Gloster distinguishes between orders which have different timing and methodology that re variations in risk management techniques. These variations are:
  - *Electronic-based systems*: these are generally pre-arranged orders to pay that are cleared electronically. The risks here are consider be different with a focus on minimising inter-institutional risk and reducing 'windows' where uncleared funds are made available.
  - *Paper-based systems*: The cheque clearing system is the prime focus here - and the risk that value is made available to the cust before the cheque is cleared which is de facto credit.

The issues surrounding all payments systems was summed up by Gloster. He drew attention to the basic tension existing between the delivery of a service to customer in a timely manner, and controlling the risk exposure of institutions involved in the behind-the-scenes transfer.

### 3.1.2. Externalities, Market Failures

Carew cited the Campbell Committee as having the following reason for supporting bank supervision of the domestic payment system:

Trust is a precondition for an efficient payments system - cheque clearing institutions must be able to deal confidently with each other (Cited in Carew (1991:8

Externalities and market failures are created in the payments system when trust is breached. The banking system functions because of a series of moral mo which enable people and institutions to trust that even as strangers, they will 'do the right thing' by one another. Trust is a substitute for perfect informatior.

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<sup>40</sup>. The efficiency of the payments systems, like many markets, would seem to be, a priori, positively correlated with improvements in the moral character of the market

enables the system work better than pre-existing information asymmetries would allow - people can avoid expensive investments in information-gathering. If trust is breached in one transaction, it can cause doubt in many other transactions which catalyses the entire payments system into risk.

The currency system is dependent upon trust; in other words, the public trusts currency to sustain its value. This is a function of the monopoly issuer of currency to prevent fraud, and to identify the appropriate level of currency to be issued. When currency was issued by banks, there were more grounds for externalities market failures to cause risk via poor information.

The imposition of monopoly currency may have generated costs, but these were exceeded by the benefits of reducing systemic externalities like currency fraud defaulting on issues currency. For most Australians, the successes during this century in preventing fraudulent manipulation of the currency has resulted in a low level of concern with its management.

Success, however, can breed a blindness to emerging issues. The low level of concern may be justified, but the system should still be monitored for development particularly in the area of fraud (eg. the impact of colour photocopying, foreign governments with access to modern note printing technology, etc).

Gloster has classified the non-currency payments system risk into direct and indirect risk.

Direct risk comprises two components:

- the risk of actual loss of value - where value given irrevocably to a customer is not received due to some failure of the payment<sup>41</sup>
- the risk that temporary liquidity deficiencies cause an institution to falter in its handling of payment instructions leading to possible loss of public confidence<sup>42</sup>

He describes indirect risk to the payments system as

- when customers are caught by defective payments and lose value or run down liquidity, and is so doing increase the institutions doubtful debt position

In a perfect financial market, defective payments are known in advance. In the real imperfect financial system, by revealed preference, the costs of information asymmetries and externalities have warranted intervention in the form of regulatory oversight and co-operative mechanisms.

### 3.1.3. Present Issues

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<sup>41</sup>. Davis, K. & Harper, I. (eds), (1991:124)

<sup>42</sup>. Davis, K. & Harper, I. (eds), (1991:124)

<sup>43</sup>. Davis K & Harper. I (eds). (1991.124)

A range of issues have been identified that have relevance to the Domestic Payments System

Lewis and Wallace noted that the evolution of the economy may lead to some erosion of the traditional roles of the RBA (Lewis & Wallace:37), such as:

- private banks taking some of the banking business of government
- Electronic funds transfer may reduce the role of notes
- International reserves could be put into the hands of funds managers

Further to their list, we noted the following additional issues relevant to the Domestic Payments System.

- Risks to the payments system from expanding the membership.
- Optimal number and configuration of payment systems.
- Relationship between different clearance systems.
- Prudential requirements for the payment system(s).
- Regulatory framework for the payment system(s).
- Coping with changing circumstances.
- Success is a problem - because it breeds complacency.
- System security against electronic intrusion (eg. computer hacking of the payments system).
- The need to develop a scale of system risk performance benchmarks so that domestic institutions can be accredited at an appropriate level and hence join relevant payment systems as required.

### **3.1.4. Trends**

There would appear to be the following trends at work in the Domestic Payments System. These include:

- Trend towards electronic exchange systems in general
- The trend towards maintaining an 'asset standard' where 'assets' are stored in the vaults of the system manager to enable rapid electronic transfer of funds between different players. It's an asset standard because each electronic cipher must be backed by a real asset of some kind.
- Trend towards paperless electronic exchanges.
- Smart cards and money
- The impact of electronic card payments systems
- The RBA currency monopoly
- Trend towards demands for greater access to the payments system
- Possibility of private payments systems

## 3.2. The International Payments System

### Relevant institutions

Like the domestic payments system, the main beneficiaries of this service are deposit-taking institutions. For international payments, it is more likely to be the larger institutions that are relevant. Subject to meet certain requirements, though, the system should be open to smaller players, in order to encourage competition.

#### 3.2.1. Definition

The provision of means for international exchange of payments is comprised of two components:

- foreign currency exchange
- settlement of international payment transactions.

The international payments system is an important extension of the domestic payments system. The regulatory supervision of the domestic payments system normally been significant while the international system has been considered as a smaller, albeit important, issue. This will need to change in coming years.

The trends of the past fifteen years have shown the scale of international monetary payments to be increasing in terms of size and complexity. It is possible international payments relative to domestic payments have been a growing proportion of overall payments conducted by Australian financial institutions. If the case, then it follows that the risks posed by unexpected breakdowns in the international payments system are a growing threat to the domestic payment system, of which they are a necessary extension.

Consequently, the safety of Australia's domestic payments systems will come to depend on the security of the international payments system of which it is a part. The international payments system is a structure emerging from the blending of nationally-based domestic payments systems. This facilitates the international transfer of payments and the international transfer of problems. With the increasing capacity to achieve, nevertheless, is the co-relative capacity to make mistakes the only offsetting trend in the financial system must be an increasing ability to manage the system.

As more countries create modern economies over increasingly shorter periods of time, a greater proportion of the world's fastest growing and most volatile financial systems will be maintained in nations where the level of experience will be recently earned. Like any good business, a well-managed economy probably needs to have its narrow escape from oblivion in order to encourage a greater depth of maturity in the management team.

It is unlikely that the world financial system will reach 2050 without a major financial disturbance in at least one of these newly modernised economies. The going efforts of Japanese authorities to reign in their financial system problems may be only a foretaste.

It is theoretically conceivable that a nation's badly-managed local system problem may spread to undermine that country's payment system as a whole. As it does, this may have an impact through the international payments system, creating a domino effect for other smaller players and thus a cumulative effect on many players in countries with a large exposure to the collapsing foreign system(s). The impact may be containable by the domestic regulators in other countries, conversely, it may not. Such an incident could be based around changes in the exchange rate and the collapse of payments. It may, for instance, be important for the domestic system regulator to evaluate domestic financial institutions for their exposure to foreign payments systems that show greater acceptable instability. At the very least, the international payments system should be perceived as a growing extension of the domestic system and hence necessitating greater attention.

### **3.2.2. Externalities, Market Failures**

Foreign exchange payments and the international payments system are closely intertwined services. They are both capable of suffering market failures externalities which necessitate an international regulatory effort.

Foreign exchange services, however, probably require a slightly different approach from that of payments; although, in the end, both systems work together. Risk of foreign exchange fluctuations has been around for many years. The management of disturbances in this system requires real-time co-ordination between central bank authorities for specific crises. On-going consultation will be required to cover longer run 'tectonic' shifts in the global economy which threaten to bring about loss inducing 'earthquakes'. This consultation may require joint action by countries to manage their domestic economies differently (ie. more efficiently) for the purposes of releasing pressure on the international global economy. We can anticipate that in the long run, stronger international institutions will be required to ensure that inefficient disturbances in global exchange markets are managed effectively.

The international payments system suffers from the usual problems found in domestic payments systems. The only difference in the context of the international payments system is the increased scale of the flows, the information and the problems. The increased scale ensures that there will be significant information asymmetries which will make it highly difficult for individual agents to maximise the efficiency potential of the international financial system. The foregoing alone, let alone the losses due to mishap, are likely to be significant. This warrants increased investment by all nations in developing the regulatory framework for international payments system.

Similarly for externalities, the international payments system, as a function of its size and growth, will produce externalities which have a greater effect previously observed. This raises the cost of deficient global regulation of the financial system. Assuming that management costs do not increase at the same rate as the increasing costs of externalities in a growing international finance system, there will be net benefits from improving the managerial framework.

A third problem in the international financial system, which affects both the payments system and foreign exchange, will be the effect of microeconomic distortions in the foreign economies (government failures), causing spillover impacts into the international financial system. In a similar manner to the distortions in the international trade system, these will provide a means for distorted resource allocations, possibly on a global scale. The 1980's may be our first experience witnessing microeconomic distortions in the financial systems of countries such as Japan setting up unsustainable movements in global capital. These then threaten the stability of the payments system as they unwind, or are unwound. We can expect other countries with financial market distortions to similarly under international financial stability in the future.

### **3.2.3. Present Issues**

We have identified the following general issues with respect to the International Payments System. These include:

- Methodology to control foreign exchange rate risks.
- Methodology to control payments system risk
- Need for a scale of performance benchmarks for identifying variations in system risk in different jurisdictions

### **3.2.4. Trends**

The following trends are apparent in the international payments system:

- Growing volume of offshore transactions.
- Growing volume of foreign financial centres.
- Increased speed of transactions.
- Growing political complexity of the international system and the need to establish clear rules similar to the trade rules for keeping the core system stable, while admitting more members - subject to meeting requirements.

### 3.3. Financial intermediation

#### Relevant institutions

The institutions that clearly provide financial intermediation are banking, building societies and credit unions. Superannuation funds grew out of the life insurance industry, but could be argued to be long-term deposit-taking institutions. Superannuation funds, however, are a product of government policy and concessions. As a result, we have included them in separate category called 'long term savings systems'. Other financial institutions could be argued to provide similar effect to that of deposit-taking institutions. These include finance companies (more likely to be professional investors), which are effectively provide deposit/lending facility; unit and investment trusts and retail funds managers.

#### 3.3.1. Definition

Financial intermediation is the oldest product of the financial system. The provision of deposit services combined with the re-lending of funds from an aggregate pool forms the heart of financial system activity. This pooling of funds also enables the deposit-taking institutions to capture economies of scale in managing risks of re-lending to borrowers, pooling the risk across its own shareholders, and ultimately the depositors.

#### 3.3.2. Externalities, Market Failures

Carew cited the Campbell Committee as having the following reason for supporting bank supervision of bank financial intermediation.

- It is widely accepted that there is a need for a safe haven for small investors, a role that has traditionally been filled by the banks;
- A banking collapse which involved depositors in significant losses could be expected to create substantial disturbance in financial markets and their in the economy as a whole. (Cited in Carew (1991:85))

The psychological aspects of banking are so readily apparent that no-one questions the extent to which they rely on trust to do business, unlike other business where the customer pays only when the product is visually inspected by themselves (in the case of certain industries, even this is insufficient - eg. housing, cars). The reliance on trust renders the banking system peculiarly vulnerable to rumours (information asymmetries) and mismanagement (information asymmetries externalities), creating serious risks and undermining the huge benefits of capital creation. These costs are controlled by the use of government intervention in the form of prudential supervision by the central bank.

The form of risk that the prudential supervision was intended to control was the risk of a run on deposits by lenders to the bank. The existing regulatory approach deals only with the banks. Yet it is clear that other financial institutions take in deposits, and engage in re-lending. It would be interesting to know what original scheme was formed in a manner such that it excluded other institutions such as building societies. Were these considered somehow resistant to runs were they too small? The previous focus on banks did provide a means of aggregating the largest and most powerful institutions into an agreed system enabled a stable core of financial institutions to emerge.

Times have changed, however, and it appears that there is now public interest in greater protection for deposits at the smaller deposit-taking institutions. Efforts of the Victorian government to amend the Pyramid Building Society seem to make the point that governments see responsibilities as having been extended. Partly, this is the result of financial de-regulation which allowed institutions to offer high interest deposits while running high risk investments. Under a regulated system, interest rates were disconnected from risk as far as the non-specialist person was concerned. Thus when regulation arrived, it was only to be expected that customers would chase high interest rates without realising that they were chasing high risk investments. The effect, an information asymmetry. The public did not have 'perfect information'.

### 3.3.3. Present Issues

The major issue here would appear to be that of providing a free market in risk/investment while protecting the inexperienced investors. Coping with this in a de-regulated financial market while providing a scenario where risk taking can be indulged in by those with sufficient knowledge, is difficult. If we take the case of building societies, we can see that they are strongly perceived as safe places to put money - a view that the societies themselves have sought to encourage. In these circumstances, it is feasible for a building society manager to offer high interest rates, and to make high risk investments without declaring a change in the status of the institution - all because the level of risk is relatively invisible to the outsider lacking the time or resources to inquire otherwise.

There are some institutions that claim to be 'safe' (ie. relatively riskless), and there are some institutions that do not make claims about the risk status (no-one to be risky!). The banks with the prudential supervision arrangement are the closest approximation of riskless status in a deposit-taking institution.

It is important that all deposit-taking institutions wishing to be seen as 'riskless' should seek cover under the central prudential arrangements. Other deposit institutions can stand outside this arrangement, but only on the grounds that they display a prominent 'risk warning on all products' revealing the actual determined risk level for the product, rated on some universal scale (this will need to be provided by a central banker). Thus these institutions and their depositors will have full knowledge of the risks that they are running. It will force all financial institutions competing for investment funds to match the risk 'honesty' of deposit-taking institutions, and to begin discussing, enumerating and acknowledging this very important aspect of their business.

The following points also seem to be significant with respect to financial intermediation:

- Whether or not it is appropriate to bring regional deposit-taking institutions into the national DTI prudential safety net;
- The significance of differential taxation of different forms of saving as the main barrier to competitive neutrality;
- The relationship between short-term savings vehicles, medium-term savings vehicles and long-term savings vehicles;
- The optimal composition of savings vehicles for the Australian financial system in the medium term.

### **3.3.4. Trends**

The most obvious trend within the financial system is the convergence between banks and building societies/credit unions.

Secondly, the trend toward superannuation investment would appear to have some implications for financial intermediation in general, and raises the question of the optimal mix of savings vehicles is.

### **3.4. Financial system risk reduction and management services**

#### **Relevant Institutions**

A wide range of institutions engage in this market. Arbitragers and speculators are the most often thought of as dealing in these instruments. The services, however, are more broadly offered, and bought, by merchant banking, stockbroking and banking. The services are bought by other financial institutions such as funds managers, life and non-life companies, superannuation funds, etc. Some customers for the products exist outside the financial system as large corporations, individuals and other agents.

#### **3.4.1. Definition**

While the existence of risk is not fully acknowledged in the markets serviced by deposit-taking institutions, other financial markets have a range of services explicitly deal in risk. These other financial markets have products such as swaps, options, synthetics, securitisation etc. which allow financial markets risk (underlying exposures) to be bought, divided, hedged, re-allocated and manipulated in a variety of ways to optimise the business tasks of the financial and financial players. Such products enable different institutions and other players to move their position in the markets to suit their future requirements expectations.

#### **3.4.2. Externalities, Market Failures**

The markets for such sophisticated products are dominated by organisations with a considerable expertise and cashflow. This is not an area where we should be able to find investors or players unaware of the enormous risks that they run. Logically, we would expect that rational players would seek to position themselves in such markets in a manner appropriate for their organisations. Recent experience has revealed a series of players (such as Barings) in overseas markets, who have acted less than rationally and who have paid dearly for their behaviour.

This empirical evidence of supposedly skilled players losing their way in complex markets has sent signals to many that these newly developed markets are problematic, even dangerous. Indeed, they *are* dangerous to the unwary. poorly trained or downright stupid, but this is true any business when it is not properly managed. Economic analysis may be inaccurate when it theorises about the markets based on perfect information, but it is not wrong in the sense that business whether it be in derivative markets or buses is risky. If agents do not stay focused, they will lose their resources and their business. Such a powerful incentive

an important and necessary condition to keep people from losing touch with the purpose of the businesses they manage - although such dangers are, for companies, not sufficient. Such losses cannot be helped - they are 'part and parcel' of doing business in these markets as in any other.

The dangers that society should seek to manage in these new markets are those that threaten the financial system as a whole or even in part. In particular, the depositors' funds should be taken seriously, while threats to shareholders' funds should be taken as a warning to those investors to better manage their business. Threats to depositors' funds can undermine the entire financial system and the whole economy.

This provides an idea of the type of risk that society needs to guard against with respect to the markets in financial risk management. Such threats are likely to arise from areas where the actions of agents, which may seem privately rational, amount to irrationality at the system-wide level. These threats are most likely where market failure or externalities (the invisible elbow) cause unexpected effects on other transactions.

In markets as complex and fast moving as financial risk markets, the most difficult task will be spotting the problem in advance. Information about the problem will probably be confined to the players concerned, who may or may not take an interest. Where the problem is systematic and repetitive - at scales that are threatening to the system - the regulatory authorities may be able to move fast enough to change key elements, or to lean on the relevant managers to make amendments in the long-term interest of the market.

In other instances, problems will arise too rapidly for preventive action. The authorities will accordingly have to deal with the emerging situation with whatever resources are to hand. What the regulatory authorities will require is 'strategic depth'; that is, the capacity to contain the problem without causing problems elsewhere. History is full of situations where the heroes are confronted with a bad situation, which is then compounded by other factors, and where their actions have served to trigger the situation in the first place. It can be difficult to conceive of disasters in advance.

'Strategic depth' implies that there is sufficient depth in the emergency resources held aside for such an event, for the regulating authorities to buy themselves in order to further contain the problem. In the financial system, depth is equated with capital reserves on the part of institutions that participate in such markets. If the problem cannot be predicted, which is the implication of these new markets, the only defence is to have reserves against such contingencies, while constructing out various hypotheses in simulations. In particular, the deposit-taking institutions which form the core of the financial system, plus long-term savers and institutions, are probably the institutions most in need of deep reserves if they engage in these markets. (The financial system can probably withstand the loss of the odd merchant bank!)

### **3.4.3. Present Issues**

As far as the Financial System Inquiry is concerned, there are perceived dangers in financial engineering. An effective recent overseas example was the collapse of Barings Bank in Singapore. However, it would appear from first glance, that these situations have more to do with bad forecasting and poor management than the dangers of financially-engineered products *per se*.

#### **3.4.4. Trends**

The most obvious trend in this sector is the rapid expansion in the use and influence of financially engineered products. This appears to be matched by a general lack of knowledge of these products and how they work. Therefore, this raises questions about the safe handling of such new opportunities.

### **3.5. Non-financial system risk reduction and management services**

#### **Relevant Institutions**

These institutions tend to include the life insurance companies, non-life insurance companies and friendly societies.

#### **3.5.1. Definition**

The institutions centrally involved in this sector are those which provide a service that minimises the risks, from non-financial sources, faced by clients rather than from individuals to corporations and governments. The provision of insurance against unwanted events is achieved by risk reduction products. The price differs fundamentally from that offered by the deposit-taking insurers, on the basis that the payment is - generally speaking - a fee for service. The premium is expected to be refunded; although, should the unwanted happen, it is expected that the insurance company will pay according to the contract. Thus there generally speaking, no deposits to create 'runs' on insurance companies. This does not mean that there are no risks from the insurance companies; but rather the risks take a different form, and they may not, therefore, threaten the financial system.

The insurance industry has also been the home for long-term savings such as superannuation. In this case, the service provided by such a system was to enable people to save for their retirement. The presence of active government encouragement has expanded this sector, which shares characteristics with both deposit-taking institutions and the insurance companies. This hybrid sector has been given a section of its own as 'long term savings' and is not discussed here.

#### **3.5.2. Externalities, Market Failures**

Market failure is the largest problem for the risk reduction products offered by the insurance industry. The customers' awareness of their product is likely to be low, and hence there will be considerable opportunity for asymmetries in information to cloud the true nature of any contract between an insurer and a customer. The contract may be in place for many years before the parties realise the nature of the misunderstanding - normally at a moment when there is already considerable stress. These misunderstandings can lead to large losses in litigation, economic damage, reduced confidence, etc. Despite this, it is unlikely that circumstances can lead to an event in the insurance industry which equates to a 'run' scenario for deposit-taking institutions.

The absence of deposit risk deprives the regulator of a rationale for active prudential supervision of the reserves that are crucial to the survival of insurance businesses. This issue can be left to the market to regulate since the collapse of one insurance company, under ordinary circumstances, should not undermine the entire financial system. Such institutions are economically significant, however, and losses will create negative impacts for the economy in general - especially since the loss is likely to be a surprise which will 'shock' investment markets where the assets have been invested. Some regulation over liquidity, capital adequacy, solvency and related areas should go some way towards reducing the cost of collapses in insurance-related institutions.

The area of product-related regulation is important for the insurance-related companies. This requires companies to provide adequate information about insurance products. Insurance products generate information asymmetries, because customers are faced with purchasing complex legal contracts to cover various

understood future events. Ensuring that the customer receives the right information will mean a reduction in misunderstanding or misleading behaviour by se of such products. Product regulation reduces the information asymmetry problem. This will enable the level of industry output to rise through greater p confidence. There will also be reduced costs because of lower levels of litigation, economic damage and other problems associated with failed contract insurance.

### **3.5.3. Present Issues**

The present issues with respect to this product type include:

- Competitive neutrality
- Impact of differential taxation
- Long term savings and their tax treatment
- Structure of regulation

### **3.5.4. Trends**

In the same way that building societies and credit unions have converged with the banks to create a generic class of institutions known as DTI's - so, too, h friendly societies and life companies come to resemble each other as insurance providers and investment managers.

### **3.6. Information services**

#### **Relevant institutions**

Information services including actuarial, accounting, auditing, information providers and assessors are supplied by financial institutions, which are relat straightforward. Other information providers include arbitrageurs and speculators, who, by their activities, provide information to the market about inconsiste in pricing of like assets. Other institutions, like stockbroking, provide information to the market through their in-house teams of economists and analysts. In it is a function of brokers that they rely for their trade on being able to supply information about the market to other players.

#### **3.6.1. Definition**

As has already been discussed, the role of information is crucial to the efficient functioning of the market. The information enables participants to price products or value the offered services, at the efficient price. If the information is wrong or incomplete, then a mis-allocation of resources is likely to occur. cost of poor information can be very high. On the other hand, information is expensive to obtain. Between the benefits of receiving information and the cos information procure, lies a window of opportunity for specialist information providers to supply data required by private market operators.

The provision of information to market players helps to fill in the information asymmetries that naturally exist in any market, and which result in inefficiencies. Supply of information is normally the province of specialist, independent providers because of the moral hazard of large conglomerates acting as inform providers - they would suffer a credibility problem which would make their involvement unrewarding.

This draws attention to some of the characteristics of market information. It is likely to be sufficient only to meet the needs of private agents. The information generated will not necessarily meet the needs of regulators for effective management of the financial system. In such instances, the regulators have provided their own information, and presumably make use of the private information services as required. The arrangement between the central bank, the reporting bond dealers and the authorised market dealers is based, in part, on a deal to supply information services from the private sector to the central bank. The role of broker previously described, is partly based on their access to information.

### **3.6.2. Externalities, Market Failures**

The market for information represents a spectrum of almost infinite possibilities. By definition, market participants and the regulators will never know enough to be absolutely certain of financial system stability. The information market is in a permanent state of incipient market failure, whereby the participants are unsure of whether an optimum balance (between the cost of gathering information and the benefits of gathering information) has been achieved.

The concealed location of the optimum balance requires extensive, on-going information gathering. It also requires alertness to the fact that whatever information is gathered will need to be constantly tested for gaps. Any perceived gaps in information will need to be rigorously explored. The approach to information should be 'risk averse' - ie. one must gather more than is apparently optimal, otherwise the expected losses will rise dramatically. Large, potentially high uncertainties can only be handled effectively by risk-averse strategies. It would also be useful to implement an information strategy specifically targeted at identifying weaknesses in the knowledge base. For this reason, it is useful for the relevant authorities to encourage outside analysis and publishing to a greater degree, to enable fresh views that may challenge the dominant paradigm, but may also result in useful insights.

Likewise, it is sensible for private agents to enthusiastically support efforts by the regulatory authorities to efficiently gather information. It will reduce the risk of market losses and increase the efficacy of forecasting, all other things being equal. While this may be bad for those who trade in volatility and uncertainty, it will be good for the market as a whole since it will increase the volume of business, and assist the real economy to expand, bringing greater all-round benefits to all parties.

### **3.6.3. Present Issues**

The primary issue with respect to information providers is to focus on the failures of information which led in part to investors overestimating the safety of institutions during the late 1980s- early 1990's. While the problem has temporarily disappeared from view, the questions that should concern the Inquiry is the quality of information about investment institutions can be improved and rendered more accountable.

### **3.6.4. Trends**

The trend in this area has been for information providers to be made more accountable in the terms of the data they collect. This trend may warrant encouragement; it certainly warrants further analysis. *A priori*, one would have expected in a relatively efficient market that information providers would be accountable for their actions - yet this does not appear to be the case.

### **3.7. System management services**

#### **Relevant Institutions**

Relevant institutions include the central bank, AFIC, ASC, Stock Exchange, ISC, Authorised Money Market Dealers, Reporting Bond Dealers, Council of Financial Supervisors and the ACCC.

#### **3.7.1. Definition**

The interconnected web of financial markets and players constitute a financial system. As has already been substantially discussed, the financial system exhibits an array of traits that inhibit the functioning of a pure free market. In consequence, it has been necessary to develop a suite of system management authorities to ensure that the markets maximise social welfare. The system management authorities are presently grouped under the titles:

- central bank - managing (protecting) the deposits of bank depositors and managing the domestic and international payments system;
- associated central bank management institutions - assist the central bank to achieve its management functions;
- competition regulation - ensuring that markets are as competitive as possible;
- insurance and superannuation oversight - ensuring that the investments of superannuation and life insurance customers are well looked after;
- corporations oversight - ensuring that companies are properly formed and structured;
- the stock exchange - ensuring the efficiency of the market in company shares;
- non-bank financial institutions - managing the deposits and investments maintained by the non-bank financial institutions, but not covered under insurance and superannuation; and
- a forum body where the regulators meet to exchange views and discuss information.

This corps of regulators has grown in response to a series of problems experienced by the financial system from its earliest days. The central bank was the institution to appear during the last century. Since that time, the pace with which regulations and new institutions have appeared seems to have been accelerating.

These institutions are bureaucratic by nature, with the exception of the stock exchange and the supporting central bank institutions. The stock exchange, private institution, should be thought of as a company delivering a specific service to its clients in the stockbroking industry. The significance of bureaucratic

this context is that it is a management methodology which has an impact on the efficiency with which institutions serve their goals. Government has tended to bureaucratic structures to manage its functions, with some degree of success in terms of stability. The FSI is projecting ahead to look at the management rapidly changing financial system where change appears to be accelerating, new developments arise faster, and hence more problems can also be generated. changes will bring bigger rewards in economic performance and bigger risks.

The financial system of the future is not likely to be less stable in periods between changes, but rather more frequently subject to change. Thus the range of abilities demonstrated by regulators will need to evolve beyond the concept of 'stability'. The organisational structure of the regulator must be able to deliver active, considered and timely intervention.

### **3.7.2. Externalities, Market Failures**

Bureaucratic structures lead to time lags as information floats upwards. Bureaucratic structures also tend to have the wrong performance effect, reward adherence to the 'dominant paradigm', particularly as expressed by upper management - who are not necessarily at the 'frontline' where the tasks are completed. The tendency to stifle views inconsistent with those of upper management is part of a 'lords and serfs' effect where the staff see their role supporting senior management, rather than supporting the goals of the organisation. This in turn extends from senior management who see staff as supporting management vision - rather than rewarding excellent performance in terms of achieving the organisation's goals.

In turn, all of this depends upon the extent to which senior management has objectives that are coincident with the organisation's objectives. The coincidence of organisational objectives with senior management objectives is dependent upon the incentives and disincentives faced by senior management. If they are focused on the organisational objectives, then the senior management interests will coincide with organisational objectives.

The dangers revolving around a bureaucratic management structure accelerate as the speed and scope of change expand. The dangers are caused by the structure failing to respond in an adequate or timely manner. There is no doubt that the bureaucratic structure will eventually develop a grasp of the problem, but time the essence as the speed accelerates - possibly leaving the system management behind in the wake of change.

The Australian Stock Exchange is likely to be bureaucratic to the extent that companies employ bureaucratic techniques as a part of actual, day to day, Australian management practice. Since the tendency to bureaucratic management is high in Australian business management, this will no doubt be reflected in organisations like the stock exchange. Thus, while private institutions are likely to be somewhat more efficient, they are generally not close to the frontiers of management efficiency performance. This is owing to lag effects, information asymmetries, cultural information distortions, etc, that limit the ability of organisations (even those subject to relatively strong competitive pressure) to adopt the most efficient management techniques. This particularly applies to organisations where senior management and staff are further separated from the day-to-day-focus of the business - keeping customers happy.

By contrast, entities like the reporting bond dealers are likely to be relatively efficient because they are effectively flat in their structure, with a series of t possessing a highly focused view of their roles. For a reporting bond dealer, there are few hierarchies to climb; there is only the reality of either making mon losing.

As monopoly management entities, the regulators - whether they are the stock exchange or the public entities - are obviously supreme expressions of m failure. Poor performance by the regulators will result from poorly focused management that lacks the direction most monopolists have of achieving p maximisation. Rather, the system management entities in use in the financial system, constrained by the critical reviews of their customers, tend to ha reasonable focus on system survival. Do they have, however, enough of a focus to become more dynamic in this area, and thus able to respond to the r changes of this environment? Why do we need an Inquiry for instance? Can't the system reform itself? And what does this say about its future abilit respond? Since the management system has grown and evolved, largely as a response to crisis, its biggest failing may be that it lacks the structure require achieve greater performance.

### 3.7.3. Present Issues

The following issues are identified by Lewis and Wallace. Their first set of issues lay in monetary management. These include:

- The degree of independence from central government (Lewis & Wallace:37)
- The appropriate objectives of monetary policy (Lewis & Wallace:37)
- The use of short term instruments for monetary control (Lewis & Wallace:37)

Lewis and Wallace also identify issues in prudential management. These include:

- The extent of the supervisory web (Lewis & Wallace:37)
- Broaden the role of the central bank to include supervision of secondary supervisors (Lewis & Wallace:37)
- Risks in the international operation of Australia's banks (Lewis & Wallace:37)
- The 'abandonment' of bank controls in the late 1980's (Lewis and Wallace:31)

Further to these points, we will add the following:

- The role of supervision in the non-bank financial intermediary problems of the late 1980's
- The efficient supervision of the banking sector's off-balance sheet activities
- RBA oversight of short-term money market and foreign exchange market participants (Lewis and Wallace:31)
- Prudential supervision of overlapping institutions

- Relationship between national and state supervision
- Regulating financial conglomerates.
- Coping with change
- Developing a efficient yet innovation encouraging regulatory structure
- Inefficiencies in the bureaucratic structure hampering ability to respond to crises
- Need for more publicly available dialogue between the regulators

With specific reference to Friendly Societies, we have also identified the following concerns (which are elaborated upon in the main AFSA submission):

- Structure of regulation
- The role of AFIC
- User pays in financial supervision

### **3.7.4. Trends**

Some of the key trends appear to be:

- The movement towards cooperative federalism
- The future of a super regulator and the regulatory approach in general
- Market concentration and the role of foreign institutions.

### **3.8. Long-term Savings System**

#### **Relevant institutions**

Superannuation funds are the best example of long-term savings systems. They have been produced by government policy to encourage saving for retirement. Other examples may include friendly society bonds and life insurance bonds. These latter instruments are designed to absorb savings over periods shorter than superannuation but longer than that often associated with DTI's.

#### **3.8.1. Definition**

'Long term savings' vehicles are products created by government policy and are designed to attract the long-term savings of individuals. These savings are for retirement only upon reaching a certain retirement age. The vehicle is made attractive by tax measures, and the tax benefit encourages it to grow artificially faster. This is an advantage that other long term savings options (traditionally involving shares and property, for example) do not have. Long term savings options have always been available but have mainly been utilised by those with the available income - without government assistance. It has been assumed that the remainder of the population is too hard-pressed by life's circumstances to voluntarily save for retirement. A specific long-term savings vehicle is a creation of government policy designed to ensure sufficient income for all retirees.

The long-term savings vehicle has characteristics common to both the life insurance industry and the deposit-taking institutions. It does not fit easily in a category. When examining a product however, in order to ascertain its regulatory requirements, it is necessary to evaluate the externalities or market failures that may be associated. The lack of a clear identity for superannuation or long term savings vehicles suggests that the product may need a category of its own. The category of 'long-term savings vehicles' responds to the challenge presented by superannuation which looks like an overlap between deposit-taking institutions and life insurance institutions. This raises questions about the appropriate focus for regulation.

Adding further complexity to the issue are the savings instruments that have been created to cover periods of ten years and more. These savings instruments, such as friendly society bonds, provide a means of meeting the shorter-term savings requirements of the public such as children's education and others. These have a long-term nature, but not a thirty or forty year time horizon as is associated with superannuation.

Short-term savings/credit vehicles receive no tax benefit and possibly a tax disincentive through lack of inflation-adjusted tax treatment. Longer term savings vehicles, however, do receive a tax benefit. It would appear that the concentration on either superannuation or short-term DTI savings is excluding a significant class of savings vehicles and needs. The savings debate should be conducted in terms of the above continuum. Measures adopted to increase savings in the long term should not undermine savings in the intermediate period - the savings policy which creates a long-term vehicle should take coherent account of intermediate and short term vehicles.

The observation that savings, as presently structured in Australia and, as one would expect from an *a priori* perspective, are really described by a continuum, suggests that the focus of savings policy should be on the entire spectrum of savings requirements. The public policy justification for a compulsory superannuation policy and its associated tax benefits must be a presumption that with respect to the long term (ie. 30-40 year savings), the average economic agent suffers from myopia which makes it difficult for them to see their long run optimal path.

If this observation is correct, and there is little reason to doubt its accuracy for the overwhelming majority of people, the same observation must apply to investments for other relatively long-term purposes that are not retirement focused. When the longer term end of the savings spectrum receives a tax benefit, all other things being equal, the flow of funds to switch to the long term products. Lewis and Wallace noted that:

a larger proportion of household savings in recent years has flowed to the long end of the financial sector.<sup>44</sup>

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<sup>44</sup> Lewis and Wallace. (1993:137)

In this circumstance, it is to be expected that the middle of the savings continuum would suffer most - since the short end has practical benefits and the long end has a significant tax benefit to offset perceived myopia on the part of economic agents. At this stage, the middle of the range has the insurance/friendly so bonds - which have an attached tax benefit for those who keep funds in for longer than 10 years. This provides a public benefit in helping to counter the myopia of the economic agents with respect to intermediate term investments. These products however, still suffer from the problems of information asymmetry externality associated with superannuation investments.

### **3.8.2. Externalities, Market Failures**

The investor in long term savings is thinking about an event that is often too far away to seem real, hence the investor reaction is likely to be similar to those who take out insurance. Until the policy is needed, it seems a little 'unreal' and hence is likely to be neglected as people spend time on more short-term products providing more immediate gratification. Yet concurrently, it is likely that people will become more and more conscious of the investment in their superannuation savings account - thinking of it in a manner similar to other deposits. These two strands of likely behaviour by individuals make the long term savings vehicle particularly vulnerable.

Superannuation takes deposits which are kept for a very long time, increasing the risk of information asymmetries blurring the understanding between client and supplier. The investor is not likely to pay the issue very much attention, and hence, *ceteris paribus*, the information asymmetry is likely to be stronger. Yet the scale of the savings represented by super, the significance of the investment for well-being at a vulnerable time and the difficulty of recouping losses towards the end of a working life it is highly likely that people will react with great fear at the prospect of their superannuation savings being threatened - giving rise to a product all the risk of deposit taking institutions and all the poor information associated with a life insurance product. This suggests a significant need for regulatory oversight. The regulatory oversight should also apply to the risks and market failures associated with intermediate term vehicles. These risks and market failures are in the same category as those applying for long term vehicles.

### **3.8.3. Present Issues**

Apart from a general concern over the artificiality of superannuation as a savings vehicle, the prime focus of debate seems to be how we structure this long-term savings vehicle to increase aggregate savings of the non-savers, while not distorting the savings patterns of existing customers. With respect to friendly societies, the following two issues come to the fore:

- The impact of long term savings on the intermediate savings
- The impact of the tax structuring arrangements in inducing non-savers to save rather than causing existing savings to distort their pattern of saving.

### **3.8.4. Trends**

The prime trend of note here seems to be that the concept of a superannuation system is here to stay, and hence can be taken to be a reflection of the Australian community's preferences. The question that remains to be settled is whether this is sufficient to restructure the Australian system of savings, or whether more needs to be done.

#### **4. Conclusion**

The product categories produced by the financial system should be the focus of Australia's regulatory approach. The financial system is intended to produce products as its ultimate contribution to society. When it fails to produce these products, we know that society will be worse off. Thus the failure of the current payments system will produce great loss of wealth and 'happiness'.

The loss of a 'product' or its reduced output, can be caused by the efficient operation of the 'invisible hand' because there is a better allocation of resources generating a better outcome in terms of wealth and welfare. These types of changes should be encouraged and not impeded by the regulatory framework because the net benefits they provide. However, wherever we see the invisible hand, the 'invisible elbow' can often follow!

The 'invisible elbow', in terms of market failures and externalities, causes resources to be 'bumped' into activities that cause losses in the net welfare of society focusing on the output of the financial system, we are able to distinguish between activities that need the regulatory intervention to reduce the impact of the 'invisible elbow' and activities that are being guided by the invisible hand. The list of products, and their externalities and market failures, produce a rationale for the regulatory framework of the financial system.

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Table 2. Type of Regulatory Framework relevant to each product/service.

Treasury should chair the Council of Financial Supervisors (CFS).

\*\*\*\*\*indicates the financial products are strongly regulated by the respective institutions. Less stars indicates less supervision.

Existing Supervisory Institution	RBA	ISC - superannuation division	ISC - insurance division	AFIC	ASC	ACCC	ASX
Proposed change	The RBA include banks, building societies and credit unions (ie DTI's)	Spins-off a superannuation arm	ISC insurance division and AFIC join up to become the FIC	AFIC joins the insurance arm of the ISC to form FIC			
Existing Supervisory Task	Prudential Supervision of Monetary Supervision of banks	Prudential supervision of insurance & superannuation	Prudential supervision of insurance & superannuation	Prudential supervision of all NBFI's	Corporate Supervision	Competition Supervision	Stockmarket supervision
Proposed Supervisory Regulator	RBA	Superannuation Commission (SC)	Financial Institution Commission (FIC)	Financial Institution Commission (FIC)	No change	No change	No change
Proposed Supervisory Task	Prudential Supervision of Monetary Supervision of all DTI's	Superannuation only Prudential supervision	Insurance only Prudential supervision (see adjacent column)	Prudential supervision of all non-DTI, super FI's	Oversighting of corporate conduct	Ensuring markets remain competitive	Ensuring the stockmarket is efficient
	Institutions affected by the proposed RBA structure	Institutions affected by the proposed SC structure		Institutions affected by the proposed FIC structure	No structural changes proposed	No structural changes proposed	No structural changes proposed

