ANZ SUBMISSION

TO THE

FINANCIAL SYSTEM INQUIRY

September 1996

Table of Contents

	Page
Preface and Summary of Recommendations	1
A. Effects of Financial Deregulation	8
1. Greater Consumer Choice	8
2. Promotion of Financial System Efficiency	17
3. Benefits to the Australian Economy	22
B. Requirement for Further Reforms	26
1. Main Factors Shaping the Financial Services Industry	26
• Customer sophistication	27
• New technologies	28
• Specialist competitors	32
• Globalisation	34
• Rationalisation	35
2. The Current Regulatory System Needs Refinement	37

- Price interference 37
- Consumer protection arrangements 41
- Competition policy 47
- Regulatory institutional arrangements 53
- Technology issues 59
- RBA regulations and activities 62
- Tax system issues 65

3. Reforms Must Not Weaken the Integrity of the Financial System 69

- Controlled access to payment system 70
- Prohibition of mixed conglomerates 71
- Maintenance of capital adequacy 72
- Continued protection of depositors 72
- Continued control of bank ownership 74

C. Recommended Reforms 75

1. Prudential Supervision 76
2. Consumer Protection 78
3. Institutional Arrangements 79
4. Competition Policy 81
5. Taxation Issues 81

Appendix I Duplication of Regulations 83

Appendix II Uniform Credit Code 85

References 90

PREFACE AND SUMMARY OF RECOMMENDATIONS

Trends in the finance sector are proceeding apace. Advances in communications technology are putting the means to access information on global markets into the hands of consumers, and consumers in developed economies are expected to take advantage of the opportunities provided with increasing enthusiasm.

In a world where banks and funds managers are already under pressure to provide a globally competitive return to their shareholders and investors, those who operate in consumer markets must increasingly provide a globally competitive offering to their customers. Operators in wholesale markets have already made the adjustment to global competition.

The consumer with the ability to discriminate between the product/price offerings of different financial institutions is a very powerful customer. Pursuit of such customers is leading product suppliers along two quite different paths. One path is to undercut the pricing of established market participants in (niche) market segments which are providing a high level of profit (the so-called cherry-picking). The second path is for institutions to seek to become universal service providers, with the aim of servicing a customer's total needs, and securing the benefits of scale in information processing.

Customers for financial services are benefiting from the outcomes of the strong competition between institutions on the two major pathways and on all the by-ways in between. The combination of deregulation, globalisation and technology has put a multiplicity of choice in the hands of customers for financial services, not least because it has put opportunity in the hands of financial service providers. The ability to identify market niches, study product offerings available elsewhere and bring a product to market is aided by the falling cost of technology and by the use of outsourcing to leverage off others' scale advantages in processing costs. Thus niche operators put pressure on conglomerates to unbundle their pricing, refine their cost structures and compete ever more keenly on the basis of the breadth of service they can offer.

The whole process delivers optimal outcomes to customers in terms of choice and price in an environment where regulation is exercised as lightly as possible (and with a view to Australia's legal and tax framework not disadvantaging Australian suppliers in a global marketplace) and where pricing is set by competitive forces rather than by regulation.

The smooth working of the financial system is of fundamental importance, not only to the domestic economy but to the reputation - and hence the ability to trade efficiently - of all Australian companies which operate offshore.

With all of the choice in financial products and in payment instruments now available, the core of the financial system remains the ability of customers of all sizes to effect payments for their purchases, and of suppliers of all sizes to depend on that payment. That is, value must be able to move from a buyer's "deposit" account to a seller's deposit account with absolutely minimal concern about the financial standing of the institutions handling payment and receipt of funds. The importance of this function merits prudential regulation of the institutions involved.

A related matter concerns the nature of the "deposit" and the risk which attaches to it. A precise definition of banking eludes central bankers and economists alike, but in developed economies it is common for banks to accept a degree of prudential oversight in return for the privilege of accepting deposits without prospectus, for repayment in full on demand or at a term agreed by the customer, or for transfer on the customer's instruction.

In Australia, depositors are offered the assurance that the Reserve Bank of Australia has a responsibility to protect their interests. This is not an assurance to banks (the RBA has made it clear that an insolvent bank would be allowed to fail) but it is a signal to customers - and to the world at large - that a bank deposit is at the very lowest end of the risk spectrum. The fact that this signal is not often needed does not negate its importance.

ANZ notes that there are many other organisations of a high degree of probity which may like to offer their customers a bank-like service. For reasons concerned with the fundamental need to preserve the highest level of confidence in the core activities of the finance sector, ANZ is of the view that institutions which wish to accept deposits without prospectus and participate in the payment system, must also accept the prudential supervision of the Reserve Bank of Australia,that is, they must become banks. Building societies and credit unions have long accepted deposits and already operate according to prudential rules as stringent as those applying to banks. They should come directly under the supervision of the Reserve Bank and so become banks. The Reserve Bank should consider how it would accommodate mutual institutions within its prudential framework.

With regard to the framework of regulation for financial institutions, ANZ considers that banking regulation has served us well in an international context and we would want to preserve that advantage going forward. We believe that our “welcome” in some of our overseas marketplaces depends to some extent on the fact that we are supervised by a recognised central bank.

Within Australia, the general regulatory framework has grown as the financial services sector has grown, and has thus resulted in some overlaps which are negating the thrust of deregulation. In addition, with the blurring of distinctions between conglomerates as they compete to become universal suppliers, the harmonisation of the various regulators needs some attention. Nonetheless, just as the skills required to manage the risks and balance sheet of a bank are quite different from those required to manage an insurance company’s risk and balance sheet, so too the skills required for prudential supervision are different. ANZ supports the lead regulator model for the prudential supervision of financial conglomerates and believes that the roles of the various regulators should be rationalised and re-defined to avoid overlaps and duplication.

Within the desirable framework of total deregulation of products and pricing, and streamlined institutional regulation for prudential purposes only, consumer protection also needs rationalisation. ANZ acknowledges the benefit accruing to consumers from clear product and pricing disclosure and believes that such disclosure should be the sole tool of consumer protection. At present, too many separate regulatory authorities have views about what constitutes adequate disclosure and such views often conflict with each other. State differences, in particular, are a contributing factor.

Competition between participants in the finance sector would be enhanced, and costs of regulation reduced, if all consumer protection were handled by a single national body which could bring a consistent view of disclosure standards to all competitors. All bodies, both Federal and State, currently handling consumer protection issues should cede the oversight and management of such issues as they relate to the finance sector, to a single authority. Our preferred candidate would be the Australian Securities Commission, first because it is national and second, because it has experience of financial sector disclosure matters through its role in overseeing propectuses. Apart from producing cost savings for the financial sector, such a move would release resources in the Insurance and Superannuation Commission, the Australian Competition and Consumer Commission and its state offices, and the various state Fair Trading offices.

Competition to be universal service providers may well lead to pressure for merger of financial services suppliers and for some activities, acquisition continues to be a viable growth strategy which should not be unnecessarily impeded. There is, however, a growing view that economies of scale in processing may be able to be realised without the disruption of merger. For example, institutions which lack sufficient scale may choose to outsource some aspects of their processing (and institutions which rate processing as one of their core competencies may choose to offer this service to others).

A particular aspect of competition policy is the extent to which foreign ownership of the finance sector would prove to be beneficial to Australia. At one end of the spectrum is New Zealand, where nearly all the banks are foreign owned (mostly by Australian parents). As long as branches remain a significant distribution channel, banks will remain significant employers but there seems little doubt that, with foreign takeovers, the major head office function skills - together with the most talented management - are lost as the head office functions are diminished. These skills are financial, legal, strategic planning, market development, product design, systems design and computer programming - all with their allied purchasing power of other professional services, plus networks of graduates recruited and consultants employed. Taken to its logical conclusion, the end result must be a significant "brain drain", both because the most talented management leaves to work in the head office of the overseas acquirer and because the opportunities for employment of allied professional services and new graduates are diminished.

Further, Australian-headquartered banks are of particular value to Australian companies which are endeavouring to develop overseas markets. Having Australian banks represented on the ground in their chosen export destinations makes it likely that identified market opportunities will be fed back to them by their bankers. This would not necessarily be the case if their bankers were foreign-owned, because market opportunities abroad would be more likely to be reported back to customers in the bank's home base.

Debate about the desirability of overseas ownership is not peculiar to the financial services sector but a reconsideration of competition policy in relation to the finance sector will inevitably raise the question of overseas ownership. ANZ believes that the Foreign Investment Review Board (FIRB) should have its views on the issue well developed ahead of the time pressures which may arise if particular proposals were to be presented.

We acknowledge the obligations of our citizenship, which include being subject to Australia's competition policy and FIRB guidelines.

The financial services sector is facing an era of accelerated change and ANZ welcomes any changes to the structure of regulation which will give flexibility in the way institutions position themselves to meet the challenges of all the markets in which they compete. Nonetheless, we feel that the fundamental importance of stability in the financial system requires that change should be managed in an orderly fashion; a reasonable period of notice - say two years in the case of any major structural change - will enable the transition to a new era to be managed with minimal disruption to markets.

Against this background, ANZ seeks acknowledgement by the Committee of Inquiry of:

1. **The efficiency of competition as a price determinant and the efficiency constraints which result from price regulation.** Thus ANZ recommends:

    - that governments of all levels relax their price controls in recognition of the fact that bank managements are best placed to make pricing decisions in the interests of their customers as well as their shareholders. Price controls effectively exist via the deeming rate legislation and via the regulations imposed by State governments in relation to interest payable on trust accounts. An emerging trend to call for inquiries into private sector pricing also concerns us.

2. **The fundamental importance of the safety of the payments system.** Thus ANZ recommends:

    - that direct access to the payments system be limited to institutions prudentially supervised by the RBA,

    - that the AFIC/SSA regulatory framework be dismantled and that building societies and credit unions be supervised by the RBA. Under these arrangements the RBA would be the sole prudential supervisor for all deposit-taking institutions: banks, building societies and credit unions.

- that the issue of open system Stored Value Cards (SVCs) be limited to deposit-taking institutions prudentially supervised by the RBA.
- that the supervision of financial conglomerates be formalised by the establishment of a 'lead regulator' model.
- that mixed (ie combinations of financial and non-financial) conglomerates not be eligible to hold a bank licence.

3. **The international perspective of financial sector regulation.** Thus ANZ recommends:

- that several key planks of the existing regulatory regime be retained, ie
  - that Australia continue to adhere to the Basle Capital Accord as developed under the guidance of the Bank for International Settlements (or any globally recognised framework that succeeds it),
  - that the current 10 and 15 per cent limits on individual bank shareholdings be maintained but applied at the holding company level in the case of financial conglomerates.

4. **Disclosure as the sole tool for consumer protection, with disclosure standards for the financial sector to be handled by a single national authority.** Thus ANZ recommends:

- that one national body (the ASC) be given sole responsibility for consumer protection in financial services,

- the Uniform Credit Code be revised to substantially reduce its prescriptiveness and remove the civil penalties for breaches.

5. **The need for an internationally acceptable privacy regime.** Thus ANZ recommends:

   - that national privacy legislation (of minimal prescriptiveness consistent with international obligations) be developed in consultation with industry participants and that such legislation supersede any relevant State legislation,

   - that in this - or any other - area, future State or Federal consumer protection measures be subject to thorough assessment to demonstrate (a) existence of a clear case for its introduction and (b) that the benefits of the proposed measure outweigh the costs.

6. **The need to allow market participants the flexibility to determine their preferred size and structure, within the constraints of the competition policy determined for Australia.** Thus ANZ recommends:

   - that Competition Policy be applied to banking in the same way it is applied to other industries. This would involve:

     - adoption by the ACCC of more appropriate market definitions when assessing the implications of bank mergers. These definitions should recognise that competition is not confined within state borders, substitute products are provided by non-bank suppliers, and economies of scale are important in bank processes,

- removal of the 'six pillars' policy of restricting mergers between major banks and major insurance companies in favour of assessing each merger proposal on its economic merits,
- clarification of policy regarding foreign takeovers.

7. **The need for a transition period preceding any major structural change to the regulatory framework.** Thus ANZ recommends:

- that any structural changes to the regulatory framework for the finance sector are introduced from a date which allows a period of orderly adjustment, say two years for any major change.

8. **The need for a group of key changes to the role and supervision of the Reserve Bank of Australia.** Thus ANZ recommends:

- that the non-callable deposit requirement contained in the Banking Act be abolished in favour of fees to cover the cost of supervision,
- that the RBA cease its commercial activities in provision of direct entry and Financial EDI services and open its Commonwealth Government Securities registration, clearing and settlement service to competition,
- that the Prime Assets Requirement in Prudential Statement D1 Supervision of the Adequacy of Liquidity of Banks be abolished,
- that prescription as to who may sit on bank boards be removed from Prudential Statement B1 Ownership and Control of Banks.

9. **The need to address several taxation issues.** Thus ANZ recommends:

- that FID and DT be abolished,
- that stamp duty on financial transactions be abolished or reduced,
- that tax arrangements to allow unit trust mergers be introduced,
- that the inequitable tax treatment of bank deposits relative to other types of investment asset be redressed.

SECTION A: Effects of Financial Deregulation

This section argues that the impact of financial deregulation has been clearly advantageous in terms of consumer benefits, the operation of Australia's financial system, and performance of the Australian economy.

1. Consumers enjoy greater choice and better prices as a result of deregulation.

a) Pre-deregulation

Prior to deregulation, banks and other financial institutions were tightly constrained in the range of products and services they could offer and the terms on which they could make them available to customers.

These regulations and controls resulted in a number of undesirable consequences.

- Savings bank interest rate controls were designed to make home ownership affordable for all Australians. However, they had the perverse effect of ensuring that the lowest cost finance was more likely to be accessed by the relatively wealthy.

- Credit rationing meant that small businesses were often forced to obtain funding from expensive secondary sources.

- Higher risk businesses could not obtain funding from banks because the banks were unable to vary the interest rate according to the risk.

- Lending controls did not achieve their macro-economic objective of controlling growth in the money supply because customers turned to alternative (non-controlled) funding sources.

The deregulation initiatives were clearly successful in removing these distortions and improving the choice available to customers.

b) **Expanded range of suppliers**

Customers now have a much greater choice of suppliers for financial services. The numbers of financial institutions alone do not show this, as many institutions offer a wider range of products and services than in the regulated era, and some specialist providers occupy important market niches.

For instance, within the banking sector, the number of licensed banks has increased since 1985 from 25 to 50: 19 domestic banks and 31 foreign banks. These numbers mask the numbers of their specialist subsidiaries, such as funds management, stockbroking and insurance. Merchant bank numbers have also increased, from 60 in 1982 to 140 at present.

The entry of foreign banks has been particularly important, as they have intensified competition in several key markets. Most foreign banks are active players in the corporate market, and have been successful in Australia thanks to their skills and products developed overseas, and in some cases their parents' credit ratings which offer funding cost advantages. Some foreign banks have targeted other market niches, such as Rabobank in agriculture and Citibank in consumer lending.

Considerable changes have also occurred in the numbers of financial institutions in the non-banking sector, as well as the range of products that typical institutions offer. Since 1982, the numbers of building societies, finance companies and general financiers has fallen by 80, 37 and 83 respectively, but this reflects mergers of smaller players within these segments and conversions to other institutions. Credit co-operative numbers are little changed. The number of superannuation funds has grown, so that there are now about 120,000 funds.

Superannuation funds are an example of how institutions are expanding their activities to compete in non-traditional segments. Many now offer their members discounted home loans (such as through the Superannuation Members Home Loans scheme established in 1994), and more recently some funds have entered the commercial loan market (such as Super Business Loans, established earlier this year).

In some cases, the number of competitors in a segment does not really matter if those players are price leaders. The mortgage originators provide the best example of this, having exercised an influence over the home loan market which is disproportionate to their numbers.

Mortgage originators are also part of another post-deregulation trend: the rise of specialist financial providers. Unencumbered by a ‘bricks and mortar’ branch network and taking advantage of superannuation funds and other institutional investors’ interest in securitised loans, mortgage originators have been able to underprice some bank housing loans. Some car manufacturers use finance packages to win customers, competing against finance companies and personal loan providers. The increase in providers has intensified competition in most market segments, pushing down prices and leading to product innovation.

c) **Expanded service options**

The number of locations at which customers can access their bank accounts has increased dramatically. In addition to an extensive branch network (around 7,000 bank branches and over 1,500 building societies and credit union outlets), customers now have access to their funds via a wide range of new devices and delivery channels (such as ATMs, EFTPOS, telephone banking and mobile managers) which offer greater convenience. Where once it was necessary to plan cash for weekends, cash is available 24 hours a day via ATMs and most payments can be made by credit card or EFTPOS. Telephone banking is gaining wide acceptance and direct access to accounts via the Internet or other electronic networks is becoming widely available.

In addition to this dedicated infrastructure, numerous retailers, oil companies, charge card issuers, cash management trusts and Australia Post outlets offer payment services (usually within a ‘closed’ environment where payment instructions do not require clearing between clearing institutions).

Wider payment choices for consumers also benefit businesses, as they reduce the costs and risks of holding cash. With EFTPOS and credit cards, fewer payments are made in cash, and consumers are not constrained by the amount of cash they are carrying. These payment methods have the added attraction of reducing the risk of losses from dishonoured cheques and allow businesses to receive same-day value for transactions (as they do for cheques if banked on the day of receipt).

Since deregulation, businesses have benefited considerably from the increased competition in the financial services market, as technological developments have facilitated the development of new products and services. The introduction of electronic banking services such as ANZ's

PC-based OnLine allows businesses to perform on-line monitoring, transfers and reconciliations, as well as payroll and creditor payments. Larger corporates can make paperless payments (both domestically and internationally) through Financial Electronic Data Interchange (EDI), offering considerable savings in their administrative costs. Importers and exporters now have the capacity to make some currency transfers and trade documentation on-line. To meet the cash management needs of large corporates, banks have developed new products and systems, such as ‘sweeping’ the balances of all their accounts to a single account at the end of the day.

Greater competition has also placed a premium on customer service for both consumers and business customers, as customer service and pricing are the two major arenas for competition. In the regulated era, the lack of competition and rationing of credit created an environment in which there was no impetus for banks to market their products according to their customers' needs and preferences. Bank products were more likely to be designed to suit the bank and its internal systems requirements.

Now, with the impetus of competition, banks and other financiers devote considerable resources to understanding their customers’ needs and offering appropriate products and services. At the consumer end of the market, this can be seen in service quality initiatives such as ANZ's Teller Queue Guarantee and loan turnaround commitments. For business customers, most banks have the equivalent of ANZ's relationship managers. These managers aim to understand their customers' businesses so that they can meet their financial needs and typically offer a degree of management expertise and flexibility which is a considerable advance on the offerings of the regulated era.

d) **Expanded product range**

Competition has triggered a significant expansion in the number and variety of customer accounts, and in the array of products and services available to businesses.

Consumers now have some 700 different retail transaction accounts to choose from. Most banks, building societies and credit unions offer a range of different retail transaction accounts. For example, ANZ offers eight of these accounts: Access Account (with or without a cheque option, and with two fee options), Access Simplicity Account, Personal Cheque Account, High Performance Passbook and Deeming Account, Cash Management Account and Visa PAYCARD.

This choice of accounts reflects the increasingly diverse range of customers' needs and preferences. There are significant differences in the features and benefits of products offered by various institutions. The major differentiating factors for transaction accounts are: interest payment, frequency and calculation method, free transaction levels and fee waivers, linkages with other accounts, loan offset accounts, passbook or statement records, access facilities (cheque, ATM, EFTPOS, phone banking), overdraft facilities and other product enhancements such as travel insurance. New electronic options for payment of bills have also been introduced.

Similar developments have occurred in home loans. Prior to deregulation, little flexibility existed in the style of home loan. Repayments could only be made monthly, and there were no redraw facilities. Now a much larger array of housing loan products is available (over 400) and they have fewer pre-conditions. Differentiating features include: interest rates (fixed and variable), flexible repayment arrangements, redraw facilities, no-frills products, fee waivers on other accounts and interest offset accounts. It is now possible to apply for and obtain an ANZ housing loan without visiting an ANZ branch. ANZ Direct allows customers to apply for a housing loan over the telephone. Once the application process has commenced, the customer deals only with customer service operators over the phone, or a mobile manager who visits the customer’s home or workplace.

The range of products for businesses has also grown considerably since deregulation. With the lifting of exchange rate and interest rate controls, businesses have needed tools to protect themselves from rate fluctuations; this has led to a proliferation of risk management products such as swaps and options, as well as advisory services. As discussed above, electronic banking services offer on-line monitoring, transfers and reconciliations, as well as payroll and creditor payments. The range of credit card products has been increased by such products as ANZ's Business Visa Card and Visa Purchasing Card, which allow greater cost control for businesses as well as convenience.

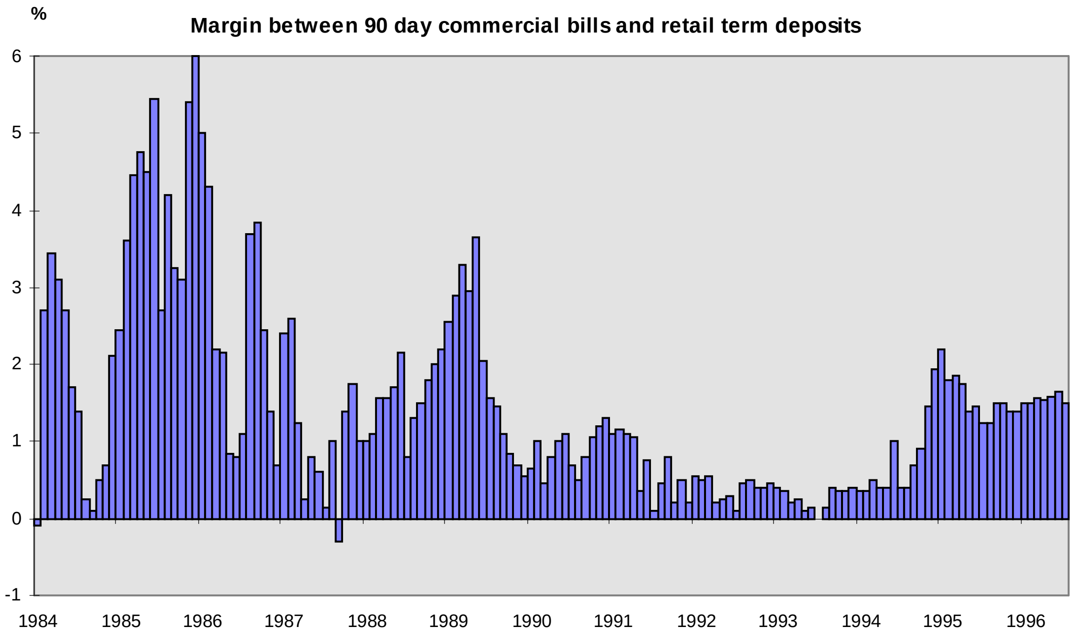
Products and services aimed at large corporations have proliferated, as an increasing number of these businesses seek to tap offshore finance as well as structured finance packages.

e) **Better prices**

Increased competition has also brought better prices to customers.

Interest rates paid on deposits have improved significantly. Retail term deposit rates have moved to better reflect market rates (Chart 1). Banks have also taken advantage of pricing freedom to offer more attractive deposit products. Since 1980 the percentage of retail deposits earning market interest rates has risen from 45 per cent to 91 per cent.

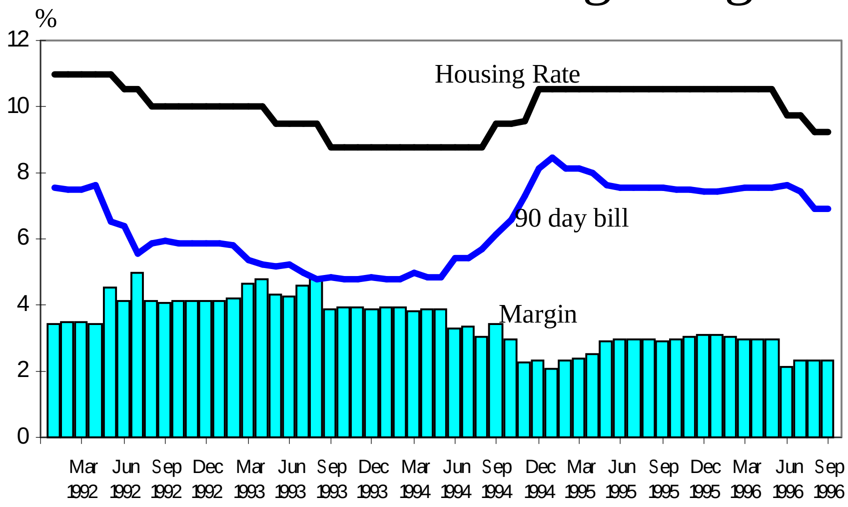
Chart 1



Mortgage originators, while having a relatively low share of the market (less than ten per cent of new approvals) have put considerable downward pressure on housing loan rates, particularly during this year (Chart 2).

Chart 2

Variable Rate Housing Margin



In the corporate and large business market, margins have become very fine. The capital market itself has become an increasingly important competitor over the past 15 years, providing a competitive discipline in pricing. Large international banks have followed their multinational clients into Australia and price their services to protect their global relationships. Merchant and investment banks ensure very competitive pricing in project and structured finance.

In the small business market, the entry of regional banks has increased competitiveness: according to the Yellow Pages Small Business Index, the non- major banks' share of small business lending increased from 18 to 22 per cent in the two years to 1995. For very small businesses borrowing under $1 million, competition is intense and the fact that residential property is generally pledged and credit assessment skills are not as vital as in cash flow lending is allowing even mortgage originators to supply this market.

2. **Deregulation has promoted the further growth and development of an efficient financial system in Australia.**

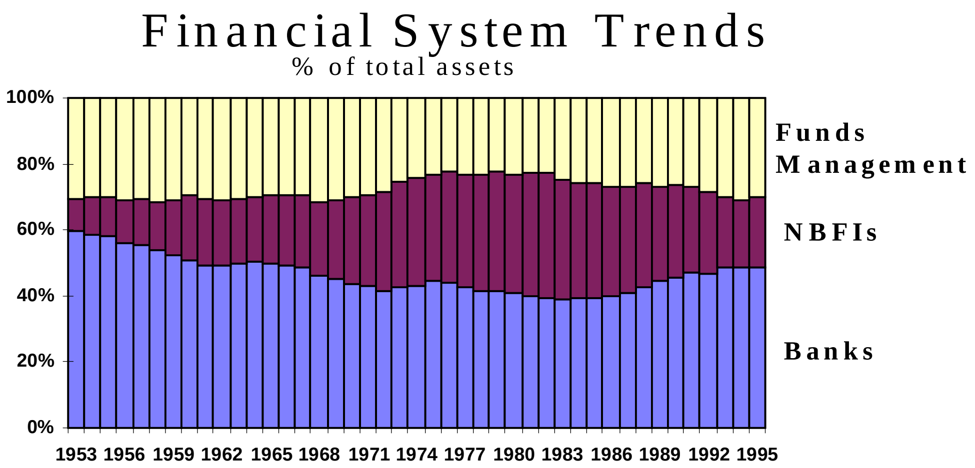
The removal of key restrictions over the course of the 1980s recognised that competitive pressures were the most effective means of creating conditions to promote efficiency in the financial system. The Committee of Inquiry into the Australian Financial System (the Campbell Committee) identified three efficiency dimensions:

- allocative efficiency: the extent to which the financial system directs funds into the highest yielding areas;
- operational efficiency: whether resource costs are being minimised for the level of service being provided; and
- dynamic efficiency: the adaptiveness of the system to changing needs and its ability to adopt technological innovations (1981, p2).

A market-based system relatively free of distortions leads to more efficient allocation of resources. Allocative efficiency has undoubtedly improved in many areas. Carmichael (1992) notes the fact that "real interest rates around the world...., have converged to a large extent over the past few decades is *prima facie* evidence that capital has flowed on balance to those offering the greatest promise of return. In this sense, capital flows have probably added to economic efficiency."

Once unshackled, a banking sector that had languished during the 1960s and 1970s resumed growth. Controls had been rationing funds lent by banks and their removal provided banks with the ability to assess proposals across the whole spectrum of borrowers, allowing scarce savings to be better mobilised. The institutional structure of the industry changed with banks regaining considerable market share from non-bank financial institutions, mainly building societies (some of which became banks), finance companies and credit unions (Chart 3).

Chart 3



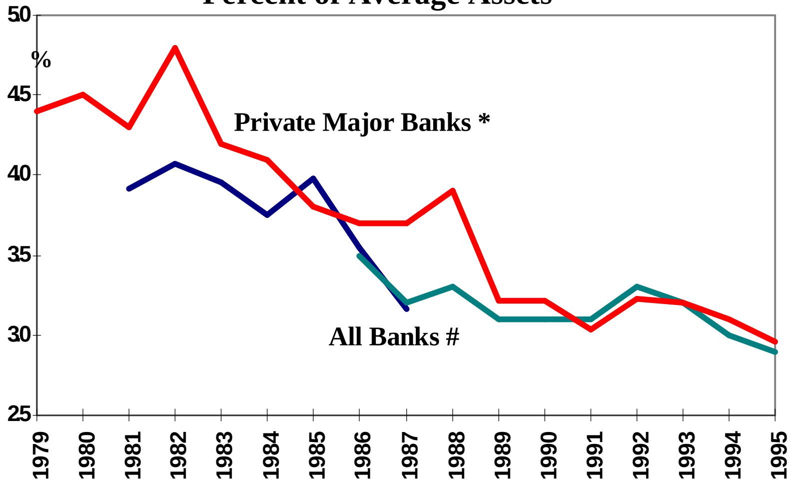
While allocative efficiency has improved, further gains could be made by removal of constraints on rational pricing of bank products and services and more uniformity of tax treatment of savings vehicles. These points are taken up in Section B.

Evidence on operational efficiency relates to banks and suggests some improvement since deregulation. Except for the temporary effects of slower economic growth and substantial balance sheet ‘cleansing’ in the early 1990s, banks’ operating costs as a percentage of assets has continued to trend down from about 4.8 per cent in 1982 to 3 per cent in 1995 (Chart 4).

Chart 4

Operating Expenses

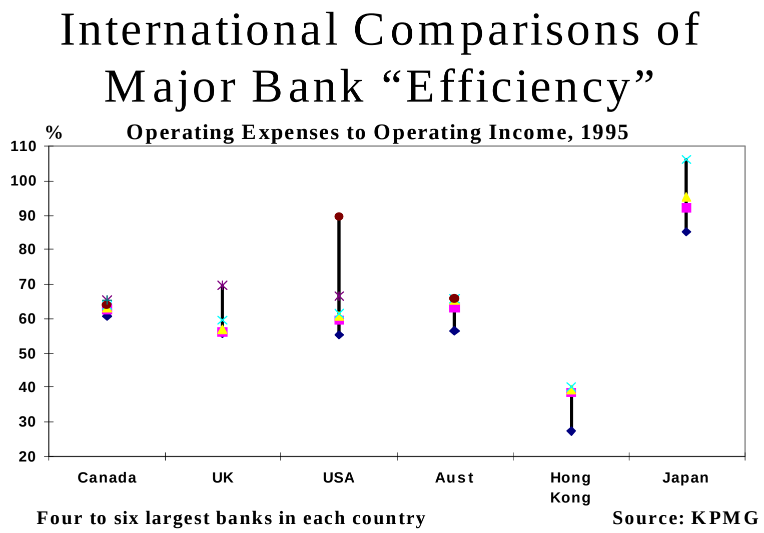
Percent of Average Assets



*** ANZ, WBC, NAB, Source: ABA and Annual Reports**
 # 1981 to 87, OECD; 1987 to 1995, KPMG

Australia's major banks' operational efficiency as measured by 'operating expenses/operating income' is comparable to other English-speaking countries (Chart 5, Note: each symbol on the chart represents a bank). The similarity between Australia and Canada is particularly noteworthy given the comparability in population size, geographic characteristics and industry structure.

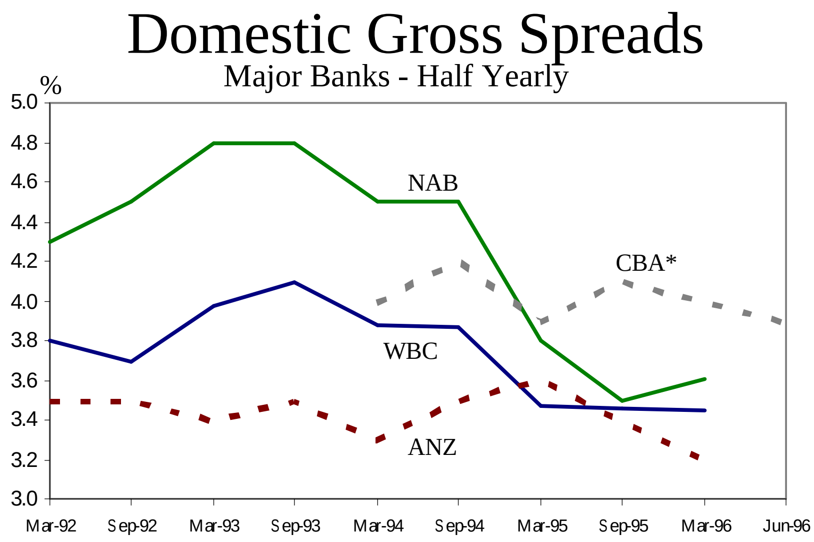
Chart 5



Further gains can be expected as branch networks are cut back to levels comparable with those in other countries. Australia is heavily branched compared to other countries, for example, in 1995 Australia had 371 branches per million population compared with 264 and 283 in the United States and United Kingdom, respectively (BIS, 1996).

Compression of margins as a result of competition has been particularly apparent recently although it has perhaps been slower to arrive than originally anticipated (Chart 6). The principal reason for the delay was that for much of the decade following deregulation, the yield curve was inversely sloped (short-term rates were higher than long-term rates). This made it very difficult for potential competitors (such as mortgage originators) to offer a product that would have been attractive to customers and put genuine competitive pressure on margins. In addition, the appeal of securitized products, both to investors and to borrowers, was probably set back by several years as a result of the unfortunate experience of securitized schemes sponsored by state governments in the late 1980s/early 1990s. However, these competitive pressures are now being felt in full.

Chart 6



* June and December Half Years

Source: Annual and half-yearly reports

Improvement in dynamic efficiency is clearly evident in the customer focus of banks (accompanied by the rise of the marketing function) and the rapid rate of adoption of new technology, especially electronic delivery channels. Without deregulation, financial innovations were more likely to have been tailored towards overcoming the imposed restrictions rather than being directed towards improving customer service:

> “ it is very likely, they (innovative financial products, instruments etc.) would have been less extensive and some of them would have been of the ‘second best’ kind - designed to by-pass regulation.” (Argy, 1995)

3. Deregulation has yielded net benefits to the economy as a whole.

While it is difficult to isolate the effects of deregulation from other reforms which have affected the Australian economy, it is fairly clear that deregulation has had an overall positive impact.

Although the Australian economy has grown more slowly since deregulation (4.5 per cent a year in the 20 years before deregulation versus 3.4 per cent in the 13 years since) the difference is more than explained by the slower rate of population growth and the slowdown in productivity growth experienced by most industrialised countries since the mid-1970s.

The positive effects of deregulation can be seen more clearly by comparing the experience in Australia with that of other economies.

Prior to deregulation the Australian economy grew broadly in line with the average rate of major OECD countries whereas since deregulation it has expanded at 1.25 times the average rate.

Since deregulation Australia has experienced its strongest growth in exports, imports and business investment (Table 1) while the relative importance of dwelling investment and public expenditure has declined. Deregulation has directly contributed to the improvement in Australia's export performance by facilitating adjustment in the Australian dollar to levels more consistent with Australia's internal cost structure - an adjustment which (as the experience of other countries with less flexible exchange rate regimes clearly demonstrates) would have been much more traumatic had the pre-1983 regulatory structure been maintained.

Table 1: Selected Economic Aggregates Pre- and Post-Deregulation

	Average annual rate of growth (per cent)	
	Pre-deregulation (a)	*Post-deregulation (b)*
Expenditure components of GDP		
(in constant 1989-90 prices) -		
Private consumption	4.2	3.3
Dwelling investment	4.9	2.0
Business investment	4.8	5.1
Public expenditure	4.8	2.5
Exports of goods and services	6.3	8.0
Imports of goods and services	5.5	7.4
Gross domestic product	4.5	3.4
Gross domestic product per capita (c)	2.5	2.0
Employment	2.1	2.2
Inflation (d)	6.5	4.8
Memo item		
Seven major OECD countries' real GDP (e)	4.2	2.7

Note: (a) September quarter 1959 through December quarter 1979. (b) December quarter 1983 through March quarter 1996. (c) 'Pre-deregulation' period in this instance is from June quarter 1960 through December quarter 1979. (d) As measured by the implicit price deflator of private consumption expenditure. (e) 'Pre-deregulation' is March quarter 1960 through December quarter 1979.

Sources: ABS, *Australian National Accounts: National Income, Expenditure and Product* (catalogue no. 5206.0); ABS, *NIF-10S Model Data Base* (catalogue no. 1342.0); OECD, *Quarterly National Accounts*; and ANZ calculations.

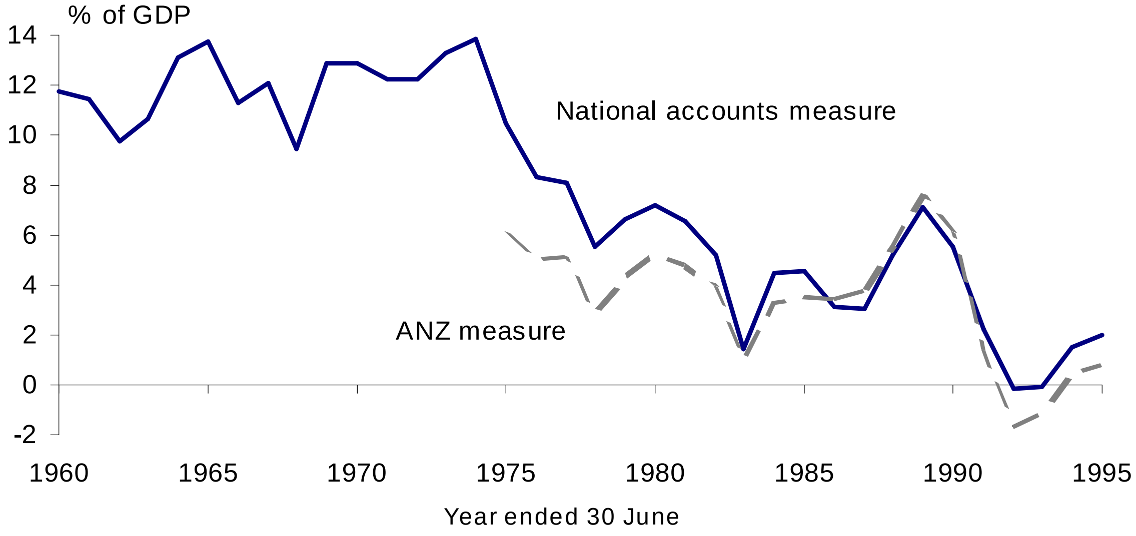
Deregulation has contributed to a lower and more stable inflation rate. Since deregulation, inflation has averaged 4.8 per cent a year, compared with an average of 6.5 per cent a year during the pre-deregulation era (or 5.1 per cent during the five years prior to the 1972 oil and food commodity price shocks). The standard deviation of annual inflation rates has declined from 4.8 percentage points before deregulation to 2.5 percentage points.

While net national saving has declined since deregulation, a range of factors have influenced this.

The decline represents a continuation of a long-term trend in Australia (Chart 7) and is consistent with experience in many other industrialised countries with more pervasive regulation than Australia.

Chart 7

Measures of Net National Saving



Source: ABS, *Australian National Accounts: National Income, Expenditure and Product* (cat. no. 5204.0), 1994-95; and ANZ, *Saving Report*, March quarter 1996. The ANZ measure is not available before 1974-75.

The trend to lower saving has almost certainly been reinforced by the greater availability of credit since deregulation (elimination of 'credit rationing' was one of the aims of deregulation). However, the key driver of this trend has been the demand for loan funding fuelled by a widespread perception that geared asset acquisition was the key to wealth creation. While the resultant surge in credit demand persisted for a period of high real interest rates, it now appears that - in an era of reduced inflation - the appetite for high gearing has been reduced.

SECTION B: Requirements for Further Reforms

This section identifies the major factors which will change the financial services industry over the coming decade and highlights the areas of financial system regulation and administration that will need to be reformed to keep pace with these changes. It also identifies the key aspects of current regulation that must be preserved in order to maintain the integrity of the financial system. Recommendations for reform are contained in Section C.

1. The financial services industry will be reshaped over the coming decade by five key factors.

The financial services industry is undergoing rapid transformation. Key drivers of change are the revolution in information and communication technologies and the trend to globalisation. The emergence of electronic service technologies coupled with changing customer attitudes and behaviour is overturning many of the advantages previously held by banks, while simultaneously opening up new product and service possibilities. Supported by 'new' technologies, specialist competitors have emerged across virtually the full range of traditional bank activities. Technology has enabled financial services providers to see the world as their marketplace. Global suppliers of financial services - both banks and non-banks - compete in the Australian market and Australian financial services suppliers are taking a global view of the industry and its opportunities. The co-incidence of these changes is rapidly transforming the nature of competition in the industry, and traditional providers are accordingly seeking to 're-invent' themselves in order to compete effectively.

Rapid change places significant responsibility on regulators to maintain the integrity of the financial system and protect the interests of its users and members, while not hindering the natural development of the industry and the ability of the banks, in particular, to respond to competitive pressures.

The major factors behind these changes and some of the implications are outlined in more detail below.

a) **Customers are becoming increasingly sophisticated** in their usage and understanding of financial services.

   In the past, consumers and businesses were quite conservative in their use of financial services. They tended to use a narrow range of relatively simple financial products and remained loyal to a few suppliers.

   Now, however, customers are well informed about the range of suppliers and products available in a marketplace that is highly competitive. This is changing the market in two ways.

   First, customers are now looking to their suppliers for convenient access to a much wider range of services. Rather than just a bank passbook savings account, consumers are seeking to buy market-linked investment products. Where businesses may have previously relied on long-term fixed rate debt, they now want flexible credit facilities with variable interest rate risk management capabilities. These increasingly sophisticated customer needs require that banks and other financial service firms broaden their product range and place much greater emphasis on product innovation and development. It is this trend which is driving the emergence of bancassurance and other “cross-product” developments (for example, bank investment in stockbroking).

Second, greater sophistication has led customers to become increasingly discerning in purchasing financial services. Whereas customers used to rely on advice from ‘their’ bank and purchase from it exclusively, they are now prepared to ‘unbundle’ their requirements and seek out the best offering from a range of financial service providers. The large amount of ‘churn’ in the mortgage market during the past few years as customers switched suppliers and refinanced existing mortgages at more attractive rates testifies to this.

These developments have pricing implications for banks:

- the level of cross-subsidisation among services which could be sustained when customers were brand loyal and bundled their financial service purchases, cannot be sustained; and hence

- if full-service banks are to survive they must adjust their pricing policies towards a more rational, user-pays system and adjust their product offerings to match the market.

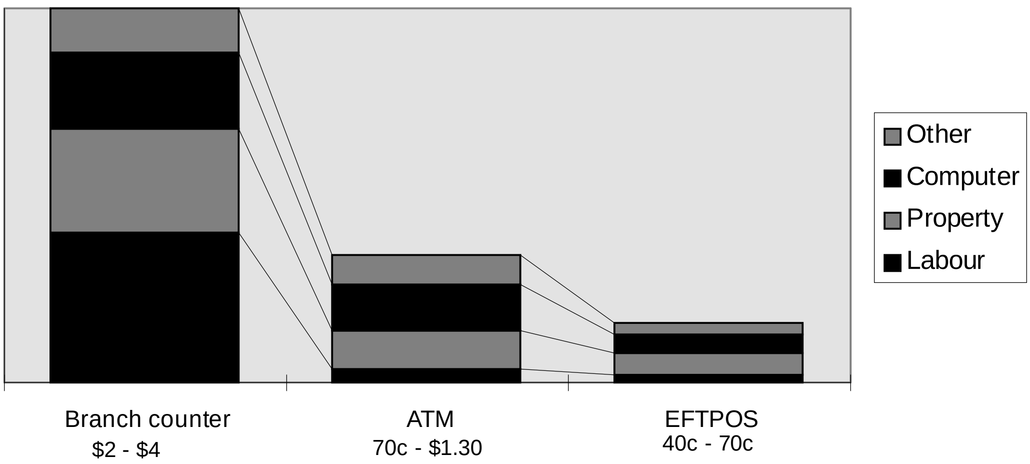
b) **New technologies** are revolutionising the financial services market.

Technology has already had a huge impact on financial services and will continue to do so at an accelerating pace in the future.

A dramatic shift has occurred in service delivery mechanisms. ATMs, EFTPOS and now increasingly, telephone and PC banking are making the old ‘bricks and mortar’ bank branch networks obsolete. This trend is set to continue as customers become increasingly comfortable with new technologies and as bank pricing is modified to reflect the relatively lower costs of these channels compared with branches. (At the moment, bank pricing does not reflect cost differentials between different delivery channels. It costs ANZ about six times as much to service a withdrawal across the branch counter as it does through an EFTPOS terminal (Chart 8).) As pricing policies are reformed to reflect these differences the shift towards electronic service systems will accelerate.

Chart 8

ANZ transaction costs - withdrawals



Emerging technologies will have a similar revolutionising impact on the financial services industry.

Stored Value Cards (SVCs) may over five to ten years largely displace cash payments for frequent, low-value transactions such as convenience purchases. Australian banks are amongst the first in the world to test the technology which will allow customers to ‘reload’ their card from their savings or cheque account via an ATM, telephone, or PC. Some systems will also support card-to-card value transfer. This trend will further reduce the need for customers to use ‘bricks and mortar’ networks.

Electronic ‘virtual’ banks are also beginning to emerge. The first example of this, Security First Network Bank, opened in 1995 on the Internet. There are hundreds of other banks displaying information on the Internet, but SFNB is the first exclusively Internet bank. It has no physical network and offers a 24 hour a day, 7 days a week service which allows customers to transfer funds between their own accounts, reconcile bank statements, pay bills, and effect brokerage transactions. In time, it is expected to also be able to offer payroll services, insurance policies and origination of loans.

By using the Internet, CompuServe or On Australia electronic infrastructure, providers can offer low cost, easily accessible financial services around the world. Australian customers are already able to invest in some US managed funds via the Internet and, within a year or so, Australian banks will be delivering a wide range of services via electronic networks (current offerings by Australian banks are generally limited to marketing and product information). Customers can access these networks easily with an Internet-capable PC and without special financial software.

The need to maintain the integrity and authenticity of payment transactions transferred electronically has been a major barrier to using the Internet for the transfer of payment instructions, to the extent that most Australian banks have recommended their merchant clients do not offer such services. However, recent development of an international specification for transaction authentication - the Secure Electronic Transaction (SET) specification - is expected to result in a significant increase in the use of open networks such as the Internet for electronic transfer of payment instructions. SET has been endorsed by major card scheme and technology providers and commercial availability of the supporting technology is expected in 1997.

It is likely that debit cards will also be supported through domestic extensions to the SET specification. Likely integration of smart cards as secure SET tokens will further strengthen the security associated with SET and its derivatives and will, over time, enable the banks to offer a fully integrated payment facility to their customers incorporating debit, credit and stored value.

Such services will also enable retail customers in the future to make purchases internationally via the Internet. Merchants will be able to accept payments from overseas consumers with clearing and settlement effected securely by banks’ payments clearing systems.

Business to business dealings will also move increasingly to electronics, leveraging the commercial availability of non-proprietary security services, such as SET, with strong authentication provided through digital signatures.

The Australian regulatory framework must respond to these specific new technologies and have enough flexibility to accommodate other new technologies, such as micropayment systems on the Internet, which are still being developed.

c) **Specialist service providers** are emerging to compete with full service banks.

Technology is fundamentally altering the economics of banking.

Technology has made disaggregation or unbundling of services into their component parts possible, while deregulation and the relative slowness with which banks came to understand the cross subsidies which existed between their products have provided profitable opportunities for new entrants.

As a result, new competitors operating from lower cost bases have been able to enter virtually all of the markets traditionally served by banks, ‘cherry-picking’ banks’ more profitable customers. Competition for financial services has become ‘commoditised’. Many of these new players are non-bank specialist providers of financial services, using technology to create and deliver products and services in innovative ways.

The change in the type of competitors is illustrated in Chart 9.

Chart 9

Competitive Framework

	Generalist	**"Niche" Player**
Old Game	**Major Banks**	**Regional Banks** Housing & Term Deposits **GE Capital** Credit Card Issuing
New Game	**First Direct - UK** Branchless Bank	**Aussie Home Loans** Origination/Securitisation **AMP Priority One** Mortgage Products **EDS** (outsourcing data processing)

The degree of specialisation increases from left to right and the extent of innovation increases from the top of the matrix to the bottom. The top left hand box is where the major banks sit. They offer a full range of traditional banking services to all customers.

On the top right hand side of the matrix are competitors providing a limited or specialist range of products using the traditional distribution system. Examples of these include companies such as GE Capital entering the credit card business.

In the bottom left of the matrix, are competitors offering a broad range of products but in new, innovative ways. Midland's First Direct in the UK is an example: banking is via telephone only, without the support of branches.

In the bottom right of the matrix is where competitors are emerging most rapidly. These competitors provide a limited or specialist range of products in innovative ways. An example is Aussie Home Loans, offering only home loans and by-passing traditional forms of funding by securitising the asset and selling it to an institution that does not require capital underpinning for the loan - a superannuation fund for example.

These competitors are not burdened by past requirements to invest in extensive branch networks; they have access to outsourcing possibilities in scale intensive processing functions and are unhampered by much of the regulatory burden carried by banks. These advantages allow them to operate at low cost and to target the higher margin segments left exposed by the traditional ‘cross-subsidised’ pricing practices of mainstream banks.

The regulatory framework must recognise the emergence of these new competitors and provide adequate freedom for traditional banks to respond to these challenges effectively.

d) There will be **increasing globalisation** of the industry.

Technology, combined with international deregulation, has introduced an increasingly global market in financial services. In shaping the financial services industry, global factors will be more important than local factors in the decade ahead. Two forces will drive this trend in the future.

First, customers are taking an increasingly global perspective on the supply of financial (and other) services. Australian businesses have ‘internationalised’ and are looking for banks which can support them with appropriate products and services in all the markets where they operate. (This is the basis for ANZ’s International Strategy. ANZ operates in 43 countries, holds 40 per cent of its assets offshore and has full branch representation in all of Australia’s top 10 trading partners, which in 1995 accounted for over 70 per cent of Australia’s merchandise trade.)

Consumers are also beginning to seek off-shore services, for example, international investment products. Within a few years, personal and small business customers will be able to access a wide range of products through the Internet.

Second, financial services suppliers driven by the need for growth and the imperative of cost competitiveness, are also moving across borders as they seek to leverage their domestic capabilities in other markets and to obtain further scale benefits.

Australian regulatory structures must accommodate these trends towards globalisation. Consumers must be allowed to exercise their choice but must understand clearly the boundaries of domestic protection. Australian banks must not be disadvantaged in their home or offshore markets relative to competitors domiciled in other countries.

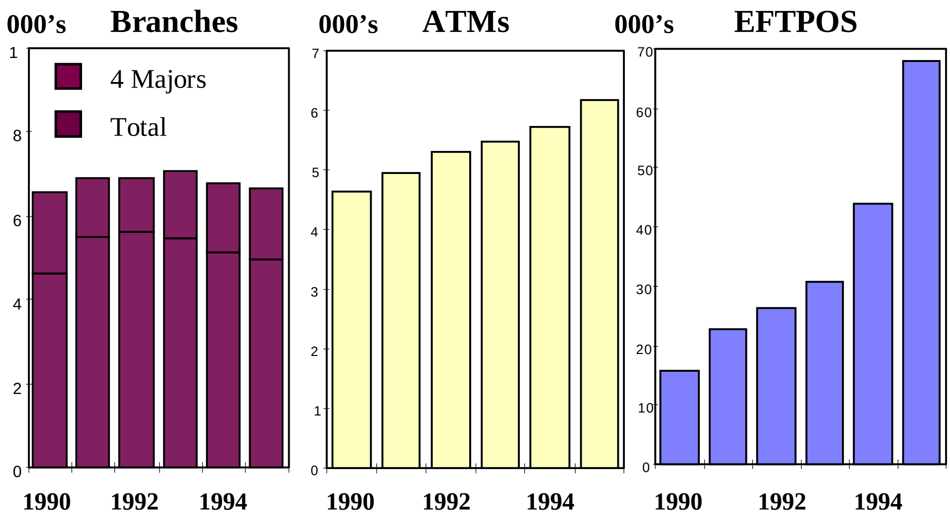
e) There will be significant **pressure for industry rationalisation.**

All of the factors referred to above will contribute to powerful pressures for industry rationalisation, both at a domestic and an international level.

Excess capacity has emerged in the financial services industry as a result of the introduction of electronic services delivery and new entrants. Banks have invested heavily in electronic delivery channels - ATMs, EFTPOS, telephone and PC delivery platforms - while their branch networks have been barely pared back (Chart 10). Electronic channels have vastly increased delivery capacity and infrastructure growth has outstripped growth in demand.

Chart 10

AUSTRALIA
SURPLUS DISTRIBUTION CAPACITY

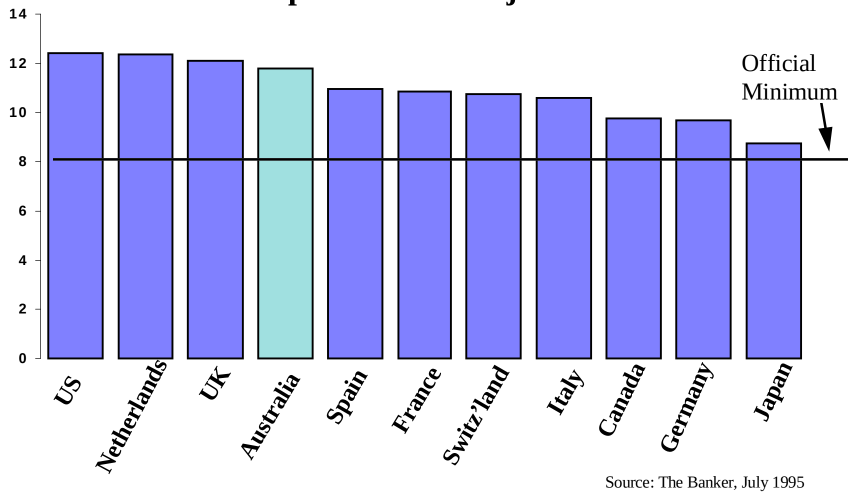


Excess capacity in financial services is a global development. Adoption of electronic channels and emergence of new types of competitors is a world-wide phenomenon. As is the case in Australia, many banks' capital ratios are excess to BIS requirements (Chart 11). Where a bank has excess capital, to ensure an acceptable return to shareholders it can: expand its balance sheet (which generally entails riskier lending), repay capital to shareholders or make an acquisition. Increasing risk profile can ultimately destroy shareholder value; some banks will repay capital but others will choose a merger or acquisition strategy.

Chart 11

“Excess” Capital - A Global Development

BIS Capital Ratio - Major Banks



Source: The Banker, July 1995

The challenge posed by these pressures is for regulators to allow the industry to pursue any economic benefits associated with rationalisation and consolidation while maintaining the integrity of the system and ensuring that customer interests are not compromised.

2. There are seven major areas in which current regulatory and tax arrangements will hamper the industry’s ability to respond to these changes.

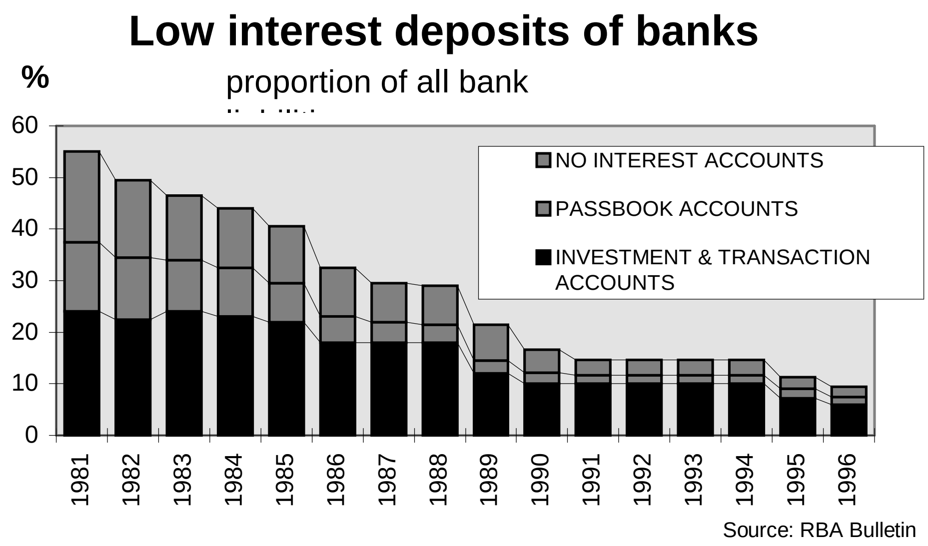
a) **Interference in pricing** is placing banks at a disadvantage relative to non-bank competitors.

Banks are being disadvantaged by interference in product pricing which hampers their ability to recover the cost of services provided to customers. These controls are also reducing incentives for product and service innovation.

Prior to deregulation, banks cross-subsidised the costs of providing transaction services through the spread earned on deposits. Government controls ensured that banks had a significant base of low-interest and no interest deposits which could be used to subsidise the cost of transaction services provided to customers.

Deregulation has changed this situation. New competitors for deposits have emerged, many of whom do not offer the range of transaction services provided by traditional banks. These new suppliers compete for customer deposits by offering deposit security as well as high rates of interest. In the face of this competition, banks' base of low cost deposits has been significantly eroded. Low interest and no interest deposits have declined from about 55 per cent of bank liabilities in 1981 to about 9 per cent in 1996 (Chart 12).

Chart 12



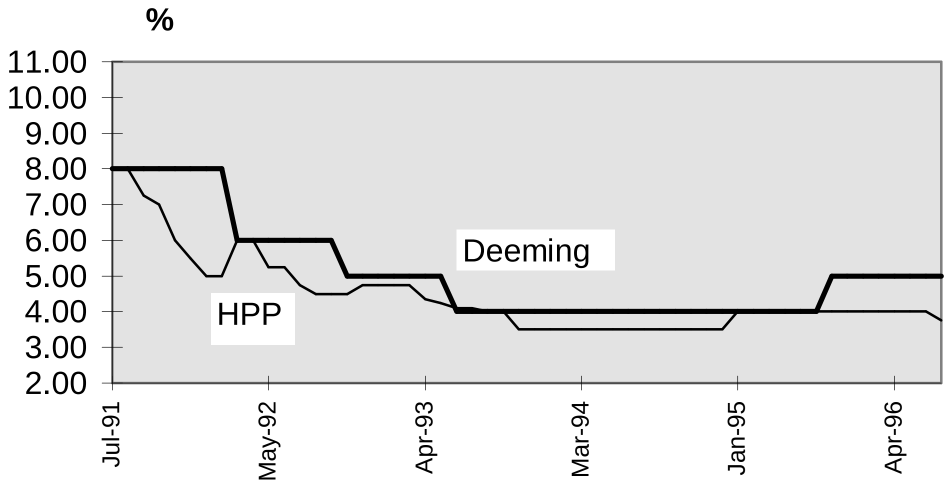
These developments have meant that transaction services, viewed separately from other services, have become highly unprofitable for banks. A Reserve Bank study (August 1994) comparing fees and margins of Australian banks with those of banks overseas concluded that Australian banks would be forced to obtain an increased proportion of their income via fees, since competition would drive margins down. (Costs and profitability of Australian banks are similar to comparable full service banks in other countries, but Australian banks' net interest margins tend to be relatively high while non-interest income tends to be relatively low.)

Fees have been introduced but they still recover only about 15 per cent of transaction costs in the retail market. Strong community pressure to block fees on transactions led to an inquiry by the Prices Surveillance Authority in 1995. Even though the PSA did not impose specific price controls, this level of intervention is of concern to banks. Given the imperative for banks to realign fee and interest income and to reduce their cost structures, any government intervention in pricing decisions puts full service banks with large branch networks at a severe competitive disadvantage relative to other providers.

Government intervention in bank pricing policies has been more direct in the case of deeming accounts. This legislation effectively sets minimum interest rates for one group of customers: social security recipients. Deeming account rates are generally higher than the rates for comparable 'non-controlled' accounts (Chart 13). The ANZ High Performance Passbook has features identical to the deeming account apart from its interest rate. It follows that customers entitled to deeming accounts regularly earn a higher return than other customers. We estimate that deeming costs ANZ in the range of $15 to $20 million per annum. This limits our ability to be more competitive in other interest rate offerings.

Chart 13

High Performance Passbook and Deeming rates for $20,000 deposit



Similar issues of price intervention occur in the case of (solicitor or real estate) trust accounts. Interest on trust accounts is commonly required to be paid to a body designated by legislation, to fund activities sanctioned by state governments. Some state governments pass legislation specifying the minimum acceptable interest rate and the form in which the interest calculation must be made (for example, on daily balance). While banks are prevented by law from conducting joint approaches to pricing, nothing prevents a free exchange of information between our customers, so that the highest rate paid by any bank in any state often becomes the norm which is prescribed. The prescribed rates are higher than we are prepared to offer elsewhere for deposits but a decision not to offer trust accounts would have serious implications for our solicitor and real estate customers, who naturally prefer to conduct their trust accounts and their working accounts at the same institution.

Beyond the resultant distortions to competition and the erosion of bank shareholders' returns, price controls reduce innovation and penalise those customers who are at the wrong end of the cross-subsidies.

b) **Consumer protection arrangements** are not well structured for pursuing their legitimate objectives.

ANZ accepts and fully supports the need for a framework for safeguarding customers' legitimate interests in their dealings with banks and other financial services providers. However, the current arrangements often run counter to interests of the customers they are designed to protect.

There are four major weaknesses in the way consumer protection is operating.

First, it is fragmented and this results in overlapping responsibilities, unnecessary confusion and cost. Prudential regulators (the RBA and ISC) as well as the ASC and ACCC all have responsibilities for consumer protection. The result within conglomerates is inconsistent regulatory requirements, additional compliance costs for institutions (ultimately paid by customers) and customer confusion. The case study from ANZ Funds Management illustrates the impact.

CASE STUDY

Impact of Different Regulatory Regimes on the Customer: ANZ Funds Management

An ANZ customer approached his branch manager seeking investment advice. The manager explained that the regulations prevented him from offering advice directly but he could arrange for the customer to receive advice from a Personal Investment Manager (PIM) from ANZ Funds Management (ANZFM).

A few days later the PIM visited the customer. After discussing the customer's financial situation and investment objectives, the PIM formed a view that the customer's needs would be best met by investment in one of ANZFM's unit trusts. These products fall under the ASC regulatory regime and impose a number of specific obligations on the PIM and the Bank.

- ANZ must hold a Dealer's Licence to sell these products.
- The PIM must hold 'proper authority' from the Bank to act on its behalf.
- The PIM's primary responsibility is to the client and he/she must act accordingly.
- Before recommending an ANZ product, the PIM must research the adequacy of comparable non-ANZ products and point out any limitations of the ANZ product.
- The PIM must provide a printed guide which explains to the customer the relationship of the PIM to ANZFM including Funds Management.

After further discussion, the PIM thought that a good alternative for the client would be to invest in a life insurance product with a savings component. These products fall under the ISC regime and impose different requirements on the PIM.

- The PIM provides a different guide explaining his relationship to ANZFM.

- The PIM has to advise the customer that he is now acting on behalf of a life insurance company (ANZ Life) and that his primary responsibility is to the life company and not the client.

- The PIM has to comply with a different set of customer advice standards, which require him to ensure that the customer understands the advice but do not impose specific requirements to provide warnings about product limitations.

The differences between these regulatory regimes confuse customers, and impose additional costs and compliance difficulties on financial institutions.

Additionally, the system is administered through several different pieces of legislation by numerous regulatory bodies. For example, in the case of credit cards there are five different laws and ten different regulators pertaining to the provision of customer information plus six laws involving 12 regulators who supervise the nature of the credit contracts. There are five possible forums for dispute resolution. Details of duplication of regulations are contained in Appendix I.

Second, the consumer protection regime is often overly prescriptive in that it seeks to specify precisely how the financial institution should interact with its customers rather than specifying the required outcomes and allowing the financial institution to comply with these in the most sensible way.

Third, it does not adequately distinguish between the value of the protection and the cost of providing it. While a high standard of protection is clearly required for major financial transactions (for example, selecting a housing loan or establishing a pension plan), this same standard is not appropriate for simple day-to-day transactions. Existing legislative structures do not distinguish between these situations and impose similar levels of protection regardless of the risks or related costs.

Fourth, penalties in some instances are overly onerous.

The Uniform Credit Code, which is due to take effect on 1 November 1996 contains all of these weaknesses. This legislation will achieve national uniformity in consumer credit law and replace a number of different state-based credit regimes. However, the worth of the other benefits usually attributed to the legislation needs to be assessed against factors such as reduced flexibility in serving the customer, the avalanche of information presented to the customer, the compliance costs which will be borne by the customer and the fact that many of these benefits could have been achieved through existing legislation. Appendix II covers these matters in detail.

Serious deficiencies also exist in the privacy aspects of some consumer protection. Privacy safeguards are promulgated through four separate restrictions: common law duty of confidentiality, fiduciary obligations of non-disclosure, restrictions imposed by the Privacy Act, and obligations imposed by the Code of Banking Practice (Table 2). The effect of these overlapping arrangements is that:

- the banking division can pass on information about a personal customer, but not a commercial customer, to its subsidiaries (provided the personal customer does not object);

- subsidiaries of a bank cannot supply information about any of their customers (personal or commercial) to another of the bank's subsidiaries;

Table 2: Consumer Privacy Safeguards

Restriction	Detail
Common law duty of confidentiality	The bank has a common law duty of confidentiality to its customers which prevents disclosure of all information about a customer acquired by the bank in its role as banker except where it is required by law or the customer consents to the transfer of this information.
Fiduciary obligations of non-disclosure	A bank’s subsidiaires are bound by their fiduciary obligations not to disclose information about their customers. Customers who provide information for a specific purpose are entitled to have the information used for that purpose only. Information gathered on say an Esanda debenture application form cannot be sent to ANZ Stockbroking or to an ANZ Personal Investment Manager, unless the customer agrees to this.
Privacy Act	The Privacy Act 1988 (Commonwealth) regulates the provision of information about individuals for credit purposes.

Code of Banking Practice	The Code of Banking Practice, due to come into effect fully on 1 November 1996, also affects the exchange of customer information within a financial services group.

- subsidiaries cannot supply information about their customers, personal or commercial, to the banking division except for the express purpose of assessing a customer's group-wide liability (necessary for sound prudential management).

Customers are disadvantaged by these restrictions in that they prevent the financial conglomerate from pooling its information in order to meet customers' needs to the best of its ability. This problem can be overcome but only through a costly and cumbersome process.

For example, when ANZ Funds Management wants to send a special insurance offer to Esanda's equipment finance customers, Funds Management has to provide the offer material to Esanda. Esanda then has to prepare an introductory note (inviting its customers to consider the offer and to contact Funds Management if they are interested) and mail out the Funds Management offer material to its customers. Paradoxically, no such problems would be encountered if Funds Management were to obtain these referrals by purchasing a mailing list.

Within this process, the customer may have to complete separate application forms for products supplied by different legal entities or provide information which is already held within the bank by another subsidiary. This process creates an administrative burden for customers and also deprives them of the opportunity of having a single relationship manager to handle all their dealings with the bank.

These restrictions add significant bank costs and interfere with the customer relationship in unproductive ways. While ANZ aims to introduce revised documentation to seek direct customer consent for information sharing within the group, this is an expensive process which could take years to complete.

A more efficient approach would be to allow financial institutions to exchange marketing and credit information between companies within the group, and to extend the bankers' duty of confidentiality to cover the activities of the group as a whole, rather than individual entities within the group. Customers would still be assured that their personal information would not leave the group, and that their information would have the protection of the common law, in contrast to the largely unregulated treatment of information held by non-banks. This approach is broadly consistent with the Code of Banking Practice's stance on data sharing.

Legislation is needed to achieve this position. In any case, enhanced national privacy legislation will be needed in Australia by 1998, as a result of the recent European Union directive which will restrict the flow of personal data on European citizens between the European Union and other countries which have privacy laws that are inconsistent with the directive. The NSW government has recognised the implications of the directive and is in the process of developing legislation. However, ANZ believes that a national approach is essential.

c) The current **competition policy** is overly restrictive.

Competition in the finance sector is constrained in two ways.

- The 'six pillars' policy prohibits mergers between any of the four major banks (ANZ, CBA, NAB and Westpac) and between the largest insurance companies (AMP, NML and MLC).

- The way in which competition policy is applied to banking is too restrictive. The Australian Competition and Consumer Commission (ACCC) has tended to define market boundaries quite narrowly. For example, in the 1995 Westpac-Challenge Bank merger, the market was defined as being bound by state borders and recognised only those services offered by banks as distinct from all competitive services, irrespective of whether they were supplied by a bank or a non-bank service provider. This constrains the scope for mergers.

These restrictions do not recognise the change occurring in the industry. Financial services delivery is increasingly electronic, not constrained by physical branch networks. Consequently, markets are generally national and increasingly global. The corporate market globalised rapidly following deregulation; consumer and small business markets are not yet global but this is imminent. Non-bank and specialist service providers are competing effectively with traditional banks and their products and services represent legitimate substitutes (Table 3).

Table 3: Competition in key market segments by typical products

Consumer products	**Typical providers**
Home loans	Major banks, regional banks, foreign banks, credit unions, building societies, life offices, super funds, home loan originators
Transaction and investment accounts	Major banks, regional banks, foreign banks, credit unions, building societies
Personal loans	Banks, credit unions, building societies, finance companies
Bill payments	Major banks, regional banks, credit unions, building societies, Australia Post
Credit cards	Major banks, regional banks, foreign banks, credit unions, building societies, credit card specialists
Debit cards	Major banks, regional banks, foreign banks, credit unions, building societies
Small business products	
Transaction banking	Major banks, regional banks, foreign banks, credit unions, building societies
Overdrafts	Major banks, regional banks, foreign banks, credit unions, building societies
Commercial bills	Major banks, regional banks
Term loans	Banks, credit unions, building societies, superannuation funds, life offices, mortgage originators
Leasing	Major banks, regional banks, finance companies and equipment manufacturers
Credit card merchant facilities	Major banks, regional banks, credit card specialists
Large business products	
Overdrafts	Major banks, foreign banks
Commercial bills	Major banks, foreign banks, merchant banks

Term loans	Major banks, foreign banks
Leasing	Major banks, foreign banks
Credit card merchant facilities	Major banks, specialist providers (eg Amex)
Electronic business services	Major banks, foreign banks, specialist providers
Trade finance	Major banks, foreign banks
Risk management tools	Major banks, foreign banks, merchant banks
Capital markets products - domestic	Major banks, foreign banks, merchant banks, investment banks (eg BZW, BT, Macquarie)
Capital markets products - international	Foreign banks, some major bank involvement
Project and structured finance	Major banks, foreign banks, merchant banks, investment banks

ANZ does not argue for more sophisticated interpretation of competition issues in the belief that economies of scale are of vital importance in banking and that fewer, larger institutions would provide significant benefits to customers. A survey of the evidence (much of it from the US) does not support the proposition that mergers deliver more efficient banks (a sample of this evidence is contained in Table 4). ANZ's own experience of the commercial reality is that the savings that appear possible on paper through, for example, removal of network and system duplication, are not always fully realisable. Moreover, cost-cutting may be accompanied by revenue-cutting and a portion of the acquired market share lost.

Table 4: Economies of Scale in Banking - Summary of Investigations

Study/Author	Evidence reviewed	Findings
Berger, Allen and Humphrey, David (1992) "Megamergers in Banking and the Use of Cost Efficiency as an Antitrust Defense", *Antitrust Bulletin*, Vol 37, pp 541-600	69 mergers of US banks in 1981-89, with assets of acquiring banks and acquired banks greater than $1billion.	Cost efficiency, on average, did not improve following merger Profit rates, on average, did not improve following merger Banks making in-market mergers did not improve efficiency compared with other mergers
Spong, Kenneth and Shoenhair, John (1992) "Performance of Banks Acquired on an Interstate Basis", *Financial Industry Perspectives* (Federal Reserve Bank of Kansas City), December, pp 15-32	179 interstate mergers in the US between 1985-87.	Cost efficiency tended to improve somewhat relative to that of peers. Returns on assets and equity generally declined relative to those of peers (based on mean), but did not decline or increase relative to those of peers (based on median).
Peristiani, Stavros (1993) "Evaluating the Postmerger X-Efficiency and Scale Efficiency of US Banks", Federal Reserve Bank of New York	4,900 mergers of US banks in 1981-88 (including 2,000 intra-group mergers). Included a control group of similar but non-merging banks.	Compared to the control group: • Expense ratios of banks in single mergers increased • Non-interest expense ratios in multiple mergers did not improve • Return on assets on the merged group improved • Scale efficiency improved in multiple mergers but declined in single mergers.

		X-efficiency did not improve, and in some cases declined
DeYoung, Robert (1993) "Determinants of Cost Efficiencies in Bank Mergers", Economic and Policy Analysis Working Paper 93-1, Office of the Comptroller of the Currency, Washington	348 mergers of US banks in 1987-88 (and their effects for 4 years afterwards). About 31% relate to mergers of failed banks, and 43% relate to affiliated banks.	Efficiency gains did not generally result from mergers, but were more likely when both parties were inefficient prior to a merger.
Walker, Greg (1995) "Banking on Size: Australian Evidence", *The Australian Banker*, June, pp 113-116	Two studies (1994 and 1995) based on a sample of banks (majors and state) for various products from the 1970s to 1991	Constant returns to scale based on a simple measure of economies of scale (proportional increases in all costs to output when output of all products is increased. An alternative measure that allowed for variation in product mix supported economies of scale where product mix is "judiciously managed"

Source: Rhoades, 1994 and Walker, 1995

Significant scale economies exist in the information technologies used in bank processes (as opposed to the banking industry *per se*). Most banks centralised the back office functions attaching to their retail branch networks several years ago. The next wave of centralisation is occurring in other areas such as mortgage processing, handling of customer telephone enquiries and trading activities including foreign exchange and derivatives. Processing of some types of transactions is becoming global: ANZ Visa credit card transactions conducted in India are processed in Melbourne and it is just a matter of time until credit card transactions done in other countries are also processed in Melbourne. Trading activities in many large banks are being centralised into fewer larger trading rooms to provide stronger presence in a market and make better use of the capabilities offered by new technologies. Realisation of these economies can allow an organisation to become a competitive supplier in markets that would otherwise be uneconomic.

These economies can be accessed in various ways: through outsourcing, through merger and through expansion of activities in foreign markets. Banks should be free to pursue their chosen strategy. Any proposal involving merger or acquisition should be subject to ACCC review, as would occur in any other industry. As in other industries, a high level of competition in the domestic market is the best way to ensure the creation and maintenance of competitive advantage in an industry, the benefits of which will flow through to both shareholders and customers. The argument for ‘national champions’ in which domestic competition is seen as wasted and one or two institutions are favoured by government policy in order to achieve the ‘critical mass’ required to compete against international rivals is a recipe for poor performance and failure to innovate (Porter, 1991, p.117).

Policy needs to be clarified regarding takeover of domestic banks by foreign banks. New Zealand's banks are almost all foreign-owned. The cost to the New Zealand economy has been a loss of skilled and expert personnel from bank head offices and a reduced propensity to export financial services to the rest of the world. Australian banks are well placed to be significant financial services exporters in the emerging era of cross-border banking supported by electronic infrastructure.

d) The current **regulatory institutional arrangements** are not well suited to effective supervision of financial conglomerates and 'near-banks'.

Financial conglomerates have emerged to enable institutions to meet the broad range of financial services needs of their customer base. A financial conglomerate refers to "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)" (Tripartite Group of Bank, Securities and Insurance Regulators, 1995, p.1). Banks have invested in life insurance companies, finance companies, stockbrokers, investment banks and other specialised areas.

Most Australian financial conglomerates are headed by a substantial supervised institution such as a bank or an insurance company. In future, however, the regulatory framework will need to be able to cope with other types of configurations such as conglomerates headed by holding companies or conglomerates in which banking, insurance and funds management activities are more equally weighted.

Conglomerates pose particular supervision challenges. For both financial and mixed conglomerates, the key risk requiring regulation is ‘contagion’. One way of dealing with contagion is to put ‘firewalls’ in place between divisions of conglomerates, creating separate legal entities subject to the supervisory regime relevant to that area. However, ‘firewalls’ alone cannot be relied upon. Even where strong ‘firewalls’ are in place, particularly in financial conglomerates that include a bank, contagion, or fear of it, can cause depositors to take flight.

Effective supervision of a conglomerate requires a supervisor to look across the firewalls in order to assess the health of the conglomerate and identify possible threats in good time. The right to access prudential information from all parts of the conglomerate and a high level of co-operation between supervisors where more than one is involved is critical.

At issue is how this high level of co-operation between regulators is to be achieved. Some degree of ‘harmonisation’ between regulators has been achieved on a voluntary basis through the Council of Financial Supervisors, but ANZ believes a more formal arrangement would have merit.

A better way to achieve these objectives would be to introduce a ‘lead regulator’ system. A lead regulator would be appointed on the basis of the conglomerate’s business mix with the supervisor responsible for the larger part of the group’s business taking the lead role. It would be responsible for gathering information, assessing capital adequacy of the group and coordinating any remedial action that may be required. Monitoring intra-group exposures and the risk of contagion arising from them would be the responsibility of the individual supervisors. In groups headed by a holding company, the supervisor of the dominant entity would take on the lead regulator role. Where the business is split fairly evenly, say between insurance and banking, the banking supervisor should be the lead regulator on the basis that banks are vulnerable to runs by depositors.

The alternative is the ‘mega-regulator’ model under which a single regulator with specialist divisions (banking and insurance at a minimum) would assess the capital adequacy of a group, review each specific line of business risk, and co-ordinate any remedial action. ANZ believes it would be difficult to maintain the required specialist skills within a mega-regulator and is concerned that such an arrangement may become bureaucratic and out of touch. We note that few other markets have chosen this model (Canada and Sweden are the only OECD exceptions - see Table 5. Singapore also favours the single-regulator model).

Table 5: Supervision of Financial Conglomerates

	Banking	**Insurance**	**Banking & Insurance**
Belgium	Banking & Finance Commission	Office de Controle des Assurances	
Canada			Office of the Superintendent of Financial Institutions[1]
France	Commission Bancaire[2]	name not known	
Germany	Federal Banking Supervisory Office	Federal Insurance Supervisory Office	
Italy	Bank of Italy	ISVAP	
Japan	Ministry of Finance/Bank of Japan	Ministry of Finance	
Luxembourg	Luxembourg Monetary Institute	Commissariat aux Assurances	
Netherlands	Nederlandsche Bank[2]	Insurance Board	
Sweden			Financial Supervisory Authority[3]
Switzerland	Federal Banking Commission	Federal Office for Private Insurance	
United Kingdom	Bank of England	Department of Trade & Industry Insurance Division	
United States	Office of the Comptroller of Currency	Respective state authority	

Notes:

1. Insurance supervision is shared with provincial authorities

2. Supervisory body only. Other institutions have responsibility for other aspects of

banking, such as legislation

3. The FSA supervises the entire credit market.

Source: Tripartite Group of Bank, Securities and Insurance Regulators, 1995

Building societies and credit unions conduct what is essentially a 'banking' business: they collect deposits, provide loans and payment services with membership of the payments system through their respective industry associations and Special Service Providers. The AFIC prudential regime is based on the bank prudential regime and is in some respects more onerous (Table 6). To the extent that it is more onerous it distorts competition and to the extent that it duplicates the RBA regime through its cumbersome national-state framework it adds cost to the financial system. It would be preferable to bring building societies and credit unions under the supervision of the RBA.

Table 6: AFIC and RBA Prudential Regimes

	RBA	AFIC
Capital adequacy	8%, of which at least half Tier 1	8%, of which at least 3/4 Tier 1
Liquidity requirements	6% PAR[1] and 1% NCD[2]	7% (PLAR) [3]
Operational liquidity	No similar requirements	2% of total liabilities to be kept in on-balance sheet liquid assets, and access to additional sources of on- or off-balance sheet funds to a further 4% of total liabilities
Interstate trading restrictions	Nil	SSA[4] approval must be obtained before trading outside of state of incorporation
Emergency liquidity support schemes	RBA's depositor protection duty	Half of PLAR is available for SSAs to support illiquid but not insolvent entities. Credit unions must also contribute to contingency funds which are used when there is a deficiency of assets in a wind up.
Establishment of subsidiaries	Must be clearly separated from the bank	SSA approval must be obtained
Share capital	Subject to limits on individual shareholdings	Credit unions may not raise permanent share capital, building societies may do so.[5]
Lending restrictions	No primary objects requirements	Building societies: at least 50% of assets must be loans to members for residential property Credit unions: At least 60% of assets must be loans to members, and not more than 10% may be for

		commercial purposes
Paying for prudential supervision	Implicit - funded by 500 basis point margin below Treasury note rate on NCDs	Explicit - funded by industry levies

<u>*Notes:*</u>

1. Prime Asset Ratio
2. Non-Callable Deposit
3. Prime Liquid Asset Ratio
4. State Supervisory Authorities
5. Most building societies do issue share capital

e) The fact that the existing regulatory framework has not kept pace with rapidly evolving **technology** in financial services carries the risk that regulators will come under pressure to make rules which curb customer choice.

New technologies for the delivery of financial services such as the Internet and Stored Value Cards (SVCs), are developing ahead of the regulatory system and this presents a number of regulatory challenges.

The Internet and other similar electronic networks are a cross-border delivery channel. Development of electronic commerce using the Internet will be affected by progress made in developing a regulatory environment to address the legal status of digital signatures, allow the introduction of a national digital signature system and the establishment of a national public key infrastructure with regulatory backing.

SVCs can also be used as a cross-border payment instrument. This interoperability requires international co-operation and the development of common standards. It follows that Australian regulations governing these new delivery channels must be compatible with those developed in other countries.

Demand for these services is likely to grow quickly because of the potential benefits they offer customers. As in other areas, regulation here will need to provide adequate safeguards without stifling development. This raises several issues.

- Should any restriction be placed on the ability to issue SVCs or offer financial services over the Internet? At present any organisation can issue SVCs or offer financial services, including payments, over the Internet. Any regulation should be limited to that required to safeguard the integrity of the core payments system. While Australian law (including laws relating to consumer protection) can apply to entities domiciled in Australia, the near future seems likely to bring an explosion of externally-domiciled financial services to Australian customers via the Internet. This will bring two distinct pressures to bear: first, the necessity for Australian financial services offerors to be as lightly and cheaply regulated as possible (to even the playing field with less- or un-regulated competitors); second, the necessity for the education of

Australian customers to remember *caveat emptor*.

- SVCs are a new payment instrument and confidence is required for their successful introduction. Already there are some closed system, disposable, stored value cards in use (Phone Cards provide the model). These cards do not generate any need for interbank clearing and settlement. Consistent with its view that regulation should be restricted to that required for prudential and disclosure purposes, ANZ does not see the need for any regulation over the issuers of such cards.

- Considerations are different for open system SVCs which will be used widely throughout the community and on which merchants' revenue will depend. These cards generate the need for interbank clearing and settlement and consumers and merchants need to be sure that payments made by SVC will be honoured by the card issuer and that the card issuer will remain solvent. Were SVC issuers to fail to meet their obligations, community confidence in SVCs would be undermined. Potentially, this could have flow-on effects, causing confidence to be undermined in other payment instruments as well: debit cards, for example.

- New technologies rely on fast, widespread introduction to fully realise their potential. The attractiveness of SVCs is dependent on the number of merchants willing to accept them, which is in turn driven by the anticipated usage and consumer acceptance. This must not be thwarted by ill-advised regulations. SVCs are very much still in the testing stage and potential regulators should hold firmly to the view that clear disclosure should be the sole tool of customer protection. At present, it remains unclear whether customers would be prepared to pay for a system (such as the MasterCard system at present being tested) which keeps track of card ownership and thus has the capacity to impound stolen cards. (This will entail considerable costs in on-line tracking and data storage.) Another choice would be the essentially anonymous card (such as in the Visa trial on the Gold Coast), where a lost card is like lost cash and cannot be replaced. Other choices are likely to be developed and the end result is likely to be a spectrum of SVC offerings from which customers can make price/product feature trade-offs. Such choice will never emerge if regulations - beyond disclosure requirements - are imposed.

In general, regulators should seek to create broad frameworks that emphasise the required outcomes because, unlike specific rules, they can accommodate further new technologies which will inevitably be brought to the market in the foreseeable future.

f) A number of specific **RBA regulations and activities** should be modified.

There are several areas in which the role of the RBA has not kept pace with deregulation over the past decade. In some areas the RBA imposes requirements on banks that are no longer appropriate or could be better achieved through alternative arrangements. The RBA also undertakes several commercial activities which conflict with its regulatory responsibilities and distort competition.

- The RBA requirement that banks hold at least six per cent of their Australian dollar assets (less their capital base) in liquid form - the Prime Asset Requirement (PAR) - is no longer appropriate. PAR is a legacy of the regulated era, having replaced the Liquid Government Securities convention which dated from 1956. Its function according to Prudential Statement D1 is to ensure that banks have adequate liquidity to meet their obligations, even under ‘extreme circumstances’. However, the implementation of Real Time Gross Settlement (RTGS) which will significantly reduce settlement risk and the development of sophisticated and deep money markets in Australia have now made the PAR an unnecessary imposition. It is also costly because substantial losses are incurred in funding the PAR portfolio - about $25 million a year for ANZ - due to low rates of return on prime assets. In practice, emphasis has already shifted away from reliance on PAR towards banks managing their own liquidity requirements with the RBA monitoring the arrangements they put in place for doing this (Table 7).

Table 7: ANZ Approach to Liquidity Management

The RBA requires banks to develop processes for liquidity management.

> "It is the responsibility of a bank's management to ensure that its internal systems and controls are adequate to ensure resources are available to cover potential funds outflows." (Prudential Statement D1)

ANZ manages liquidity at three levels:

1. Operating Liquidity - which focuses on day-to-day cash management, ensuring the bank is well placed to carry out its operations under normal conditions;

2. Short-term Crisis Liquidity - which takes account of the liquidity pressures the bank may face should there be a short-term loss of confidence in ANZ and ensures that reserves are maintained to cover this eventuality;

3. Long-term Maturity Concentrations - which measures the bank's structural liquidity position out to and beyond five years.

ANZ's asset and liability maturity profile and related aspects are reported to various internal risk management committees on a monthly basis as well as to the RBA. In addition, the RBA reviews ANZ's policies and systems for monitoring and controlling both its Australian and offshore liquidity needs annually.

- Non-callable deposits (NCDs) are not so much a prudential supervision tool as an impost on bank operations. Under the Banking Act 1959, banks are required to hold the equivalent of 1 per cent of Australian liabilities, excluding shareholders' funds with the RBA. In the 1995-96 Budget on 9 May 1995, the government announced that the interest payable on non-callable deposits would no longer be paid at market rates but at a reduced rate of 5 per cent below the average rate on 13 week treasury notes in the previous month.

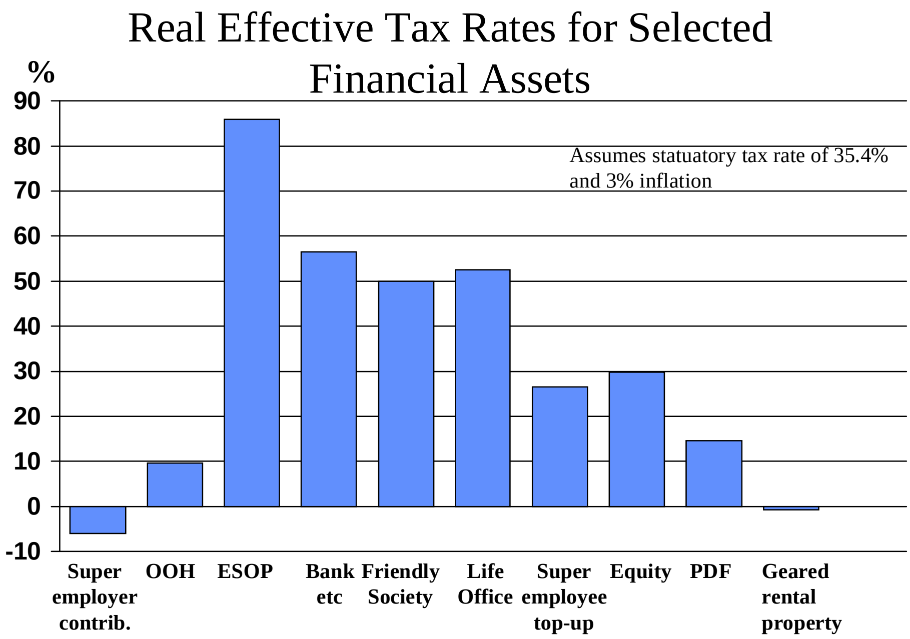
The rationale for introducing the reduced rate was as a fee to cover the costs of bank licensing and supervision. However, the arbitrariness of its introduction shows the reduced rate has no basis in actual direct costs of supervision. In the case of ANZ, the annual cost of the interest rate reduction is about $26 million and for the banking system as a whole, about $185 million. The NCD requirement should be discarded and replaced by a fee levied to cover actual costs of bank supervision.

- Some domestic commercial activities carried out by the RBA are inappropriate. The RBA provides direct entry services and financial EDI services, mainly to government agencies, although it has taken over direct entry business on behalf of Adelaide Bank and Trust Bank. (In 1994/95 the 200 million direct credits processed by the RBA represented 50 per cent of all bulk electronic transactions exchanged among financial institutions. Use of the RBA's Financial EDI facilities is growing rapidly: transactions processed in 1994-95 were up 25 per cent on the previous year.) Because the RBA competes with banks for this business, it compromises its role of bank supervisor. Furthermore, it is unfairly advantaged in offering payments services by virtue of its exemption from Financial Institutions Duty and Debits Tax payable by other banks. The RBA is also unfairly advantaged by its monopoly over registration, clearing and settlement services for Commonwealth Government Securities provided through the Reserve Bank Information and Transfer System (RITS). Other organisations are capable of providing this service and a competitive tender process would be in line with the principles of national competition policy adopted by all Australian governments.

g) Some areas of the **tax system** create significant distortions and inefficiencies in the Australian economy.

- Differences in the tax treatment of various assets create a disincentive to saving in bank deposits. Bank deposits do not enjoy the tax concessions available to other classes of investment (Chart 14). For example, the family home is tax exempt, superannuation receives concessional tax treatment, and most other investments receive an inflation adjustment under capital gains tax provisions. As a consequence, bank deposits are less attractive than they otherwise would be despite their critical role in the intermediation process and in mobilising savings. Funds invested in banks are largely reinvested in productive assets, such as loans to small and medium business, in contrast to superannuation funds which invest mainly in listed companies. Bank deposits have a special role in mobilising savings. Households use bank deposits to save for certain goals, such as a house deposit, or until they have accumulated enough funds to invest in a higher yielding asset class. As concluded by FitzGerald and Harper (1993): “incentives, and particularly the impact of taxation on incentives, do matter for the allocation of household saving”.

Chart 14



Source: EPAC Background Paper No.36

Note: the rate for employer superannuation contributions applies to annual incomes below $70,000; abbreviations are: Owner Occupied Housing (OOH), Employee Share Off Plan (ESOP) and Pooled Development Fund (PDF).

- Financial Institutions Duty (FID) and Debits Tax (DT) detract from Australia's attractiveness as a regional financial centre and promote inefficiency in the financial system and in businesses. Australia is the only country to levy these taxes and state governments need to grant exemptions to attract businesses. For instance, the NSW Government includes FID and DT rebates as part of its Asia Pacific Regional Headquarters program. In competing with firms that do not pay FID and Debits Tax, local firms are at a disadvantage.

FID and DT reduce the efficiency of the financial system by hindering businesses shifting from paper-based to electronic banking and deterring funds from flowing to take advantage of better interest rates. Cheques can be bundled to form a single deposit for the purposes of FID while FID on electronic deposits is calculated on an individual credit basis. FID and DT interfere with interest rate signals. Using an example of a $25,000 transfer in Victoria from a cheque account to a 14 day term deposit at five per cent and then back to the cheque account at maturity, the nominal interest gain of $47.95 is substantially reduced by the total tax burden of $34.03 ($4 DT and $15 FID at step one, then a further $15.03 FID at step two).

FID and DT also result in significant compliance costs and efforts directed at minimisation. Arthur Andersen and the Australian Society of Corporate Treasurers found that an average Australian corporate has 2.3 people involved in FID compliance. Businesses structure their accounts to minimise their liability and use couriers to deposit cash and cheques in FID-free Queensland.

- Stamp duty distorts the loan market. Although competition has provided customers with keenly priced housing and other loans, stamp duty adds substantially to the cost of refinancing (stamp duty and Titles Office fees add almost 0.5 per cent to the cost of a typical housing transaction in Victoria). The NSW Government moves to waive stamp duty on refinancing of loans was a step in the right direction for realising the full benefits of deregulation.

- Banks are required to act as an unpaid government agent for collecting revenue - FID and DT - and transaction information. FID and DT are difficult to comply with from a bank's point of view. Legislation is state-based and rates vary by state. The laws lack uniformity and even where they are similar, interpretation and implementation may vary. Moreover, manual calculation of FID liability is frequently required for interstate transfers of funds. It costs ANZ about $20 million a year to collect FID and DT.

AUSTRAC transaction reporting obligations aimed at discouraging money laundering activities impose $2 million a year in data collection costs. Data is supplied by AUSTRAC to law enforcement agencies at no charge. As a result, the information is inappropriately valued and the impost on banks' operations keeps growing.

- Tax rules are a barrier to merging unit trusts that are uneconomic to operate. Merging a trust triggers capital gains tax and stamp duty on the transfer of the assets which significantly reduces the value of the assets. Furthermore, tax losses from one trust cannot be carried forward to the merged trust, effectively preventing trustees from approving the merger of a poorly performing trust. The ability to merge trusts and pass across accumulated tax losses without incurring capital gains and stamp duty would improve efficiency and allow unitholders to benefit from better performing trusts.

3. Although regulatory reforms are required, the integrity of the financial system must be maintained.

While the issues outlined above indicate the need for reforms to the existing regulatory structures, it is vitally important that these do not interfere with the integrity of the banking system.

The banking system differs from other industries in two ways.

First, the banking system plays such a central role in the economy that any failure would wreak havoc in the economy's overall functioning. Specifically, its role in providing payments and settlement, intermediation and a 'safe haven' for savings is key.

Second, banks are subject to the threat of systemic risk. Banks face this unique risk due to their 'liquidity transformation' function, where illiquid loans (assets) are converted to liquid fixed value deposits (liabilities). This function raises the possibility of 'runs on the bank' where depositor withdrawals trigger a 'firesale' of assets which reduces the value available to remaining depositors. Because of the delicate nature of public confidence, a run on one institution can quickly lead to a loss of confidence in other banks and a run on the entire system.

These two unique characteristics underpin the need for a regulatory framework which maintains public confidence in the system. There are several specific aspects of the current regulatory structure which are key to this.

a) Controlled access to the **payment system**

"Payment and settlement systems are potentially a key institutional channel for the propagation of systemic crises" (BIS, 1994, p.177). This indicates the need to continue to control access to the payment system.

Currently, responsibility for the management and operation of the payments system rests with the Australian Payments Clearing Association (APCA). APCA is owned by banks together with building societies, credit unions and their associations and participating membership of its clearing systems is open to these institutions and Special Service Providers.

Initiatives are underway which will improve the performance of the payment system and reduce systemic risk.

From end 1997, Australia's deferred net settlement system will be augmented with a Real Time Gross Settlement (RTGS) system for high value electronic payments. Under RTGS, high priority, high value electronic payments will be irrevocably settled intraday through Exchange Settlement Accounts held with the RBA. If insufficient funds are available to effect settlement, the payments will be queued until the funds become available. In this way, settlement risk is minimised and the uncertainty that surrounds the unwinding of transactions that have built up over the day in a deferred net settlement system is eliminated. RTGS should minimise systemic risk since it makes it possible to isolate failure to a single institution.

In conjunction with the introduction of RTGS, the Bank Interchange and Transfer (BITS) system will be phased out and replaced by a Payment Delivery System (PDS), a real time messaging system that will provide the interface to the RTGS. BITS is used to transmit domestic payments between member banks, including the Australian Dollar leg of foreign exchange transactions which gives rise to settlement risk known as Herstatt risk. The system will therefore be protected against contagion but due to asynchronous settlement of transactions reflecting different time zones and different opening hours of the various exchanges around the world, there is no protection against Herstatt risk. Hence, while initiatives minimise systemic risk, they do not eliminate it altogether.

Insulation against contagion is one way of ensuring a robust system that can withstand the collapse of a participant. However, strength and standing of individual participants and their expertise in risk assessment is the best protection against disruption of the system and systemic failure. For this reason, direct access to the clearing system should continue to be restricted to payment services providers who meet APCA criteria. Others should seek indirect access through APCA members on commercial terms.

b) Prohibition of **mixed conglomerates**

As outlined earlier, financial conglomerates pose particular challenges for regulators. However, they provide important benefits to customers.

Mixed conglomerates - those with a range of commercial activities extending beyond financial services to include businesses such as retailing or telecommunications - pose further more serious contagion problems. Here the supervisory rules and practices applied to the financial activities cannot be meaningfully extended to the commercial activities. Even if supervision were to be extended, the regulator would need adequate specialist knowledge to assess the business risks in each line of business. Given the importance of maintaining mutual confidence amongst the participants in the payment system, it would not be appropriate to allow the formation of mixed conglomerates in Australia.

c) Maintenance of **capital adequacy**

Australian financial institutions operate within the global financial market. Capital adequacy requirements reassure counterparties that banks hold adequate capital to meet their credit risk. Australian requirements conform with the Basle Capital Accord developed by the Bank for International Settlements (BIS). While there may be opportunities to refine the specifics of capital adequacy requirements in Australia, it is vitally important that any changes remain in keeping with the BIS framework or any other international framework that succeeds it.

d) **Protection of depositors**

It is also important that depositors continue to be protected under any new regulatory structures.

Under the Banking Act 1959, the RBA is required to "exercise its powers and functions ... for the protection of the depositors of the several banks". No explicit guarantee of depositors' funds is provided; rather, depositors' claims on the bank's assets rank ahead of claims of all other creditors should a bank become unable to meet its obligations. These arrangements should be kept in place to maintain confidence in the system.

Increased disclosure requirements such as those recently implemented in New Zealand would not eliminate the need for depositor protection. Banks' balance sheets are 'opaque' and depositors are therefore not in a position to assess the riskiness of the institutions to which they are entrusting their money. Banks can, and do, rapidly change their risk profile. William McDonough, President of the Federal Reserve Bank of New York noted that:

> "Formerly you could look at the balance sheet of a financial institution and quickly get a sense of exposure and risks ... today, balance sheet information is clearly inadequate for this purpose ... the fast pace of activity in today's market renders financial statements stale almost before they can be prepared" (Dale, 1996).

Australia’s arrangement is also preferable to explicit deposit insurance arrangements that operate in the US, Japan and various European countries including Britain and France. Explicit deposit insurance arrangements appear to carry with them a particularly high degree of ‘moral hazard’. In the US, for example, the Federal Deposit Insurance Corporation (FDIC) manages the bank insurance fund and the Federal Savings and Loan Insurance Corporation (FSLIC) manages deposit insurance for Savings and Loans. The failure of a large number of Savings and Loans in the early 1990s resulted in the bankruptcy of the FSLIC and a $150 billion rescue program from the US Government and taxpayers. The FDIC, while not going bankrupt, experienced a sharp increase in the number of banks in difficulty.

e) Continued control of **bank ownership**

The Banks (Shareholdings) Act sets specific limits (an upper limit of 15 per cent) on the proportion of voting shares in a bank which may be held by one shareholder or group of shareholders. This effectively prevents a single party from exerting undue control over a bank which could be counter to the interests of depositors. Where a bank is a subsidiary under a holding company structure, the Act should apply to the holding company.

Maintenance of these provisions is important to promote continued confidence in the system by the community.

SECTION C

In light of the pressures identified in Section B, ANZ makes a series of recommendations for regulatory reform. They are grouped into five sections:

- prudential supervision,
- consumer protection,
- institutional arrangements,
- competition policy and
- taxation issues.

The financial services sector is facing an era of accelerated change and ANZ welcomes any changes to the structure of regulation which will give flexibility in the way institutions position themselves to meet the challenges of all the markets in which they compete. Nonetheless, we feel that the fundamental importance of stability in the financial system requires that structural change should be managed in an orderly fashion.

It is recommended that any structural changes to the regulatory framework for the finance sector be introduced from a date which allows a period of orderly adjustment, say two years for any major change.

1. Prudential Supervision

a) It is recommended that direct access to the payments system be limited to institutions prudentially supervised by the RBA.

The payments system is the heart of the financial system and so maintaining its integrity is of paramount importance. Real Time Gross Settlement will minimise settlement risk within the domestic payments system and this, in turn, will reduce the risk of contagion being transmitted through the payments system to create a systemic crisis. However, if risky institutions are given access to the payments system they will heighten the risk of systemic failure, irrespective of the system's safeguards against contagion. Institutions supervised by the

RBA (ie banks) are required to be, by virtue of that supervision, at the least risky end of the spectrum.

b) **It is recommended that supervision of financial conglomerates with a holding company structure be on a consolidated basis and that mixed conglomerates not be eligible to hold a bank licence.**

Regulation should allow sufficient scope for financial conglomerates to respond to market forces but still protect the financial system against undue risk.

c) **It is recommended that the issue of open system Stored Value Cards (SVCs) be limited to deposit-taking institutions prudentially supervised by the RBA.**

Allowing unsupervised institutions to issue open system stored value cards would put prudentially supervised institutions at a competitive disadvantage, put the payments system at risk and undermine public confidence in SVCs (in the event of settlement problems).

d) **It is recommended that:**

- **The non-callable deposit requirement contained in the Banking**

Act be abolished in favour of fees to cover the cost of supervision;

- **The Prime Assets Requirement in Prudential Statement D1 Supervision of the Adequacy of Liquidity of Banks be abolished;**

- **Prescription as to who may sit on bank boards be removed from Prudential Statement B1 Ownership and Control of Banks.**

Some of the RBA's prudential requirements are too prescriptive. An objectives based approach to regulation would be more appropriate.

e) It is recommended that several key planks of the existing regulatory regime be retained.

- **It is recommended that Australia continue to adhere to the Basle Capital Accord as developed under the guidance of the Bank for International Settlements (or any globally recognised framework that succeeds it).**

Any reduction in prescriptiveness in Prudential Statement C1 dealing with capital adequacy and any shift towards reliance on banks' internal risk management procedures must be made within the framework of the

Basle Capital Accord.

- **It is recommended that the current 10 and 15 per cent limits on individual bank shareholdings be maintained but applied at the holding company level in the case of financial conglomerates.**

2. Consumer Protection

Consumer protection should be simplified and rationalised. The overly prescriptive nature of consumer protection regulation should be modified in favour of ‘objectives’ based regulation.

a) It is recommended that:

- **The Uniform Credit Code be revised substantially to reduce its prescriptiveness and remove the civil penalties for breaches.**

- **National privacy legislation (of minimal prescriptiveness consistent with international obligations) be developed in consultation with industry participants and that such legislation supersede any relevant State legislation.**

- **Any future State or Federal consumer protection measures be subject to thorough assessment to demonstrate (a) existence of a clear case for its introduction and (b) that the benefits of the proposed measure outweigh the costs.**

b) It is recommended that governments of all levels relax their price controls in recognition of the fact that bank managements are best placed to make pricing decisions in the interests of their customers as well as their shareholders.

Banks must be able to respond to the competitive challenge presented by the new breed of non-bank competitors who are generally lightly regulated. They also need to be able to leverage off their domestic base to compete in world markets. This implies a shift towards more rational pricing of products and services.

3. Institutional Arrangements

Institutional arrangements should be modified to reduce overlapping responsibilities and to provide effective supervision of financial conglomerates.

a) It is recommended that the AFIC/SSA regulatory framework be

dismantled and that building societies and credit unions be supervised by the RBA. Under these arrangements the RBA would:

- **be the sole prudential supervisor for all deposit-taking institutions: banks, building societies and credit unions;**

- **cease its commercial activities in provision of direct entry and Financial EDI services and open its Commonwealth Government Securities registration, clearing and settlement service to competition.**

b) **It is recommended that the supervision of financial conglomerates be formalised by the establishment of a 'lead regulator' model.**

Under a 'lead regulator' approach a sufficient degree of oversight of individual regulators would be maintained by virtue of the fact that all regulators come under the Treasurer's jurisdiction. Monetary policy would remain with the RBA. This arrangement would avoid the 'shadow regulation' by the monetary policy authority seen in other countries where supervision of deposit-taking institutions is separated from the monetary policy function.

c) **It is recommended that one national body (the ASC) be given sole responsibility for consumer protection in financial services.**

Issues of fragmentation and duplication of regulation in consumer protection should be resolved through establishment of one national regulator for consumer protection. The ASC is well suited for this role because it has a strong market focus and sound knowledge of the financial industry. The ACCC should pass its responsibility for administering Section 52 of the Trade Practices Act in financial markets to the ASC (as it has in the case of prospectuses).

The need for harmonisation of roles through the Council of Financial Supervisors would be substantially reduced under these arrangements.

Consumer protection responsibilities of the ISC and the RBA (except for depositor protection) should also pass to the ASC. The ISC would remain the prudential supervisor for insurance companies and life offices and ensure regulatory compliance of superannuation funds.

4. Competition Policy

Banking has been treated in the past as a ‘special’ industry for purposes of competition policy and this now presents an impediment to the ability of bank managements to adopt their preferred strategies.

It is recommended that competition policy be applied to banking in the same way it is applied to other industries. This would involve:

- **adoption by the ACCC of more appropriate market definitions when assessing the implications of bank mergers. These definitions should recognise that competition is not confined within state borders, substitute products are provided by non-bank suppliers, and economies of scale are important in bank processes.**

- **Removal of the 'six pillars' policy of restricting mergers between major banks and major insurance companies in favour of assessing each merger proposal on its economic merits.**

- **Clarification of policy regarding foreign takeovers.**

5. Taxation Issues

a) It is recommended that:

- **FID and DT be abolished;**
- **stamp duty on financial transactions be abolished or reduced; and**
- **tax arrangements to allow unit trust mergers be introduced.**

FID and DT are an impediment to Australia's attractiveness as a regional financial centre, stamp duties create inefficiencies in the financial system as do impediments to the merger of uneconomic unit trusts.

b) It is recommended that the inequitable tax treatment of bank deposits relative to other types of investment asset be redressed.

A clear tax bias exists against bank deposits despite their critical role in mobilising savings.

Appendix I

DUPLICATION OF REGULATIONS - Consumer Protection

Key - I = Information requirements

D = Dispute resolution procedure

C = Regulation of contractual terms, and how they may be amended

P = Privacy

L = Licensing

	Consumer transaction accounts	**Consumer loans**	**Insurance**	**Investment loans**	**Investments**	**Business transaction accounts**	**Business loans**	**Credit cards**
Code of Banking Practice (Australian Payments System Council)(APSC)	I,D,C,P	I,D,C,P		I,D,C,P	I,D,C,P			I,D,C,P
Corporations Law (ASC)		L		L	L,I		L	
Discrimination Acts (Human Rights & Equal Opportunity Com'n)	C,D	C,D	C,D	C,D	C,D	C,D	C,D	C,D
EFT Code of Conduct (APSC)	I,D,C							I,D,C

	Consumer transaction accounts	Consumer loans	Insurance	Investment loans	Investments	Business transaction accounts	Business loans	Credit cards
Fair Trading Acts (Consumer Affairs Depts/ Fair Trading Office)	I,D,C	I,D,C	I,D,C	I,D,C	I,D,C	I,D,C	I,D,C	I,D,C
Farm Debt Mediation Act (NSW) (Rural Assistance Authority NSW)							D	
General Insurance Code of Practice (ISC)			I,D,C					
Insurance Contracts Act (ISC)			I,C					
Insurance (Agents and Brokers) Act (ISC)			I,C,L		I,C,L			
Hire Purchase Acts (Consumer Affairs/Fair Trading Offices)		C						
ISC Life Insurance Code of Practice (ISC)			I,C		I			
Life Insurance Act (and regulations) (ISC)			I,C,D		I,D,C,L			
Lending of Money Act (Tas) Dept of Consumer Affairs		I,C						

	Consumer transaction accounts	**Consumer loans**	**Insurance**	**Investment loans**	**Investments**	**Business transaction accounts**	**Business loans**	**Credit cards**
Privacy Act (Privacy Commissioner)	D,P	D,P	D,P	D,P	D,P	D,P	D,P	D,P
Superannuation Industry (Supervision) Act (and regulations) (ISC)			I,C,D,L		I,D,C,L			
Trade Practices Act (ACCC)	I,C	I,C	I,C	I,C	I,C	I,C	I,C	I,C
Trustee legislation (relevant state Trust Controller/ Officer)					C,L			
Uniform Consumer Credit Code Consumer Affairs Dept/Fair Trading Office		I,D,C	I,C					I,D,C

Appendix II

UNIFORM CONSUMER CREDIT CODE

Benefits to consumers usually attributed to the legislation, and the existing legislation that covers that area, are listed below.

Benefit to customer	Existing Regulation/Comment
Pre-contractual and ongoing disclosure, and plain English requirements: - Consumers know exactly how much they will be liable to pay under the contract. - Interest rate and fee changes (increases) will be notified to the customer. - All debtors will receive regular statements of the account. - Guarantors receive written notice of important matters. - The consumer knows exactly how the relationship with the credit provider will work. - Disclosure of all terms must be made to all parties (including guarantors and mortgagors) before the contract is entered into.	Code of Banking Practice obliges banks to provide full, clear explanation of all products and changes to products without being overly prescriptive.
Altering the parties' relative positions during the course of the contract: - Unjust contracts can be reopened. - A customer who suffers hardship during the course of the contract can apply to the credit provider and to the court to have the terms of the loan changed. - Courts can halt repossession proceedings. - Unconscionable interest and other charges can be struck out.	This is inappropriate given comprehensive pre-disclosure requirements. Unconscionable conduct of any sort is already covered by the Trade Practices Act.

Advertising standards: - Minimum advertising standards must be met by the credit provider.	Trade Practices Act, Fair Trading Acts both provide minimum standards.
Liability for third party mortgage introducers: - Credit providers are liable for the actions of third party mortgage introducers as their agents.	Trade Practices Act provides extensive remedies for customers.
Penalties: - Civil penalties for some breaches can result in all interest charges under the contract being waived. - Compensation may be awarded to a guarantor/mortgagor.	Some of the penalties are harsh and unreasonable and go well beyond those in similar laws
Other: - Third party mortgages have been prohibited.	

Examples of the shortcomings of the Uniform Consumer Credit Code legislation as measured against other criteria are given below.

Disclosure requirements are overly prescriptive, which reduces the ability to respond flexibly to customers' needs and adds to their costs.

Some examples are:

- The need for strict compliance with overly prescriptive disclosure requirements means that flexibility in response to particular customers' needs must be sacrificed to ensure compliance is achieved by staff.

- ANZ's systems did not already produce the data in the required format and system resources have been almost totally occupied for two years with implementing the necessary changes to satisfy the disclosure requirements. In addition to direct costs, this means that new product development has been set back by a significant period of time.

- The added costs of compliance must be borne by consumers. The additional cost to ANZ's business of ongoing compliance is estimated to be approximately $9 million per annum.

- Disclosure requirements and the harshness of the penalties for failing to comply have forced credit providers to add significantly to the length of the contracts. An ANZ letter of offer for a home loan will be approximately fourteen pages in length, compared to eight pages before introduction of the Code.

- Informal credit arrangements cannot be allowed to exist under the new legislation, and customers are required to incur the expense and effort of formalising even small, and sometimes temporary, credit requirements.

- The Code effectively prohibits interest being charged other than daily in arrears on unpaid daily balances, thereby limiting the credit providers' ability to satisfy some legitimate customer preferences.

Penalties are onerous

Some examples are:

- The penalties contained in the legislation are so onerous and, therefore, banks' resources so occupied with strict compliance, that real issues of customer service cannot always be given the priority they should be accorded.

- Breaches of various sections of the Code result in imposition of either, some or all of:

  - a civil penalty

  - a criminal penalty

  - compensation to the consumer

  - the relevant contract/security provisions being void.

  Those results may be extremely harsh on the credit provider, and the Code does not provide for exceptions in the event of inadvertent errors. Other legislation, such as the Trade Practices Act and the Corporations Law allow for civil penalties, but provide some protective mechanisms, such as who may apply for them. There are no such provisions in the Code.

- The maximum penalty of $10,000 for failure to comply with the pre-contractual disclosure provisions has resulted in ANZ's decision to ensure all contracts are system produced. Apart from the cost of doing this, any flexibility to meet a customer's out-of-the-ordinary needs has been eliminated.

- A breach of a 'key requirement' could lead to a penalty of forfeiture of all interest charges paid under the contract or maximum fines of $500,000 per contravention.

It is administered by different regulatory agencies which has been responsible for the extremely protracted time taken to develop the legislation, and which adds layers of cost to any compliance and correction processes going forward.

Western Australia:	Ministry of Fair Trading reports to Minister for Family and Children's Services; Youth; Seniors; Women's Interests; Fair Trading

Tasmania:	Consumer Affairs Council, Department of Justice, reports to Attorney-General, Minister for Justice, Minister for Tourism and Minister for Workplace Standards.
Northern Territory:	Office of Consumer Affairs and Fair Trading, Attorney-General's Department reports to Attorney-General; Minister for Education & Training; Minister for Sport & Recreation; Minister for Constitutional Development.
South Australia:	Office of Consumer & Business Affairs, Attorney-General's Department, reports to Attorney-General & Minister for Consumer Affairs.
Queensland:	Office of Consumer Affairs, Department of reports to Attorney-General & Minister for Justice
Victoria:	Office of Fair Trading & Business Affairs, Department of Justice, reports to Attorney-General; Minister for Fair Trading and Minister for Women's Affairs.
NSW:	Consumer Affairs Directorate, Department of Fair Trading, reports to Minister for Fair Trading & Minister for Women Office.
ACT:	Consumer Affairs Bureau, reports to Attorney-General, Minister for Consumer Affairs, Minister for Police, Minister for Emergency Services, Minister for Planning and the Environment and Minister for the Arts and Heritage.

It is costly

For ANZ, implementation of the legislation is estimated to be $13 million and the ongoing costs are estimated at about $9 million a year (for increased paper usage, increased resource time and compliance checking). Estimates gathered from its member banks by the Australian Bankers' Association put the cost of implementation of the Code by the banking industry at $160 million. These costs must ultimately be borne by customers.

References

Argy, Fred (1995), *Financial Deregulation: Past Promise, Future Realities*, CEDA Research Study P42, Committee for Economic Development of Australia, Melbourne.

Committee of Inquiry into the Australian Financial System (1981), *Final Report*, AGPS, Canberra.

Bank for International Settlements (1994), *64th Annual Report*, Basle.

Bank for International Settlements (1996), *66th Annual Report*, Basle.

Carmichael, J. (1992) Capital Inflow and Macroeconomic Stability Under Australia's Floating Exchange Rate System, EPAC Background Paper No. 17, AGPS, Canberra.

Dale, Richard (1996), *Regulating the New Financial Markets*, Paper presented to the Melbourne Business School's conference "The Future of Prudential Regulation", 12 July.

Fitzgerald, V. W, and Harper, Ian, (1993), Taxation and the Allocation of Household Saving - Further. Evidence For Australia, Baxter Conference.

Reserve Bank of Australia (1994), *International Comparisons of Bank Margins*, Submission to the House of Representatives' Standing Committee on Banking, Finance and Public Administration, August.

Rhoades, Stephen A (1994), *A Summary of Merger Performance Studies in Banking, 1980-93, and an Assessment of the "Operating Performance" and "Event Study" Methodologies*, Staff Study 167, Board of Governors of the Federal Reserve System, Washington

Tripartite Group of Bank, Securities and Insurance Regulators (1995), *The Supervision of Financial Conglomerates*

Walker, Greg (1995), "Banking on Size: Australian Evidence", *The Australian Banker*, June, pp 113-116

Porter, Michael E, (1990), The Competitive Advantage of Nations, The Free Press, New York