



Australian Financial Institutions Commission

Submission to the Financial System Inquiry

6 September 1996



Summary

- 1.1 Building societies and credit unions generally:
- are significantly smaller financial institutions than banks;
 - operate in domestic retail markets many of which are regionally focused;
 - are reliant for payment settlement services on industry owned entities known as special services providers, and, in the case of credit unions, are reliant on these entities for treasury and banking services;
 - are identifiably local or state based institutions (although increasingly operating across state borders).
- 1.2 All credit unions and approximately one third of building societies are mutually owned.
- 1.3 Because of these characteristics, AFIC submits that any regulatory system covering the institutions presently supervised under the Financial Institutions Scheme should incorporate the important elements of the present Scheme. These are that:
- appropriately tailored prudential standards should govern the supervision of these institutions; and
 - institutional supervision should be delivered at a regional level because they are geographically widespread and local knowledge is important.
- 1.4 The main outcome sought to be achieved by the FI Scheme is the protection of depositors from the risk of loss. Approximately 6 million Australians hold deposits in FI Scheme institutions.
- 1.5 The political risk attaching to the failure of state based financial institutions also motivated State and Territory governments to establish the Scheme.
- 1.6 The FI Scheme:
- provides appropriate prudential supervision on an institutional basis;
 - operates under a prudential standards mechanism with flexibility to adapt to changing market circumstances;
 - addresses the risk profiles of FI Scheme institutions by providing supervision at a regional level;
 - takes proper account of the size and structure of the Scheme's institutions;
 - is well placed to undertake the prudential supervision of the friendly society industry early in 1997;
 - separates the responsibility for prudential supervision from those governments which have set up independent supervisory authorities; and
 - is transparently funded.



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- 1.7 AFIC's strategies continue to focus on improving the efficiency and uniformity of the FI Scheme.
- 1.8 Communication and co-operation between AFIC and other financial system supervisors on a bi-lateral level and through the Council of Financial Supervisors ensures that the prudential standards governing FI Scheme institutions are broadly consistent with the supervision of the banking sector which is supervised at the Commonwealth level. The closer style of supervision is appropriate for the smaller size and scope of the institutions supervised.
- 1.9 This submission:
- provides information about the FI Scheme and the industries it supervises: section 2
 - describes why the FI Scheme works: section 3
 - makes recommendations on the regulatory arrangements for building societies and credit unions: section 4
 - looks at the differences between FI Scheme institutions and banks in terms of supervision: section 5
 - considers some of the strategic issues affecting the FI Scheme: section 6, and
 - addresses the terms of reference: section 7.



2. The FI Scheme

FI Scheme structure

- 2.1 The FI Scheme is a co-operative scheme between the States and Territories. It is set up by the application, in each of the participating States and Territories, of Queensland legislation. Each of the States and Territories passed application of laws legislation which apply the template Financial Institutions Code and Australian Financial Institutions Commission Code set up by the originating legislation. Amendments to the Queensland legislation automatically apply in all participating jurisdictions thus guaranteeing on-going uniformity.
- 2.2 The FI Scheme is overseen at the governmental level by the Ministerial Council for Financial Institutions (MINFIN).
- 2.3 The Australian Financial Institutions Commission (AFIC) is the national prudential supervisor of credit unions and building societies under the FI Scheme. It sets prudential standards and co-ordinates supervision policy for the supervision of those institutions under the Scheme.
- 2.4 State and Territory based “State Supervisory Authorities” (SSAs) undertake the day-to-day supervision of FI Scheme institutions and monitor their compliance with AFIC’s standards and the FI Code.
- 2.5 AFIC also sets prudential standards for and directly supervises entities registered under the Scheme called “Special Services Providers” (SSPs). These entities provide services to societies including banking, treasury and payment settlement services.
- 2.6 Under current proposals, friendly societies will be regulated and supervised under the FI Scheme from 1 January 1997.

Prudential standards

- 2.7 AFIC issues prudential standards after a 60 day consultation process with SSAs, industry and other interested parties.
- 2.8 If an urgent standard is required, the AFIC Board can pass a standard but it has effect for only 120 days or such lesser period specified in the Board’s resolution.

Credit unions

- 2.9 There are 285 credit unions. While the industry has seen considerable rationalisation since the 1970s when there were over 700 credit unions, there can be no doubt that they will continue to play an important role in the financial system, serving over 3 million members and holding in excess of \$15 billion in assets. Traditionally serving personal finance requirements, the industry is looking more toward home lending for growth in its asset book, with housing loans now making up more than 50% of credit union lending.
- 2.10 All credit unions are mutually owned and only one has issued subordinated debt.



- 2.11 Because they are mutually owned, credit unions have little access to capital markets. They rely on building up reserves to provide capital on which to expand their asset base. In a time of intense competition in the retail banking sector and pressure on margins and, therefore, profitability, there is little scope for credit unions to increase reserves and profits.
- 2.12 Credit union assets and membership have had sustained growth over the life of the FI Scheme.

Building societies

- 2.13 The building society industry comprises 25 societies, with the period since the commencement of the Scheme seeing a considerable rationalisation within its ranks, from 35 in July 1992. Despite significant growth in competition, the industry has generally held its profitability in a crowded market.
- 2.14 A number of the largest institutions have converted into banks, and the expected creation of the Queensland based “Q-Bank” will see Suncorp Building Society (currently Australia’s largest building society) exit the industry. In addition, there is at least one planned merger between two building societies in Queensland.
- 2.15 Building society ownership takes a wide variety of forms:
- a) demutualised societies registered on the Australian Stock Exchange;
 - b) demutualised societies registered on an exempt stock market;
 - c) societies wholly owned by life companies;
 - d) societies wholly owned by friendly societies; and
 - e) mutually owned societies.
- See annexure A for details.
- 2.16 Building society industry growth in assets and membership has also been sustained over the life of the FI Scheme.



3. Why the FI Scheme works

- 3.1 The need to ensure depositor protection and industry stability and to reduce the political risk inherent in the failure of a state-based financial institution motivated the States and Territories to establish the FI Scheme.
- 3.2 Since its commencement on 1 July 1992, the Scheme has succeeded because:
- it revolves around prudential standards that are based on national and international benchmarks and which have been tailored specifically to suit the supervised industries; and
 - the “hands on” supervisors have maintained a regular and thorough inspection process which has assisted institutions to develop their own compliance systems or to rationalise their operations in order to meet the standards required of them.
- 3.3 It has also succeeded because of the high level of support for the Scheme from FI Scheme institutions.
- 3.4 Increasing levels of co-operation between FI Scheme supervisors together with regular formal and informal consultation with industry has ensured that the Scheme remains aligned with the needs of the supervised industries.
- 3.5 Co-operation at a national level between the Reserve Bank of Australia (RBA) and the Insurance and Superannuation Commission (ISC) has ensured a close alignment in approach to prudential standards.
- 3.6 The FI Scheme has had a steady but significant impact on these industries since 1992 and has allowed societies to prosper despite intense competition in the market.
- 3.7 FI Scheme industries’ response to the new regime of compliance with prudential standards was impressive with substantive compliance being effected by mid 1994.
- 3.8 The majority of State and Territory Governments and the Commonwealth Government have recognised that the status of the industries under the FI Scheme warrants the removal of legislative discrimination against them.¹

Communication

- 3.9 FI Scheme supervisors have small but highly qualified professional staff from different disciplines to monitor, develop and apply the prudential standards.
- 3.10 There is a determination on the part of those involved in the Scheme to make the Scheme work which continues to drive the development of the FI Scheme.
- 3.11 As part of this new culture, there has been an openness in AFIC and SSA consultation with national and state industry bodies and with individual societies.

¹ On 20 June 1996, NSW passed “omnibus” legislation amending 96 Acts to remove provisions which prevented building societies and credit unions from competing on an equal footing with banks. Queensland, SA and ACT Governments have all approved the preparation of similar omnibus legislation. The Commonwealth has approved the amendment of the Cheques and Payment Orders Act 1986 to permit building societies and credit unions to issue cheques.



- 3.12 AFIC has maintained a close bi-lateral relationship with the RBA and is developing its relationships with other regulatory agencies. AFIC is a member of the Council of Financial Supervisors.
- 3.13 AFIC and SSAs directly consult with industry bodies on their operating costs and the amount and sourcing of levies to cover those costs.

Strategic direction

- 3.14 AFIC's strategies continue to focus on improving the efficiency and uniformity of the FI Scheme.
- 3.15 The Board of AFIC has set the following priorities for the strategic development of the Scheme:
- To enhance the uniformity of supervision provided by the Scheme across the country. This strategy is being implemented through an agreed set of nationally uniform procedures and policies on the frequency and type of inspections and off-site analysis and the monitoring of compliance with those procedures and policies.
 - To ensure cost effective data collection and, in time, electronic document lodgement and exchange and e-mail. AFIC and SSAs are implementing a common data system to be operational by 30 June 1997.
 - To provide all supervisors in the Scheme access to a reference resource to foster the uniform interpretation of the legislation and standards expected of the Scheme as a national scheme. AFIC is developing, in consultation with SSAs, a national policy and legal precedent system.



4. Recommendations on regulatory arrangements

- 4.1 AFIC submits that prudential supervision of deposit taking institutions (DTIs) is necessary for financial system stability, depositor protection and the international standing of the Australian financial system.
- 4.2 Institutions permitted to accept deposits from the public must be supervised in order to protect the interests of depositors. This dictates that prudential supervision of DTIs must be institutionally based. Stability of DTIs is important to depositor protection.
- 4.3 Building societies and credit unions generally:
- are significantly smaller financial institutions than banks;
 - operate in domestic retail markets many of which are regionally focused;
 - are reliant for payment settlement on industry owned entities known as special services providers, and, in the case of credit unions, are reliant on these entities for treasury and banking services;
 - are identifiably local or state based institutions (although increasingly operating across state borders).
- 4.4 All credit unions and approximately one third of building societies are mutually owned.
- 4.5 Because of these characteristics, there will continue to be a need for prudential supervision of these institutions which is specifically tailored for them.
- 4.6 As these institutions are geographically widespread and local knowledge is important, supervision is best delivered at a regional level.
- 4.7 The main outcome sought to be achieved by the FI Scheme is the protection of depositors from the risk of loss. Approximately 6 million Australians hold deposits in FI Scheme institutions.
- 4.8 The political risk attaching to the failure of state based financial institutions also motivated State and Territory governments to establish the Scheme.
- 4.9 The FI Scheme:
- provides appropriate prudential supervision on an institutional basis;
 - operates under a prudential standards mechanism with flexibility to adapt to changing market circumstances;
 - addresses the risk profiles of FI Scheme institutions by providing supervision at a regional level;
 - takes proper account of the size and structure of the Scheme's institutions;
 - is well placed to undertake the prudential supervision of the friendly society industry early in 1997;



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- separates the responsibility for prudential supervision of FI Scheme institutions from those governments which have set up independent supervisory authorities; and
- is transparently funded.



5. Differences between the Supervision of FI Scheme Societies and Banks

Differences in prudential standards

- 5.1 The differences between AFIC's prudential requirements for FI Scheme institutions and the Reserve Bank's prudential requirements for banks are set out in Annexure B.
- 5.2 The globalisation of markets and threat of systemic risk arising from failure have heightened international co-operation on prudential standards. Even though the products and services offered by FI Scheme institutions are similar to those offered by retail banks, AFIC considers some regulatory and supervisory standards adopted in Australia by the RBA in its supervision of banks do not readily relate to the prudential or institutional supervision of FI Scheme institutions. AFIC does not apply prudential standards without consideration of their applicability to the institutions supervised and the cost/benefit of their introduction.
- 5.3 If the Inquiry favours product regulation, AFIC does not see this as affecting the prudential supervision of FI Scheme institutions. This is in line with the approach currently being taken in relation to Retirement Savings Accounts and other products offered by FI Scheme institutions regulated by other regulators.

Separation of policy setting function and inspection function

- 5.4 Unlike the operations of the RBA, the FI Scheme separates the prudential standard setting function and the inspection function. However, there is a close relationship between AFIC and SSAs:
 - AFIC and each SSA has a bi-lateral relationship
 - AFIC is advised by an Interstate Consultative Committee comprised of SSAs
 - Two members of the Interstate Consultative Committee are nominated by the ICC as Board members of AFIC
 - Chairman of AFIC, Mr Richard Humphry AO, is also the Chairman of the NSW SSA, FINCOM.
- 5.5 AFIC reports to the Ministerial Council (MINFIN) and the Boards of the SSAs each report to a single State or Territory minister.

Costs of supervision

- 5.6 AFIC and the SSAs are funded by way of levies on FI Scheme societies. The method of levying costs on a user pays basis under the FI Scheme is a workable model. AFIC consults with the supervised industries prior to submitting its budget for approval by the Ministerial Council. Likewise, each SSA consults with industry on current levies.
- 5.7 There has been some comment by industry bodies about the differing levels of supervisory costs between SSAs. As the FI Scheme develops further and uniform supervision policies take hold, the differences in operating expenses of the SSAs will be evened out or at least reduced to some degree depending on the different infrastructure requirements from State to State.



Friendly societies

- 5.8 Once friendly societies are incorporated into the FI Scheme, the Scheme will have prudential supervisory responsibility for institutions offering investment life and health insurance.
- 5.9 The introduction of the Friendly Societies Scheme for the supervision of friendly societies has inherent challenges, if establishment of the FI Scheme is any indication. There will inevitably be a period of adjustment necessary as the directors and management of friendly societies adjust their societies' operations to new national prudential standards. This will come at a time of intense competition in the superannuation and investment product market.

Trustee companies

- 5.10 Proposals for a state-based framework for the national registration and supervision of trustee companies continue to be discussed at a policy level. Proposals to date contemplate a significant role for AFIC in setting prudential standards and for SSAs in supervising the industry.



6. Strategic Issues

Legislative reform process

- 6.1 The FI Scheme legislative structure is based on national template legislation. The legislative reform process requires that any amendment of the legislation must be by the approval of the Ministerial Council for Financial Institutions constituted by the 8 participating States and Territories. It must then pass through the host Parliament of Queensland.
- 6.2 The nature of gaining approval for legislative amendment is a particularly important issue because there are many areas of the FI Code that need to remain consistent with other national legislation, especially the Corporations Law and soon the Friendly Societies Code.
- 6.3 It is also important that the FI Scheme be able to respond quickly to developments within financial markets where those developments have a bearing on the prudential supervision and stability of FI Scheme institutions.
- 6.4 There are several issues that AFIC has identified as warranting attention in order to assist the legislative reform process:
- the development of the legislative structure of the Scheme; and
 - the information flow to Ministers and their advisers.
- 6.5 AFIC proposes to discuss these issues with MINFIN Ministers and advisers to facilitate reform within the FI Scheme by:
- addressing each of the legislative restrictions on FI Scheme societies' business operations in consultation with all stakeholders in the Scheme with a view to removing as many of these as appropriate from the legislation and into prudential standards;
 - developing a more flexible legislative mechanism, such as a regulation making power, for keeping the FI legislation in line with Corporations Law amendments; and
 - providing better information flows from the FI Scheme supervisors to MINFIN and to individual Ministers and advisers.

Corporate regulation

- 6.6 AFIC has debated whether the corporate regulation of FI Scheme societies should be separated from their prudential supervision and be passed to the Australian Securities Commission under the Corporations Law.
- 6.7 However, AFIC considers there to be important collateral benefits to be gained from continuing with the joint role.
- 6.8 As the majority of FI Scheme societies are small financial institutions, the regulation of their corporate compliance provides supervisors:
- with valuable information about their overall compliance status; and



- gives supervisors greater flexibility to take decisive action on an issue in line with their statutory duty of maintaining system stability without having to rely on another agency's reassessment of the issue.

Economies of scale and the cost of duplication

- 6.9 With independent supervisory authorities based in each State, there may be capacity for economies of scale to be achieved through the amalgamation of resources. Further, smaller SSAs can face problems maintaining sufficient resources necessary to provide advice to their Boards.
- 6.10 An important aspect of the FI Scheme is that the Boards of the SSAs provide independent judgement about issues faced in the prudential supervision of societies based in their State. Each SSA should remain available to address the needs and concerns of locally based institutions, their members and the community and the policy function should be retained at State/Territory level in order to provide a channel for ministerial responsibility.
- 6.11 The need for regional knowledge is important. This can be met through smaller States and Territories combining functions or outsourcing them to other SSAs servicing the needs of several States/Territories while maintaining responsibility for the function and contact with the institutions. This may provide economies of scale. Already the inspection function in Tasmania has been outsourced to a larger SSA.
- 6.12 The duplication of costs involved in the provision of State based SSA Boards and executive is relatively minor and is justified through the need for regional knowledge and ministerial accountability.

Information sharing

- 6.13 It is extremely important that government agencies be able to share information that is relevant to the carrying out of their duties and functions. AFIC and the SSAs are working on a number of initiatives to facilitate communication both within the Scheme and with other agencies such as the RBA, the ASC, the Australian Stock Exchange and the ISC.
- 6.14 In May 1996, AFIC received advice from the Commonwealth Attorney-General's Department that AFIC cannot be properly considered an agency of a State or Territory in terms of section 127 of the Australian Securities Commission Act 1989. As a result, the ASC is prohibited from releasing information to AFIC under section 127. However, the ASC is proposing legislative amendment to its Act (in the next *Miscellaneous Amendments Bill*) which will specifically authorise disclosure to AFIC.



7. Terms of Reference

This section addresses from a prudential point of view some of the issues highlighted in the Inquiry's terms of reference.

Terms of Reference	AFIC Submission
1. Results arising from financial deregulation flowing from the “Campbell Report” in 1981. Examining and reporting consequences for:	
1(a) the choice, quality and cost of financial services available to consumers and other users.	No submission from AFIC.
1(b) the effect of the financial system including its international and domestic competitiveness	No submission from AFIC.
1(c) the economic effects of deregulation on growth, employment and savings	No submission from AFIC
1(d) the evolution of financial institutions and products offered by them and the impact in the regulatory structure of the industry.	No submission from AFIC
2. Issues driving further change:	
2(a) technological and marketing advances	<p>The size of FI Scheme institutions dictates that in many areas they will not lead the financial system in the development and implementation of new technology. The increasing sophistication of necessary entry level information technology infrastructure places growing pressure on profitability will continue to rise. This is a significant prudential issue.</p> <p>Efficiencies of scale will continue to be derived through reliance on SSPs.</p> <p>FI Scheme institutions are often of such size as to be able to quickly develop and roll out new products and new marketing techniques, in contrast with their larger, rivals.</p> <p>The extent to which new players will enter the market based on new technologies (such as Internet “banking”) may increase the level of competition in a crowded marketplace, providing further pressure on the viability of institutions and encouraging further rationalisation amongst FI Scheme institutions.</p>
2(b) international competition	No submission by AFIC



Terms of Reference	AFIC Submission
and integration of financial markets	
2(c) domestic competition in all its forms	<p>Deposit taking institutions face increased competition for both growth in assets and liabilities. Recent lending trends show that non-deposit taking institutions (such as mortgage originators) are achieving significant market share on the asset side. Liability trends show longer term movement away from deposit taking institutions towards other forms of investment (many of which need not be prudentially supervised).</p> <p>The effect of this competition (which is faced by banks as well as building societies and credit unions) reduces the balance sheet and potentially decreases profitability. This is a prudential issue to the extent to which it affects the viability of institutions.</p>
2(d) consumer needs and demands	<p>Community driven reform in the area of consumer protection is most recently evident in the introduction of a nationally uniform Consumer Credit Code. With serious penalty provisions, this law has some prudential significance. Non-complying societies may be at wider risk. AFIC is examining this issue closely.</p>
3. Recommendations on regulatory arrangements and other matters affecting the operation of the financial system (including prudential and other regulations made by the Reserve Bank and other bodies) as will:	
3(a) best promote the most efficient and cost effective service for users, consistent with financial market stability, prudence, integrity and fairness.	<p>AFIC considers that any regulatory mechanism covering FI Scheme institutions should be based on a system of prudential standards where institutional supervision is delivered at a regional level. These issues are discussed further in section 4 of this submission.</p>
3(b) ensure that financial system providers are well placed to develop technology, services and markets and the financial system regulatory regime is adaptable to such innovation.	<p>The FI Scheme provides an excellent framework for prudential response to rapid market change. Financial system providers can adopt new technology or services almost overnight. These changes constantly present new issues for supervisors to assess and, when necessary, quickly develop appropriate standards in order to ensure that institutions are managing the risks involved appropriately.</p> <p>This underpins the need for prudential supervision under a flexible prudential standards mechanism, not legislated regulation or government developed standards.</p> <p>FI Scheme prudential supervision is flexible and adaptable.</p>
3(c) provide the best means for funding the direct costs of regulation.	<p>The present levy system used by the Fi Scheme is transparent and fair - providing appropriate levels of resources for supervision on a user pays basis.</p>



Terms of Reference	AFIC Submission
<p>3(d) establish a consistent regulatory framework for similar financial functions, products or services which are offered by differing types of institutions.</p>	<p>The nature of FI Scheme institutions justifies, and will continue to justify, the existence of a prudential framework which is different, though largely based on and consistent with, the prudential supervision of the bigger competing industries, that is banks competing with building societies and credit unions and life offices competing with friendly societies.</p> <p>Prudential supervision is not inconsistent with product regulation for any particular product offered by differing institutions.</p>
<p>4. The Inquiry... will take account of:</p>	
<p>4(a) The objective or procedures of the Reserve Bank in its conduct of monetary policy;</p>	<p>No submission by AFIC</p>
<p>4(b) Retirement incomes policies;</p>	<p>AFIC supports the budget decision of the Government to allow only prudentially supervised institutions (including FI Scheme societies) to offer Retirement Savings Accounts. AFIC will assist the Government as much as possible in implementing this decision as it relates to FI Scheme institutions.</p>
<p>4(c) The regulation of the general operation of companies through corporations law</p>	<p>AFIC is working with the ASC to incorporate AFIC's national names register into the ASC's names database.</p>
<p>4(d) Policies for taxation of financial arrangements, products or institutions.</p>	<p>No submission by AFIC</p>