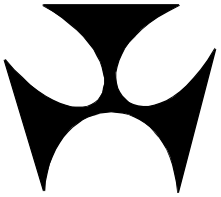
RESERVE BANK OF AUSTRALIA

Submission to the Financial System Inquiry



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EXECUTIVE SUMMARY

1. The RBA welcomes the Government's decision to hold a Financial System Inquiry. The financial system and the institutions charged with its supervision have been evolving over recent years in response to the challenges that competition, globalisation and technology have presented. The particular value of the Inquiry is that it permits a stocktaking, whereby the system is seen in its entirety, and where future challenges can be evaluated. It also presents all participants with the opportunity to have their views evaluated in the same arena as their competitors - and in the full light of public scrutiny.

2. This submission adopts a top-down approach, outlining some general principles which should underlie a sound, competitive and innovative financial system. In keeping with the RBA's responsibilities, it emphasises the need to take into account the long-run stability of the system. That is, regulation should not produce habits of mind in the public or managers of financial institutions that encourage excessive risk taking that could lead to financial crises, but should also not inhibit people from taking calculated and understood risks. The submission recognises that financial crises cannot be ruled out, and therefore the system of regulation should be also one that can minimise contagion within the financial system and the flow-on effects to the rest of the economy.

3. It is unlikely that this emphasis will be a feature of most other submissions. They will rightly be mainly concerned with issues of competitive neutrality. Is the burden of regulation too high? Does it bear more heavily on one set of institutions or products than another? Is there duplication? Are newly-evolving institutions escaping the regulatory net? These are all important issues, and there are a number of improvements that will be suggested to the Inquiry by financial institutions, regulators and by the RBA. It is the RBA view, however, that in evaluating these suggestions for change, they should be judged not only by competitive neutrality criteria, but also by the need to promote system stability.

4. There is general agreement that there are three main areas of regulation; prudential, consumer protection and competition policy. The body of this submission is directed at the first. On the latter two, the RBA puts forward some observations towards the end of the submission, but the main point is that both consumer protection and competition policy have an existing body of law and, in the main, it is intended to apply to all industries in Australia, not just to the financial sector. Any proposals for change must take that into account. Prudential regulation, on the other hand, is directed solely to financial institutions and concerns problems that are unique to them.

5. The first general principle of prudential regulation is that the type of regulation must be based on the risks being incurred. While it is possible to think of a spectrum of risk, it is not a continuous one; there is still an important division into two categories of product which are different in kind.

- *In the first category are those products which involve a binding contract on the part of the institution offering the product that it will not fall in value. The main products here are bank deposits and insurance policies. If the institution providing these cannot repay the amount they have specified in advance, they become insolvent. It also happens that some of these institutions are very important for system stability as their failure could become contagious.*

- *In the second category are the various investment products which involve an undertaking to manage funds on a "best endeavours" basis and whose return is based on the value of the underlying assets. With these products, it is the investor that bears the risk, not the institution. The value of these investments could fall without it implying insolvency for the managing institution.*

6. It is important to note that this distinction is made in relation to institutions' liabilities, ie the promises they have made to customers from whom they have accepted money. The type of regulations that should be applied needs to be based on the nature of these promises, not, as is sometimes claimed, the type of assets held by the institutions. While there has been increased blurring of assets held by different types of institutions (eg more mortgages held by superannuation funds and life offices than a decade ago), there has been much less blurring on the liabilities side.

7. The regulatory framework should recognise the different risks involved in the two types of product, both to the public and to the institutions that provide them. In the first case, it is the institution that has to be regulated with a view to minimising its chance of becoming insolvent. This is prudential supervision per se. The second form of regulation is product based and mainly relies on stringent disclosure rules, including informing the public that the investment may fall in value. It is stretching the definition to call these disclosure rules prudential regulation.

8. Because of the different nature of the two types of regulation, the RBA sees no merit in combining them in the one institution, sometimes referred to as a "mega-regulator", or "mega prudential supervisor". Indeed, there is a danger to the long-run stability of the system in so doing because of the "moral hazard" involved. If all financial products were under one government regulator, the public could see them all as being equally safe - "the Government stands behind them all". This could have implications for the public purse in the event of a financial disturbance (or even a large fall in asset values). The extra risk from the moral hazard is that institutions would be deterred from competing on safety, and they would be encouraged to take greater risks to maximise returns. (A recent well-publicised case of this concerned the Savings and Loans institutions in the US.)

9. While there may be some scope for consolidation of supervisory management, the RBA regards the "mega-regulator" model as fundamentally flawed, and would not favour it even if the RBA became the "mega-regulator". There are few examples of "mega-regulators" around the world if we mean by it a combined supervisor of banks, insurance companies and investment products such as unit trusts and managed funds. There are only four in the OECD area - Norway, Sweden, Denmark and Japan (where it is the Ministry of Finance). The financial instability in three of those four countries over the past decade does not suggest that this is a promising model to follow.

10. An argument for a "mega-regulator" is that it would help harmonise regulations by allowing inconsistencies to be thrashed out within the one organisation. This could yield some benefit at the margin, but the differences between regulatory regime will remain large. The rules of prudential supervision applied to a bank will still be very different to those applied to an insurance company, and neither will resemble the sort of product disclosure for unit trusts, regardless of whether the supervisors are in the same institution or not. The growth of conglomerates whereby the same corporate entity offers both banking, insurance and investment products provides a challenge to supervisors, although it has been happening here and abroad for more than a decade. Again, a "mega-regulator" is only one of several approaches to this issue. The more common response worldwide is to opt for a lead regulator. That is the approach being undertaken in Australia under the leadership of the Council of Financial Supervisors - the co-ordinating body of which the RBA, ISC, ASC and AFIC are members.

11. On the issue of who should be the bank supervisor, it will come as no surprise to learn that the RBA believes it should retain that role. A central bank, in addition to its monetary policy responsibility, must always take some responsibility for financial system stability and will be expected to do so by the public. Even those central banks that are given a narrow remit that excludes bank supervision always retain responsibility for the payments system on the grounds that it is vital to the stability of the financial system. The RBA believes that this extends to bank supervision, given banks' importance for stability, their role as lender to small and medium business, their susceptibility to runs, and the fact that these runs can become contagious with drastic consequences for system stability. The central bank is also in the unique position of being a participant in the financial markets on a daily basis, and is the only institution capable of injecting funds at short notice (either to the whole system or on a lender-of-last-resort basis to a particular bank). In addition, familiarity with markets is becoming more important as a potential financial crisis may be initiated in a market rather than by a bank failure (as in October 1987 in the US).

12. A number of arguments for and against the central bank being the bank supervisor are evaluated in the body of the submission and in Appendix C. There is no room to rehearse them here, other than to point out that they do not argue the central bank will be a bad supervisor, rather that supervision may interfere with monetary policy. These issues have been debated in a number of countries over recent years with varying results, but the only two instances where responsibility has been shifted

has been in Finland and Hong Kong where it was moved from a formerly independent supervisor to the central bank.

13. With bank supervision in the central bank, where does this leave insurance companies given that both are to be prudentially supervised? If the only aim was to minimise the number of supervisors, there might be a case to put them with bank supervision, but other considerations would argue strongly against it. First, there are few, if any, synergies. The structure of the balance sheets of banks and insurance companies are completely different and the skills required to supervise them are also different with actuarial assessment crucial to the latter. Second, insurance supervision is similar in many ways to the supervision required of superannuation. They are both very long run, concerned with retirement income and actuarially based. Even though accumulation-type superannuation funds are, strictly speaking, an investment product, the social cost of inadequate return and community expectation are such that some form of quasi-supervision will be required to make sure that trustees maintain an appropriately diversified portfolio and do not take excessive risks (or become excessively risk averse). With over 120,000 superannuation funds, this is a demanding and labour-intensive task and, in conjunction with insurance supervision, justifies the existence of a specialised supervisor such as the present ISC.

14. To date this summary has covered banks, but not mentioned other retail deposit-taking institutions such as building societies and credit unions. These institutions have balance sheets which are similar to banks and are currently supervised by AFIC and the State-based supervisory authorities using rules which are closely based on the ones the RBA uses to supervise banks. Again, if the aim was to minimise the number of supervisors, there is a case to have these institutions supervised by the RBA. On the other hand, there is no case on the grounds of system stability, and being under the wing of the RBA would marginally increase the moral hazard.

15. An anomaly in the Australian financial system is that merchant banks, usually owned by foreign banks, are able to undertake wholesale banking business in Australia without a banking authority. This is a hangover from the days when foreign bank entry was not permitted, and these merchant banks provided much-needed competition for domestic banks. Now that foreign bank entry is open, there is a case to expect foreign banks wishing to do banking business to gain authorisation and so face the same supervision regime. It is also becoming increasingly difficult to justify our failure to supervise these unauthorised subsidiaries of foreign banks as expected by the Basle Committee on Banking Supervision.

16. Finance companies are a different case. They do not take deposits, but finance themselves through the issue of debentures under the prospectus disclosure provisions of the Corporations Law subject to the ASC. Their liabilities are relatively long term, and they are not subject to runs or contagion. Several have failed over the past two decades without threatening system stability. The RBA sees no case to change their present regulatory regime.

17. At present the RBA separately authorises financial institutions (banks and non-banks) that trade in the foreign exchange market. In the case of non-banks, this means supervising part of an institution without first-hand knowledge of the solvency of the whole. Two solutions to this unsatisfactory arrangement are to either confine foreign exchange trading to banks, or to cease separate authorisation of foreign exchange dealers. The RBA favours the second alternative, which will bring the treatment of the foreign exchange market into line with other markets such as the bond market.

18. The present authorisation procedures for banks, including the restrictions imposed by the Banks (Shareholdings) Act 1972, have been reviewed in line with recommendation 9.2I of the National Competition Policy Review. In the RBA's view, these restrictions are in the national interest even though they involve a marginal reduction in the degree of competition in banking. The only improvement that warrants consideration is to streamline the process of granting authorisations. This could be achieved by allowing the RBA to grant authorisations, with a right of appeal to the Treasurer.

19. The RBA does not see a case for a bank licence fee or for a charge for the cost of supervision. In the latter case, the cost of supervision is well below the implicit tax imposed on banks by the penalty interest rate on Non-Callable Deposits.

20. In regard to the payments system, the major issues are risk, entry and challenges from new technology. Settlement risk has been a major concern over recent years, but is in the process of being largely eliminated by the introduction of Real-Time Gross Settlement. The right to entry to the settlement system has also been the subject of controversy but, with building societies and credit unions gaining membership through their special service providers, all significant providers of payments services are now members.

21. A recent subject of concern has been the fear that unsupervised competitors might provide an alternative payments system which would bypass the banks. A close examination of the services currently (or prospectively) offered on the Internet suggests that this is unlikely. In order to become a significant provider of payments services, an institution must accept deposits, in which case it will effectively become a bank and be supervised as one.

22. On competition policy, the RBA believes that the same broad principles which are used to evaluate mergers in other industries should be used to evaluate mergers in the financial services sector. This would mean taking a fresh look at the "six pillars" policy which prevents mergers between any of the four largest banks and the two largest life offices. The "four plus one" interpretation of the Trade Practices Act, whereby a regional bank presence is required in each State, should also be examined. It would be a much more serious step, however, to re-define competition policy in a way which effectively reduced the number of major banks in Australia to two.

23. On consumer regulation, the RBA believes there is scope for considerable rationalisation. Many financial institutions face rules on consumer protection imposed by State regulations, the ASC, ISC and Industry Codes of Conduct. The RBA plays a minor role in this area through the Australian Payments System Council and some Industry Codes of Conduct. It would be prepared to vacate this area if a more unified system of consumer protection was devised. Something along the lines of the UK Personal Investment Authority seems the most promising avenue.

1. BACKGROUND: FINANCIAL SYSTEM TRENDS

Introduction

1. This Chapter highlights the main trends in the Australian financial system which are important in thinking about the scope and structure of financial regulation. It is, of course, somewhat artificial to itemise these factors because they interact with one another. For instance, expansion of the funds management sector, with its appetite for investment assets, has made loan securitisation more viable and opened the way for mortgage originators, using innovative distribution techniques, to compete successfully with the traditional providers of housing finance.

2. An understanding of the main trends is obviously relevant to an assessment of the effectiveness of official regulation. Changes in the financial system - in the legal structures of financial institutions, the technology they employ and the nature of risks they incur - call for a review of regulations to ensure that they remain appropriately targeted and are achieving, as efficiently as possible, the Government's objectives. Meanwhile, regulations are themselves one of the many factors which help to shape the financial system.

3. A more detailed account of developments over the past forty years and of the forces which are shaping the future of the financial system is provided in Appendix A. Similar forces are evident in other advanced economies.

Changing market shares

4. Measured by assets, the aggregate market share of financial intermediaries - institutions which issue mainly deposit-type liabilities and make loans - is declining. This share is currently 62 per cent, compared with 74 per cent in 1980. The share of banks within this group has, however, increased since their operations were largely deregulated in the 1980s and entry policy was liberalised. This growth has been largely at the expense of non-bank financial intermediaries - building societies, credit unions, finance companies and money market corporations (merchant banks) - which had expanded to serve markets denied the banks by regulation. As a result, the banks remain dominant in the financial system with just under half of total assets, excluding their subsidiary operations.

5. The funds management and insurance sector has been the fastest growing sector over the past 15 years. It currently accounts for 38 per cent of assets, compared with 26 per cent in 1980. Its expansion has, however, been underpinned more by the reinvestment of earnings than by significant growth in new investments/contributions.

Table 1: Types of Financial Institution
Per cent of financial system assets

	June 1980	March 1996
Banks	41	46
Bank-owned merchant banks and finance companies	7	4
Other non-bank credit institutions	25	12
Banking group funds managers and insurers	4	8
Other funds managers and insurers	23	30

6. Assets are not the only indicator of institutional importance. While intermediaries have lost market share on that measure, they have led the way in the trading of financial instruments, particularly public sector securities, foreign exchange and derivatives. Banks are responsible for almost 90 per cent of foreign exchange dealing and around 80 per cent of over-the-counter (OTC) derivatives.

Product "mobility"

7. This refers to the offering by financial firms of products which had previously been associated mainly with other institutional groups. Conventional wisdom is that this phenomenon is increasing rapidly, and examples usually cited include:

- housing loans offered by life insurance companies and mortgage originators;
- liquid investment accounts offered by funds managers (eg cash management trusts) which are functionally similar to bank deposits. Some of these incorporate transaction facilities through links with a parent bank; and
- savings products from life companies which have similarities to term deposits (eg insurance bonds and certain term annuities).

8. This sort of overlap is not a new phenomenon. For instance, life offices were much more significant lenders for housing in the 1960s than they are now, and cash management trusts were introduced 15 years ago. It is also easy to overstate the extent and growth of these overlaps. Cash management trusts hold funds equivalent to about 7 per cent of call deposits at banks, a little less than they represented five years ago. Only around 5 per cent of deposit-type investments are held with institutions other than intermediaries such as banks and building societies, a proportion which has held steady over recent years.

Product diversity

9. Another dimension of change in financial markets is increasing product diversity. Virtually all financial firms now offer a much wider range of products and services than a decade ago, with multiple options as to rate of return, liquidity, risk characteristics, and so on. These features are combined in different ways and may be linked with other services previously regarded as separate (eg mortgage offset accounts, housing equity loans). At the same time, services previously offered in a package (eg housing loans and savings accounts) are being unbundled. As a result, the consumer of any basic financial service - such as a savings account - is confronted with a spectrum of choices, with only fine gradations of difference between them. In professional markets there has been a sharp expansion in the use of derivatives products for managing risk; some of these have been used to make retail products such as fixed-rate or "capped-rate" loans more readily available.

10. This growing diversity is driven by the relative freedom of financial groups to tailor products to the changing needs of their customers, the application of new technology to product design and delivery and an apparent increase in consumers' willingness to shop around. These and other innovations have been some of the benefits of financial deregulation.

Conglomerates

11. Financial conglomerates - the linking by ownership of institutions such as banks, insurance companies and unit trusts - have become a more important feature of the landscape. Among the causes are:

- aspirations of banks to participate in the more rapidly growing funds management sector, particularly with the prospect of increased compulsory saving in superannuation;

- the ambition of some insurance companies to be able to offer their customers payments and banking services; and

- the desire of insurance companies to make use of the banks' more extensive distribution networks, and the banks' interest in improving the earning capacity of these relatively expensive branches.

12. Conglomerates currently account for around 80 per cent of financial system assets, with the 25 largest holding almost 70 per cent of total assets. Conglomerates headed by banks have about 56 per cent of financial system assets while groups headed by insurance companies have a little over 15 per cent. Bank/insurance groups are particularly significant. Currently, seven banks own life insurance companies and one life insurance company owns a bank; collectively, these groups account for more than 38 per cent of financial system assets. The importance of conglomerates, which leads to a wide range of financial products being available in the one place, has no doubt

contributed to perceptions of "blurring" in traditional institutional boundaries and is probably a more significant factor than the phenomenon of product mobility.

Table 2: Conglomerates
Per cent of financial system assets

	1991	1995
Largest 4 conglomerates	38	36
Largest 10 conglomerates	56	53
Largest 25 conglomerates	68	68

Mergers and acquisitions

13. The high capital costs of competing systems and communications infrastructure have spurred rationalisation of the financial system through mergers and acquisitions, in pursuit of efficiencies and opportunities to streamline branch networks. This has been particularly evident among smaller institutions such as credit unions and building societies. Changes in the population of the different groups of intermediaries are shown in Table 3. Rationalisation has also seen an increase in the number of banks, due mainly to conversions from building society status and the entry of foreign banks, many of which already had a presence in Australia as a money market corporation. While driven by competitive pressures, the trend toward consolidation itself can raise concerns about potential diminution of competition. These are discussed in Chapter 9.

Table 3: Changes in Numbers of Credit Institution Groups
1986 to 1996

	Banks	Merchant banks	Finance companies	Building societies	Credit unions
Entrants	+19	+62	+95	+4	-170*
Exits	-11	-73	-132	-42	
Current number	52	78	96	25	285

* Estimated net change.

Securitisation

14. The growth of securities markets in Australia has been influential in a number of financial innovations (eg cash management trusts in the 1980s). Traditionally, securities markets have consisted mainly of government and semi-government paper, short-term private debt securities and longer-term debt of a small number of top-ranking corporates. The market for long-term private sector debt has been and remains thin, despite recent growth in the securitisation market.

15. Increasing demand for asset-backed securities from the growing funds management sector, and the advent of more sophisticated means of tailoring such securities to investor demands, will see securitisation become more widespread in the future. It has been an important feature of US markets for many years.[1] This form of funding has been exploited by the mortgage securitisers in the past year or so, and could be extended soon to credit card and other relatively standardised receivables. Over time, developments in securitisation may see interest extend to the "middle level" corporate market, as is now occurring in the US. The 1995 modification of the RBA's prudential guidelines also made it easier for banks to arrange loan securitisation without compromising capital adequacy.

Challenges to cross-subsidisation

16. When the financial system was heavily regulated and new entry relatively difficult, cross-subsidisation in pricing was common. The most prominent example has been the cross-subsidisation by banks of their payments services (cheque-clearing in particular) from the margin between interest received on loans and paid on deposits. This margin also funded the banks' extensive branch networks and large staff numbers.

17. More recently, entry into certain markets dominated by banks has become easier because of:

- new delivery methods, which have reduced the strategic importance of full-service branches in establishing contact with customers. Such channels include "virtual bank" kiosks, travelling salesmen (mobile banking), telephone and the Internet;
- other changes, such as the growth in securities markets, which have given new players access to funding without having to raise deposits; and
- a greater willingness of consumers to shop around for the best price and other features.

[1] However, the importance of mortgage securitisation in the US, where nearly two-thirds of mortgage loans are securitised, owes much to "sponsorship" of private securitisation schemes involving access to lines of credit from the US Government. Indeed, only 14 per cent of securitised mortgages go into "private label" schemes. A high proportion of credit card receivables have also been securitised.

18. Banks and other established institutions (such as building societies and credit unions) would have been vulnerable to new competitors anyway, because of their high cost infrastructures and inability to adapt quickly to more advanced technology, but the cross-subsidies in their price structures have made them more susceptible to "cherry-picking" by entrants in niche markets. Again, mortgage originators are the clearest example.

Technological change

19. Technological change, in its various guises, is having such a diverse and widespread impact as to be almost meaningless as a single category for discussion. There are, nevertheless, some useful distinctions. One is the use of *electronic data transmission* in financial services, rather than physical contact and paper flows. The clearest examples are in the payments system where, inter alia, EFTPOS and direct debiting are providing substitutes for cheques and credit cards.

20. A second impact is the application of *computing power* and advanced mathematics to the construction and pricing of complex financial products (both wholesale and retail), and to managing market and credit risks in financial firms. Such changes are clearly relevant to prudential supervision, posing questions about the management of market and operational risk. A third broad impact of technological change is *new delivery channels* for financial services. Some of this technology - such as the use of telephone for banking transactions - is not new. More modern technology includes the use of laptop computers by mobile lenders and of the Internet for inquiries and instructions about bank accounts.

New players

21. New delivery technologies are not only altering the competitive balance among established players, but along with cross-subsidies in existing price structures, are also creating opportunities for new entrants in the financial system. Examples include the mortgage originators (which have effectively linked home buyers with the wholesale capital markets or are acting as agents of traditional lenders), innovators in the field of stored value cards, and the providers of specialised telecommunications and computer equipment which are increasingly providing the linkages between financial firms and their customers. These players are bringing new skills and enhanced competition to Australia's financial system. To date, non-financial firms have not sought to become large-scale suppliers of financial services in their own right in Australia.

Payments system

22. The payments system is undergoing significant change. In very broad terms, this consists primarily of the gradual replacement of paper-based messages (cheques, money orders, etc) with electronic transmission. Stored value cards, using computer chip technology, are another prospective change in retail payments. These developments are making payments cheaper and faster, although initial infrastructure

costs can be very high; they are also creating business opportunities for new specialist entrants, as noted above. A major development in wholesale payments is the move to the settlement of interbank payments on a real-time gross basis, which will cut down interbank settlement risk and substantially reduce one potential source of system instability.

2. OBJECTIVES AND TYPES OF FINANCIAL REGULATION

Introduction

23. An efficient financial system will allocate savings to productive users of funds at least cost. It should offer a large range of financial instruments and institutions to assist investors balance risk, liquidity and return. It should also cater to a wide range of borrowers, from the well established to those with high-risk new ventures. The community should be able to trust the integrity and soundness of the system, without believing that everything is guaranteed by the Government. It should allow institutions to innovate - employing new technology and offering new products. It should be open to competition.

24. Although the features of financial systems vary from country to country, depending on their stage of economic development and the structure and philosophies of government, it is possible to identify three common themes or objectives underlying financial regulation:

- a concern with the stability of the financial system and a desire to prevent financial crises - that is, situations where problems in the financial system have the potential to cause a contraction in economic activity through their effects on community wealth, credit flows or confidence in the payments system. This objective is pursued through *prudential supervision* of key institutions, through oversight of arrangements for settling transactions among financial institutions and through "crisis management" when a problem does arise;

- a desire to protect the interests of users of financial services in situations where information about the characteristics of products, or the riskiness of institutions offering them, is hard to assess. This form of regulation - *consumer and investor protection* - attempts to improve the safety of investors' funds and requires clear disclosure of financial information and appropriate standards of financial advice so that investors and borrowers are better able to make informed decisions; and

- encouragement of appropriate levels of *competition* among those offering financial services, in the interests of efficiency.

25. Of these three types of regulation, only the first - prudential supervision - is unique to the financial sector, for reasons discussed below. Competition policy should involve the application of a common set of principles to all industries in the economy. Similarly, consumer protection rules can apply across a range of products, although there are particular issues involved with financial products; hence a lot of emphasis is given to investor protection. In the discussion below, prudential supervision receives the greatest attention because it is central to the RBA's concerns and expertise.

Prudential supervision

General aspects

26. Prudential supervision, in its broadest sense, is about maintaining the longer-run stability of the financial system by avoiding (or at least reducing the chances of) financial crises. History suggests that economy or system-wide financial crises do not occur often, but when they do their consequences are very severe. Most developed economies have only experienced such crises a few times per century. In Australia, such events occurred in the 1890s and the 1930s. Financial disturbances in the late 1980s and early 1990s reminded Australians that this danger was still present. A number of financial institutions incurred significant losses and there were some insolvencies, but the damage was less than in the earlier two episodes.

27. Prudential supervision, in its narrower sense, is about encouraging prudent risk management by financial institutions whose failure could precipitate a financial crisis. It works through rules which minimise the chance that supervised institutions will become insolvent and, failing that, by crisis management procedures. As a by-product, it offers the public a relatively safe haven for those savings where security is more important than return.

28. Certain sorts of institutions enter into contracts with the public whereby they promise to repay a specified nominal sum of money at some future date. The most common examples are deposits with banks and other retail deposit-taking institutions, where principal and interest must be repaid, or an insurance policy, where the claim must be paid out in full. If these institutions cannot meet their nominal commitments, they become insolvent and fail. Unlike a unit trust or an accumulation superannuation fund, their promised return is legally "locked in"; they cannot justify a lower (or negative) return on the grounds that market conditions proved unfavourable.

29. These products involving a fixed nominal contract have evolved over centuries to fulfil a genuine community need. Holders of deposits need to be sure that the expected funds are there when bills have to be paid, and a policyholder could be ruined if the insurance company was only able to pay a proportion of the sum insured. The public expects these institutions to still be around, and able to pay, when the time comes to get their money back.

30. For this reason, governments put in place rules designed to minimise the chances that institutions of this type will fail, although failure cannot be ruled out altogether if other unacceptable costs are to be avoided. The cornerstone of these rules is that the institutions have adequate capital to cover the risks they must take. Another characteristic of prudential supervision is that it is necessarily institution-based, because only institutions can become insolvent. Prudential supervision is, therefore, applied to banks, other deposit-taking institutions and insurance companies, but the same principle would apply to defined-benefit superannuation funds.

31. Another important argument for supervision is the "moral hazard" argument. Because of the potential suffering involved if one of these institutions was to fail, there is a widespread community belief that the "government would do something about it". In some countries this support is legislated, but even without legislation there is a belief that claims on these institutions are guaranteed. This means that in the event of failure, a government could be forced to make good the public's losses with taxpayers' funds. Also, if all institutions are viewed as being equally safe, there is no incentive for managements to compete on safety. The "moral hazard" is that the incentives tend to make institutions compete on offering the highest return regardless of risk. This will lead to excessive risk taking in the industry, increasing the likelihood of a financial crisis and the need for a government bail-out. The most recent international example of this was the collapse of the Savings and Loan industry in the US. Prudential rules are seen as a necessary restraint on this tendency. Of course, the existence of a supervisory regime might tend to confirm in the public's mind that the institutions are immune from failure; supervision itself provides no such guarantee.

32. A theoretical alternative to prudential supervision is "caveat emptor", that is, customers make their own assessments of the soundness of individual banks and insurance companies, without the support of prudential rules. With one or two minor exceptions in earlier periods, this approach has not been followed in any major country. The judgment has been made that the public do not have the required skills or time to do thorough assessments of the health of financial institutions, and the stakes are so high that an error can be ruinous. Even relatively sophisticated financial analysts have made serious misjudgments in their evaluations, so it would be reckless to expect individuals to do better. This does not mean that only governments can be responsible for the prudent behaviour of financial institutions; there is a complementary role for private ratings agencies in combination with a high level of disclosure to assist in this process, but they are not a substitute for prudential supervision.

Prudential supervision of banks

33. While both banks and insurance companies share a need for institution-based prudential supervision, banks have some special features which make them crucial for the maintenance of financial system stability.

34. First, the structure of their balance sheets makes banks vulnerable to disturbances, even short-lived ones. Most of their liabilities are at call, or very short-term, but their assets are mostly long-term.[2] It is the nature of banking to take on this maturity mismatch. It is also generic that a large part of bank lending will be to small and medium-sized businesses where information about creditworthiness is

[2] Insurance companies are almost the opposite: their liabilities are not liquid and the majority of their assets are readily marketable (shares, bonds, property). They are thus not as susceptible to runs or contagion as banks and hence not as crucial for the spread of financial crises.

difficult to obtain or standardise, and where loans cannot be securitised and hence made liquid. A bank is thus vulnerable to a run on deposits that it cannot meet. Even if the bank is sound, in that the finally realisable value of its assets is greater than its deposits, the "fire-sale" value of its assets could easily be less than its deposits.

35. Second, banks are subject to contagion. A run on one bank, which the public suspects is unsound, can easily lead to runs on other banks which were otherwise prudently managed. However, whether a bank is sound or not, it cannot withstand a determined run, and some lender of last resort is required to restore equilibrium. That lender could be another bank or group of banks, but in practice it is almost bound to be a central bank or a consortium led by a central bank or other bank supervisor.

36. Third, banks play a crucial role in the transmission of a financial crisis. Threatened with a run, banks will, not surprisingly, adopt a survival strategy - they will be reluctant to make new loans, will call in risky loans and will give preference to holding marketable government securities over non-marketable private sector loans. The provision of credit will tend to dry up, spreading the financial disturbance quickly to the real economy through a contraction in business activity. Modern scholarship on the Great Depression now sees the drying up of credit as a result of bank failures as central to its severity, and more important than the fall in the share market (see Bernanke and James (1990) and Bernanke (1994)).

37. In principle, prudential supervision could be conducted by the private sector through, for example, self-regulatory organisations or ratings agencies. However, prudential supervisors tend to be in the public sector - either central banks or other statutory bodies. Public sector supervisors can do a number of things more effectively than private bodies, eg:

- Where a bank's prudential standing falls significantly, the supervisor can attempt (usually successfully) to resolve the problem effectively and quietly, thereby avoiding a run by investors. If credit ratings were the prime source of prudential information for the public, a decline in ratings below a certain level could precipitate a run. Similarly, a supervisor might act more quickly to resolve the problem of an institution under threat than can disparate groups of creditors (who might not be able to organise decisive action until too late) or shareholders (who might gamble on a risky project saving the company from insolvency).

- The public sector, through the central bank, can be the ultimate liquidity provider to a bank which is essentially sound but suffering liquidity problems. Banks are generally the providers of liquidity to the economy, but there is always a possibility they might be unwilling to lend to a competitor about whom they lack information that a public sector supervisor has.

38. Enhanced disclosure of financial information is viewed by some as a possible alternative to prudential supervision. Improving the transparency and quantity of information contained in financial statements is important and should be encouraged.

Though unlikely to be consulted by most depositors, improved information is useful to the investment community where share analysts and ratings agencies are constantly evaluating banks' performance. Their assessment of, for example, a bank's bad loans can affect its share price and send a useful message to management. As a result of RBA pressure, banks now publish figures on their problem and impaired assets on a standardised basis to assist in market evaluation. While bank supervisors recognise the value of greater disclosure, no-one relies exclusively on this approach; disclosure can be a useful complement in that it increases private sector discipline but it is not a substitute for public sector regulation. Disclosure, no matter how comprehensive, cannot provide a timely picture of a bank's financial performance or risk profile, which can change quickly with the use of derivatives and other complex financial instruments. As the Chairman of the US Federal Reserve Board has noted:

> "A generation ago, a month old balance sheet was fairly indicative of the current state of an institution. Today, owing to the proliferation of transactions, a day old balance sheet can be obsolete."

39. The Reserve Bank of New Zealand's (RBNZ) approach is often cited as one which relies exclusively on disclosure, but this is not the case. While the RBNZ does give a lot of emphasis to disclosure, it retains a supervision department which licenses banks, imposes the Basle capital adequacy standards, monitors compliance, holds regular consultations with senior bank management, and has in place crisis management arrangements to cover potential bank failures.

Regulation of investment products

40. Investment products offer returns based on the earnings of some specified pool of assets. These include unit trusts and the various products offered by funds managers to the public or to superannuation funds. While the products are clearly defined, the institutions which manage them range from specialised funds managers, insurance companies, bank subsidiaries to friendly societies.

41. Investment products do not involve a nominal contract as the assets are managed on a "best endeavours" basis. Provided the manager is honest, the worst that can happen is that the product will yield disappointing returns, possibly involving falls in absolute value. In this event, customers might withdraw funds and move them to other providers. While substantial falls in the market value of investments, if sustained, will reduce wealth and consumption, these effects will generally be less pronounced than those which follow bank failure. Similarly, if the managing institution gets into difficulties, this has few implications for the unit holders; they will still be entitled to the market value of the underlying assets on liquidation or takeover by a new manager. Thus, these products are different in kind as well as degree of risk to deposits or insurance policies. A summary of the differences is given in Table 4.

Table 4: The Two Basic Types of Products

Deposits Insurance policies Annuities	Investment products
Specified nominal amount must be repaid	Investment managed on a "best endeavours" basis. Value of units depends on market performance
Health of institution vital to value of product	Health of managing institution has little or no effect on value of product
Underlying institution can fail, ie cannot meet commitments	Underlying institution can have disappointing performance and a negative return
Institution bears most of the risk	Investor bears most of the risk
Institution must hold substantial capital to meet commitments	Institution holds little or no capital

42. As a result of the different risk profile of the two types of products, the required form of supervision is entirely different. For the first group, prudential supervision has to concentrate on the health of the institution and the adequacy of its capital. In the second group, the underlying institution is not at risk to any great extent and the capital needs are minimal. The investor bears the risk, and should be under no illusion that the value of his or her investment is being preserved by the supervisor. People holding investment products do so because they wish to access the high-return/high-risk end of the risk/return frontier. They cannot expect the same degree of protection against the fall in the value of their investment as they would had they held deposits or insurance policies.

43. For this reason, the appropriate form of regulation of investment products is one based on disclosure of the characteristics of the product, rather than on the solvency of the institution offering the product. These are entirely separate approaches, and only the latter could be termed prudential supervision. Indeed, it would be very dangerous to the long-term health of the financial system if the public were to perceive that investment products were supervised in a manner similar to that of deposits or insurance policies. This would be an extreme form of moral hazard in that it would blur differences in risk and, at worst, could lead people to think that bank deposits and investment products were equally riskless, ie that the government or one of its instrumentalities stood equally behind them.

44. For this, and other reasons, the RBA believes that the centrepiece of financial regulation should be the clear separation of regimes for prudential supervision and product disclosure regulation. The nature of regulation for investment products is set out in the next section.

45. Accumulation superannuation funds do not fit neatly into the two-part division outlined above. Although essentially investment products in that their annual return varies with the market and can be negative, they are subject to a form of quasi-prudential supervision. They are required to operate within government rules for fund trustees in respect of their approach to risk, return, diversification and liquidity. This quasi-prudential oversight reflects the compulsory aspect of superannuation, some lack of investor choice, taxation concessions and the long-term nature of investments. These aspects add up to an implicit promise by the funds to pay back contributions plus, in the long term, a positive return not very different from the market average.

Product and advice regulation

46. Product disclosure and advice regulation (often called consumer protection) permeates all areas of retail business activity in Australia. It deals with unfair and deceptive practices (eg pyramid selling, misleading conduct), product safety and information, and dispute resolution.

47. Other areas of the economy have specific consumer legislation. It can relate to physical safety (eg food, poisons, explosives, motor vehicles and occupational health) or to situations where consumers make decisions that concern large amounts of their money (eg the licensing of builders, rules applying to the borrowing or investing of money). These specialised areas of consumer regulation are often backed up by some form of enforcement to see that retailers are complying with standards (eg health and building inspectors).

48. In the financial sector, consumer protection aims to ensure that information disclosed by product producers and sellers is sufficient for investors to make well-based decisions (which may, of course, include a decision to invest in a highly risky venture), with the ultimate objective of promoting efficiency in financial markets. Much of the regulation in relation to investment products and to financial advisers has this goal. Other regulations deal with the competence and integrity of investment trustees and managers; with provision of information to consumers about the on-going conditions of contracts (including charges); with avenues for complaint and redress when disputes arise; and so on. Sometimes information must be provided in a way which facilitates comparison of competing products or services; examples include disclosure standards for life insurance policies, consumer credit laws and the Code of Banking Practice.

49. This area of regulation is best achieved by regulating particular products or functions, regardless of institution. Unless financial products are uniquely identified with particular institutional groups, the relevant product regulator will necessarily deal with several groups. For example, the same basic principles can apply to an

independent sole-trader providing financial advice as to the largest financial conglomerate in Australia. Indeed, it can be argued that these principles could be embodied in regulation which relates to all financial instruments and services.

Regulation of financial markets

50. Market efficiency is usually concerned with the liquidity, fairness and orderly trading of markets. Participants should be able to buy or sell the products they want, in the volumes they require, and at true market prices. This requires an effective market infrastructure, transparent pricing mechanisms, good settlement and clearing procedures, and freedom from fraud and malpractice. Reliable settlement procedures and arrangements for handling a failure to settle also promote stability.

51. To promote market efficiency and stability, governments usually provide a legislative framework and allow the relevant industry or exchanges to establish detailed trading rules and enforcement procedures. The task is, of course, greatly simplified if supervision of the market-makers and the regulation of products and advice are effective.

Regulation to promote competition

52. Most countries have regulatory bodies which aim to prevent anti-competitive practices, including price fixing, monopolies and misleading conduct. They usually have authority to prevent or to challenge mergers or acquisitions which might reduce competition. Their responsibilities normally cover competition in all sectors of the economy since there is no justification to have a different (or very different) competition policy in financial services than elsewhere. Another aspect of competition regulation is the use of litigation, by both the regulator or aggrieved parties, to prosecute breaches of competition laws. Whereas prudential supervisors and regulators of products, advice or markets continuously monitor the financial industry, competition regulators tend to focus more on specific incidents or proposals.

Other regulation

53. Other types of regulation, with objectives other than stability or efficiency, impinge on the financial system. The financial system is a massive database of the economy's financial transactions and wealth. Financial institutions are required to inform the Australian Transactions and Analysis Centre of suspicious or large cash transactions. Lenders and credit assessment agencies are the only private sector bodies specifically subject to the provisions of the Privacy Act. And the Australian Taxation Office requires deposit-takers to deduct tax from the accounts of those who do not provide a Tax File Number. Taxation and social security regulations can also affect the choices people make about which financial product to purchase.

Trade-offs between types of regulation

54. While the various types of financial regulation are directed to objectives which the community has endorsed, they are not always consistent with each other. This is inevitable, and no amount of reorganisation of responsibilities can avoid it. An appropriate balancing of objectives is required.

55. For example, prudential supervisors usually have authorisation criteria relating to minimum capital and specified ownership structures. This creates a barrier to entry to the particular market which could reduce competition in some circumstances. Similarly, a prudential supervisor will sometimes resolve a potential financial crisis by requiring amalgamation of financial institutions, thereby increasing concentration.

56. In addition, there are constraints on the implementation of prudential regulation which are imposed by international competition and international financial regulators. Differences in regulatory regimes can have competitive impacts, including diverting activity to offshore markets (or vice versa). Further, the overseas expansion of Australian financial institutions can be blocked if they are not supervised to internationally-agreed standards. For example, banks operating internationally need to satisfy the capital adequacy guidelines of the Basle Committee on Banking Supervision.

3. PRESENT REGULATORY RESPONSIBILITIES

Introduction

57. Reflecting the Constitution, responsibilities for regulating Australia's financial system are divided between the Commonwealth and the States. Commonwealth agencies supervise banks and insurance companies, while the States have responsibilities for building societies, credit unions, friendly societies, trusts and unincorporated enterprises. The Australian Securities Commission (ASC) and the Australian Competition and Consumer Commission (ACCC) operate under State and Commonwealth co-operative schemes. Overlaying the formal regulatory structure is the Council of Financial Supervisors (CFS).

58. This Chapter describes how these regulatory arrangements fit together. Its main focus is prudential supervision, but it also looks at regulation to protect consumers of financial instruments and services as well as market regulation. The current regulatory arrangements in Australia are summarised in Table 5.

Prudential supervision of capital-backed institutions

Credit institutions

59. Credit institutions in Australia fall into two main categories: supervised deposit-taking institutions (banks, building societies and credit unions) and unsupervised issuers of debt securities (eg finance companies, merchant banks).

60. Banks are supervised by the RBA. Building societies and credit unions are supervised by State Supervisory Authorities under the Financial Institutions Code, which is administered by the Australian Financial Institutions Commission (AFIC). Supervisory policies for these institutions are similar in that they rely heavily on capital adequacy standards applied to the banking system by the RBA. However, differences in the main activities of the institutions and in their relative size and sophistication have led to some differences in approach. RBA supervision tends to be less intrusive and prescriptive than that conducted under the AFIC framework. In on-site work, the RBA has specialised teams which assess credit risk and market risk management by banks; SSAs conduct more detailed and frequent inspections.

Table 5: The Current Regulatory Structure

Type of regulation	Reserve Bank of Australia	Insurance and Superannuation Commission (and associated bodies)	Australian Financial Institutions Commission (& State Supervisory Authorities)	Australian Securities Commission (& self-regulatory bodies under Corporations Law)	Other Commonwealth bodies	Other State bodies/legislation (for some States & institutions these could be SSAs)	Other self regulation
	Members of Council of Financial Supervisors						
Supervision/ oversight	Banks Foreign exchange dealers	Life insurance companies General insurance companies Superannuation funds Insurance agents and brokers	SSAs: building societies, credit unions AFIC: special service providers	ASX: stock brokers SFE: futures brokers Collective investments Securities and futures dealers/advisers	Private Health Insurance Administrative Council: health insurers	Friendly societies Trustee companies/ public trustees Miscellaneous State-based institutions	
Consumer protection and selected other regulation		Life and general insurance: disclosure Superannuation: disclosure Insurance agents and brokers: conduct Superannuation Complaints Tribunal		Corporations: incorporation aspects Securities and futures: disclosure and market conduct	ACCC: • competition • general trade practice issues • pricing	Consumer Credit Acts	Banking, building society and credit union: disclosure and EFT conduct At least 6 industry-based complaints bodies (eg Bank Ombudsman)

61. Under the Reserve Bank Act, the RBA must exercise its banking policies to contribute best to "the economic welfare and prosperity of the people of Australia". The Banking Act specifies two broad objectives for bank supervision. The first is to protect the depositors of banks[3]. The second addresses the potential for problems in the banking system to create broader damage to the financial system. The RBA is charged with encouraging a bank:

- to keep itself in a sound financial position;
- not to cause or promote instability in the Australian financial system; and
- to demonstrate integrity, prudence and professional skill.

The Act gives the RBA powers to monitor and evaluate how effectively banks meet these objectives.

62. AFIC's statutory aims are to protect depositors and to promote the financial integrity and efficiency of the institutions supervised under the Financial Institutions Scheme.

63. Unsupervised credit institutions may issue securities and be regulated by the ASC under the Securities Chapter of the Corporations Law. This requires issuers of debt securities to be licensed as securities dealers and to meet ASC tests for financial soundness, competence and integrity. If securities are issued to retail investors, a prospectus and trust deed are required. The trustee will usually have powers to obtain financial statements from the company and, if trust deed provisions are breached, to act on behalf of debenture holders. Credit institutions, such as finance companies, can issue securities to wholesale markets but usually need a rating to do so. Certain standards specified by ratings agencies must be met to achieve a high credit rating.

64. Special purpose vehicles for securitisation schemes also issue securities. They are subject to the Corporations Law in the same manner as other issuers. However, they do not exist as companies *per se* but provide the vehicle by which the operations and some risks are undertaken by the arranger of the scheme or are outsourced to third

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[3] The Banking Act does not define a "deposit". Nevertheless, for the purposes of the Act, deposits can reasonably be confined to debts entered into by a bank which give rise to a banker/customer relationship - that is, cheque or term deposit accounts, rather than funds borrowed by a bank from wholesale markets. Banks' other liabilities fall outside this definition, although a broader definition may encompass some marketable instruments which are accepted in financial markets as deposits, such as certificates of deposit.

Australian law is clear about what is not to be described as a deposit: where a public borrowing by a corporation is classed as a security under the Corporations Law it has to be described as a debenture, unsecured note or similar terms. This allows borrowings of most supervised institutions (eg banks, buildings societies, credit unions, life insurance companies) or by prescribed interests or pastoral finance companies to be described as a deposits. The Corporations Law exempts banks' debts which arise in the ordinary course of banking business from the debenture provisions of the Law.

parties (eg mortgage originators, mortgage insurers). Again, they need to meet ratings agency requirements to borrow on wholesale markets.

Institutions offering insurance and superannuation products

65. These institutions comprise insurance companies, friendly societies and defined benefit superannuation funds. Life and general insurance companies and superannuation funds are supervised by the ISC[4]. Its aim is to promote public confidence and help avert instability in the insurance and superannuation sector, as well as provide a safe haven for (retail) savings. To this end, it requires such institutions to maintain adequate risk management policies and internal controls.

66. At a very general level, insurance companies are supervised like deposit-taking institutions, with an emphasis on capital/solvency requirements. However, capital requirements for life insurance companies - which hold mainly marketable assets - focus more on market risk than credit risk. There are some additional requirements for insurers: eg scrutiny of actuarial assumptions underlying the valuation of liabilities and of risk-shedding arrangements with reinsurers. Life insurance companies split their business into statutory funds. Each statutory fund can cover a wide variety of insurance policies, but capital-backed and investment-linked businesses are kept separate. Each statutory fund is required to have sufficient reserves to be able to service the business of that fund. Unlike banks, insurers are not subject to an internationally agreed supervisory framework.

67. Friendly societies are currently supervised by State bodies but are due to come under AFIC in early 1997. They operate in a similar manner to life companies and, within the AFIC regime, will have broadly similar capital and other prudential requirements.

68. The very large number of superannuation funds (around 120,000) restricts the ISC's ability to maintain close and frequent contact with each fund. The supervisory regime for superannuation funds reflects this. Trustees of company and industry superannuation funds are required to have equal numbers of company and employee representatives. Trustees are also required to determine the investment strategy of superannuation funds - namely to have regard to risk, return, the benefits of diversification and liquidity needs. The ISC's approach to supervision is similar to, but more intensive than, the ASC's regulation of unit trusts and other fund raisers. It has more of an audit-type role, concentrating on larger funds and those which appear to be in difficulty.

[4] Health insurers are supervised by the Private Health Insurance Administrative Council; friendly societies and some State government-owned institutions are supervised by State government bodies.

Oversight of funds managers

69. There are six types of funds managers, or institutions offering investment-linked products: unit trusts, investment companies, common funds, accumulation superannuation funds, some life insurance statutory funds and some friendly society benefit funds.

70. Institutions offering these products make promises about the categories of assets on which their returns will be based and about redemption arrangements. Most importantly, however, they do not promise to pay a particular, or even a positive, return on the investment. Regulation by the ASC and ISC, therefore, concentrates on whether managers are efficient, honest and fair, and have adequate resources, systems and procedures to manage the funds.

Prudential supervision of financial conglomerates

71. Because of the different risks that credit, insurance and funds management institutions face, governments, owners and markets insist that they be in separate corporate entities. For example, a funds manager could not merely pool assets and allow the returns to flow through to the investor if there were capital-backed products on the same balance sheet.

72. Financial conglomerates are groupings of these different types of institution under common ownership. Supervisors of the members of financial conglomerates face important issues including contagion risk, the transparency of legal and management structures, large and intra-group exposures and the measurement of capital adequacy (particularly to avoid double-gearing).

73. Most countries supervise financial conglomerates on a "solo-plus" basis. That is, supervision of individual entities is on a stand-alone basis but is supplemented by a general assessment of the group as a whole. In Australia, members of the CFS have agreed on principles for the oversight of conglomerates. They have, in particular, agreed to share information and to liaise with each other when a problem affecting any entity is judged to have the potential to impact on other members of the group. Progress in implementing this framework has been slowed by the need for legislative changes before some agencies (including the RBA) may share information and to protect information received. A Bill to facilitate information-sharing is expected to be introduced in Parliament later this year. Internationally, standards for supervising conglomerates are being addressed by the Joint Forum on Financial Conglomerates (see Appendix E).

74. CFS members have recommended that financial conglomerates in which a non-operating holding company owns both a bank and an insurance company be permitted, subject to appropriate regulation of the holding company. The Treasurer has announced that legislation to give effect to this proposal will not be introduced until consideration has been given to the findings of the Inquiry. In the meantime, the Colonial Mutual Group's proposal to establish a holding company structure will be

facilitated under existing banking and other legislation and will be subject to undertakings which allow for the effective oversight of the holding company by the RBA.

Product and advice regulation

75. As shown in Table 5, product and advice regulation (consumer protection) is the responsibility of a number of Commonwealth and State agencies and industry bodies. Much of the regulation has developed in the last few years, as a result of the proliferation of financial products and because of the magnitude of decisions many Australians face in providing for their retirement income. Some specific failures to provide information and advice that meets investors needs have also been a spur.

76. The RBA plays a small and indirect role in product and advice regulation. It chairs and provides the Secretariat for the Australian Payments System Council, which comprises representatives of financial institutions, others involved in the provision of payments services, consumers and other public bodies. The Council has been monitoring compliance with the Electronic Funds Transfer (EFT) Code of Conduct (since 1989), and implementation of the Code of Banking Practice (since 1993) and the similar codes developed for building societies and credit unions (since 1994). The RBA is also represented on the Board of the Australian Banking Industry Ombudsman Scheme. This method of combining industry, consumers and Government officials has worked well in improving standards of banking industry disclosure and complaints resolution. It is an approach used in many parts of the financial sector.

77. The ASC and ISC play similar roles for the securities, futures and insurance industries. Both use industry bodies in a self-regulatory role: eg the Australian Stock Exchange and the Sydney Futures Market have formal roles under the Corporations Law; the Life Insurance Complaints Service plays a similar role to the Banking Ombudsman. The ASC and ISC also have a role in product disclosure. The ASC has broad rules for disclosure in prospectuses enshrined in the Corporations Law (prospectuses should contain all the information necessary to enable an investor or professional adviser to make an informed assessment of the securities offered). It vets prospectuses issued. The ISC has issued a Circular on life insurance product disclosure and also vets customer information brochures issued by life offices.

78. The ASC administers the application of the Corporations Law to firms that provide advice regarding securities, while the ISC has requirements applying to individual life insurance agents and brokers. Advisers can give advice on functionally similar life insurance investment products and securities, but be required to follow different advice rules. There are no specific requirements applying to financial advice about bank deposits.

79. The ACCC has the responsibility of enforcing the consumer protection provisions of the Trade Practices Act; this is conducted on a case-by-case basis rather than as a continuous monitoring process. The Trade Practices Act has also been used by private parties in civil prosecutions regarding disclosure in prospectuses. The

ACCC also has a role in developing consumer regulatory policies, including pricing. Its predecessors were involved in the formulation of both the banking and life insurance codes of practice, a review of the EFT Code of Conduct, an inquiry into retail transaction deposit account pricing and the monitoring of credit card pricing.

80. The Federal Bureau of Consumer Affairs, part of the Commonwealth Department of Industry, Science and Tourism, advises the Minister for Small Business and Consumer Affairs on, among other things, consumer protection, safety and information standards. Its involvement in the financial system is relatively limited, although it has commented publicly on electronic banking issues.

81. The States also have a role in consumer financial matters. All States have consumer affairs agencies to administer their own consumer protection legislation, which includes consumer credit. Existing credit legislation differs in a number of important ways across States and does not, in general, cover housing loans. Efforts to harmonise credit legislation across Australia and broaden its coverage have recently resulted in uniform Consumer Credit Legislation which is expected to come into force in most States later this year. The States have Tribunals which can hear consumer disputes and have, in the past, awarded hefty penalties against non-complying credit providers.

Regulation of financial markets

82. Regulation of financial markets in Australia is mostly undertaken under the aegis of the Corporations Law by the ASC and authorised exchanges - the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE). The ASC, SFE and ASX are together responsible for regulation of *exchange-traded markets*. The Corporations Law envisages that much of the day-to-day regulation will be carried out by the exchanges. Exchanges are approved by the Treasurer and must have appropriate business and listing rules, and fidelity fund arrangements for the protection of users. They must also provide information to the ASC, which has some powers of market intervention. The Corporations Law also requires dealers to be licensed, sets out disclosure requirements to ensure that "investors" can make informed decisions, and prohibits certain forms of abusive behaviour (such as insider trading, market manipulation, and making false or misleading statements).

83. All foreign exchange trading and most bond trading is conducted by market-makers directly with the public and each other; these markets are known as *over-the-counter* markets. The foreign exchange market is administered by the RBA under the Banking (Foreign Exchange) Regulations. All foreign exchange transactions in Australia must be conducted with authorised foreign exchange dealers (banks and merchant banks); the RBA requires dealers to meet supervisory requirements relevant to the conduct of foreign exchange business. *Over-the-counter securities markets* are regulated by the Corporations Law, which requires a prospectus for the issue and sale of most securities and the licensing of most over-the-counter dealers. Exemptions from prospectus requirements are given for transactions in wholesale markets (eg if

individual parcels of securities for sale exceed $500,000, or if offers are made to specified classes of sophisticated investors, eg securities dealers, life insurance companies).

84. The regulatory structure for *over-the-counter derivatives markets* is more complicated and is under review by the Companies and Securities Advisory Committee. Derivatives transactions can be regulated under the futures or securities Chapters of the Corporations Law or under the Banking (Foreign Exchange) Regulations. Some contracts (eg over-the-counter commodity options) are unregulated.

85. Because banks are at the centre of derivatives and securities markets in Australia, the RBA has been working to ensure banks' systems for managing market risks are adequate. It is also working with accounting bodies to improve public disclosure of traders' derivatives activities/exposures and is implementing the Basle Committee's capital guidelines on market risk.

86. The exchanges have detailed rules for the conduct of derivatives and securities trading. These aid in enhancing fairness, transparency and financial integrity. They can assist in detecting the build-up of exposures and in discovering price manipulation. In the over-the-counter markets, industry bodies, principally the Australian Financial Markets Association, provide further guidelines for industry conduct. Nearly all securities and derivatives markets in Australia are computer-based and face substantial potential competition from equivalent markets overseas. Financial market regulators in Australia are aware that over-regulation of these markets is likely to lead to atrophy, just as they are aware that a reputation for well-regulated and efficient markets is likely to attract overseas business.

Regulation to promote competition

87. The ACCC has the primary role in regulation to promote competition. This includes prohibiting mergers and acquisitions that are judged to "substantially lessen competition". The factors on which the ACCC can make its judgments are outlined in Section 50 of the Trade Practices Act. They include the level of concentration in the market, the height of barriers to entry, the extent to which substitute goods or services are available and the extent of vertical integration in the industry.

88. The ACCC also vets some agreements among financial institutions and can authorise anti-competitive practices if they have offsetting public interest benefits. Examples include the rules of the Australian Payments Clearing Association - which govern access to and procedures for the various clearing streams of payments between banks and other members of APCA - and ASX membership rules.

Council of Financial Supervisors

89. The Council of Financial Supervisors, formed in 1992, is a co-ordinating body which brings together the heads of Australia's main financial supervisory agencies. The

Council aims to enhance the quality of financial supervision and regulation in Australia by:

- facilitating exchanges of information bearing on the efficiency and health of the financial system;
- assisting each supervisory agency to be aware of, and to understand, developments in parts of the financial system outside its particular area of responsibility;
- identifying important issues and trends in the development of the financial system as a whole; and
- avoiding unintended gaps, duplication or inconsistencies in regulation.

90. The Council encourages the harmonisation of regulatory requirements where the interests of agencies overlap. It does not, however, promote the application of identical standards to all financial institutions or products. Approaches to the protection of depositors and investors vary from one part of the financial system to another depending on a range of factors, including the nature of the products in question and the degree of risk attaching to them; the numbers and characteristics of the institutions and investors involved; and the statutory responsibilities and community expectations of supervisors.

91. The Council is not itself a statutory body, nor is it a prudential supervisor or regulator in its own right. Its creation has not altered the statutory responsibilities and powers of its members, or replaced other channels of communication between them. The Council's work has concentrated on the supervision of financial conglomerates. In addition, Council members have been establishing bilateral arrangements for information exchange and the supervision of particular institutions or groups. The Council is also overseeing a review of unintended overlaps and inconsistencies in the regimes regulating sales and advice practices for similar retail products offered by different kinds of institutions.

4. ASSESSMENT OF PRUDENTIAL SUPERVISION ARRANGEMENTS

Introduction

92. Since deregulation, the Australian financial system has been marked by expansion and innovation. It is much more sophisticated and open than systems in many larger countries. Take-up of new technology in payments and other areas has been rapid. Competition has been very strong in wholesale financial markets, and has been intensifying at the retail end more recently. At the same time, the financial system is sound and has a high level of community confidence. It suffered some instability early in the 1990s, but less than was experienced in many other countries at the same time. The recovery from that period of weakness has been quite rapid.

93. Against that background, several criticisms have been made of prudential supervision in recent times. These seem to be not so much about the quality of supervision as about whether it is organised efficiently or whether it is distorting competition. This Chapter examines some of those criticisms.

"The supervisory system is out-of-date"

94. It is sometimes asserted that prudential supervision arrangements have fallen behind developments in the market. To some extent at least that will always be the case, and is no more than an indicator of the pace of financial innovation. It is, in fact, no bad thing that supervisory arrangements should be one (small) step behind the market, not so much in terms of understanding developments but in reacting to them. In the absence of perfect foresight, any attempt by supervisors to be pre-emptive risks inhibiting innovation and efficiency.

95. The RBA would reject any suggestion, however, that prudential arrangements have not evolved with the rapid change in Australia's financial system. Although the present regulatory structure is relatively young, there has already been considerable rationalisation and updating in the past decade. The RBA's Bank Supervision Department was established in 1984. The ISC was created from four separate regulators in 1987. The ASC took over from the previous Federal and State regulators in 1991, and AFIC was established to administer the Financial Institutions Scheme in 1992. Concurrently, the supervision of the major financial sectors has been enhanced. Meanwhile, reviews of the regulation of collective investments, friendly societies, trustee companies and derivatives markets are in train.

96. The most significant recent step has been the creation of the Council of Financial Supervisors in 1992 to formalise high-level liaison and co-ordination among the main agencies. This will be an increasingly important player, both for harmonising supervisory requirements and in the oversight of financial conglomerates. Building on a policy framework recently devised by the CFS for holding company structures, more formal lead regulator arrangements will be developed for all conglomerates.

97. In the RBA's area, there has been major evolution over recent years in the methods used in bank supervision, in response both to the increasing complexity in banking and lessons learnt from problems in the late 1980s. Capital adequacy standards covering banks' credit risks on and off balance sheet were introduced internationally in 1988. By the end of 1997 these standards will have been extended to cover market risks. The new standards have been developed with extensive industry consultation, internationally and domestically, to ensure that they are both relevant to banks' own risk management and consistent with the objective of minimising regulatory burdens. A key aspect is the "internal model option" which allows banks to use their risk management systems for generating a regulatory capital charge (subject to their satisfying a number of qualitative and quantitative requirements). The RBA expects that, in future, other supervisory requirements will be based more on banks' internal systems, and will focus more on economic concepts of risk and capital.

98. This theme of evolution is also illustrated in the development of the RBA's credit and market risk visits, which commenced in 1992 and 1994, respectively. While other overseas supervisors had engaged in detailed examinations of banks' operations, the RBA was one of the first to recognise the value of targeted, high level visits to assess (and develop benchmarks for) risk management systems and methodologies. These are likely to be both more effective and less intrusive than prescriptive, rule-based supervisory methods. A number of overseas supervisory agencies, including the Bank of England and the US Federal Reserve, are now emphasising programs similar to those conducted by the RBA in their on-site work. These and other recent prudential standards - such as on securitisation and funds management - reflect the RBA's aim of finding an appropriate balance between supervisory vigilance and minimum interference with the freedom of banks to be innovative and efficient.

"Everything is Blurring"

99. It has been asserted that a blurring of distinctions between financial institutions and products effectively undermines the current institutional focus of prudential supervision. Some of these issues were addressed in Chapter 2. In the RBA's view:

- a valid distinction can be drawn between two broad categories of financial product - those which are "deposit like" and those where the return is linked to the performance of a specified pool of assets. It is this basic distinction which establishes the need for different supervisory approaches to be applied to the different institutions offering these products; and

- there has been some crossing over of products between the different types of institutions and some new finance providers have challenged traditional market boundaries. But that process is far from complete. Such innovations, nonetheless, can have implications for product regulation. The community presumably wishes to have the same information provided by all suppliers of products which are close

substitutes - to assist with choice - and to have similar avenues of redress for complaints about poor service regardless of source. But these innovations do not have any automatic consequences for prudential supervision, which is concerned with institutional viability and financial system stability.

100. Under what circumstances might blurring in the latter, more narrow, sense have consequences for prudential supervision? First, the advent of new competitors in similar products could prompt a re-evaluation of the supervision requirements for established firms. It may be that there is a case to reassess the balance which has been struck between the costs (including effects on competitiveness) and the benefits of that supervision. This balance must periodically be reviewed by relevant supervisors, with any competitive impacts being one factor taken into account. Second, where the general activities of new providers raise the same concerns - for either the protection of investors' funds or for financial system stability - which motivate supervision of established firms, they should come under broadly equivalent prudential standards.

101. Are prudential supervision arrangements in Australia applied unevenly to similar activities which pose similar risks?

Credit institutions

102. The main deposit-takers are banks, building societies and credit unions. The RBA's prudential supervision of banks is very similar to AFIC's for the latter two groups, both being built substantially on the capital standards developed by the Basle Committee on Banking Supervision, with only minor variations in asset risk-weights. The main differences in supervision relate to ownership rules, prime purpose requirements and supervisory style which largely reflect the community-based origins, narrower scope and smaller size of the AFIC institutions. Some studies have also highlighted the additional costs involved in supervising building societies and credit unions because of its State-based structure, which involves some duplication of resources.

103. Merchant banks borrow in wholesale markets and are not subject to prudential supervision in their own right. Most are subsidiaries of foreign banks and are supervised indirectly on a global consolidated basis by their "home" bank supervisor. They do not therefore have to observe local capital requirements, large exposure limits and PAR or lodge non-callable deposits with the RBA. On the other hand, they do not enjoy some of the advantages of branch status or direct access to the payments system. The fact that some such institutions have chosen to apply for a banking authority, while others who would qualify have chosen not to, suggests that the competitive advantages in the two categories are finely balanced and the net outcome depends a good deal on individual circumstances. (These institutions are discussed further in Chapter 5.)

Deposit-takers and life insurance companies

104. Banks (and other deposit-takers) and life insurance companies are both subject to capital adequacy rules, but these are constructed quite differently. In large part, however, this reflects the differing natures of the institutions - the risks they carry on and off their balance sheets and the contracts which they strike with investors or savers. One consequence of these differences is that insurers pose less risk to financial system instability than banks do, and it would not be inappropriate for them to be supervised to a different standard. Even so, it is not apparent that varying supervisory requirements do create competitive advantage in relation to the small set of savings products which are similar between banks and insurance companies. The Council of Financial Supervisors has commenced an assessment of the scope to align capital standards more closely, but this seems likely to be limited.

Funds managers and the others

105. All funds managers (other than the special case of superannuation funds) operate in a common framework of product regulation under the ASC. Where a funds management operation has a bank parent, the RBA has certain requirements to emphasise to investors the separateness of the two, but these place no particular constraint on the funds management activity itself. As described in Chapter 3, funds managers are not prudentially supervised in the way capital-backed institutions are. Nor should they be - attempts to do so would constrict the spectrum of risk for investors and alter the funds management role fundamentally.

106. The RBA's view is that there are no major instances of supervisory requirements contributing to an "unlevel" playing field, without a justification in the different nature of the institutions involved.

"Supervision should be based on functions, rather than institutions"

107. Again, it is not always clear what is meant by this view. If functional supervision means simply that all deposit-takers should be supervised alike, all insurers should be supervised alike, and so on, there is nothing exceptional in that. As noted above, Australia is very close to having such a system.

108. In other cases, functional supervision seems to mean that each type of financial asset - a government security or a housing loan, for instance - should be assigned a capital charge which would, in turn, be invoked whenever and wherever that asset occurred in the financial system. That this makes no sense is obvious if one contemplates the manager of a unit trust with a portfolio of government securities having somehow to hold capital equivalent to that required of a bank with securities on its balance sheet. As outlined in Chapter 2, the concept of a capital charge only has meaning when applied to an institution with a standard balance sheet or which incurs exposures in its own name. Even among deposit-takers it might, in principle, be quite appropriate for different capital charges to apply to similar assets. The community

may want its investments with one group to be very secure while, with another, it is prepared to accept more risk in return for higher earnings.

109. Implicit in the argument for "functional" supervision is the view that any capital charges should be calculated as the sum of all the individual components of risk. But prudential supervision has to assess the risk in an institution as a whole, taking into account possible geographic or industrial concentrations of exposure and, possibly, correlations (positive or negative) between different risks within the portfolio. Modern supervisory practice is moving increasingly in that direction. In this sense, the notion of supervising functions or products could be viewed as a rather outmoded approach to what is a complex and rapidly-evolving supervisory process.

"Supervision is too costly"

110. While it would be surprising if supervision did not entail costs for supervised institutions, the relevant questions are about the *net* costs for individual institutions - taking into account the lower funding costs and other advantages which come with greater public confidence - *and* for the financial system in the broad. The gross costs for the latter include restraints on innovation and efficiency; these need to be set against the benefits of a more stable and reliable financial system. Even at the institutional level it is difficult to measure objectively the net benefits or costs. It is virtually impossible to do so in the broader sense.

111. One approach which can be indicative is to look at outcomes. Focussing on the banking system, with which the RBA is most familiar, it would be hard to sustain an argument that prudential supervision is unduly onerous. It certainly does not appear to have hindered expansion and change there. In contrast with some other countries, Australian banking groups have considerable choice in business activities - from "traditional" banking to derivatives trading, and on to insurance, funds management and superannuation. The banking sector currently has its highest share of financial system assets since the mid 1970s, as well as accounting for the vast bulk of transactions in the securities, foreign exchange and derivatives markets. Funds management subsidiaries of banks have increased their market share in recent years, now having around one-quarter of the total compared with a fifth in 1990. The only significant regulatory requirement bearing on banks' funds management and insurance activities is that they are conducted in separate legal entities. This ensures, as far as is possible, that the deposit business of the bank and the capital supporting it are insulated from those other activities. However, this "separation" of activities imposed by supervisory requirements is probably no greater than would have arisen naturally within a banking group given the different legal, financial and risk characteristics of these businesses and the different skills required to manage them.

112. The RBA's main balance sheet requirements - leaving aside the NCD impost which has no prudential supervision purposes - relate to capital and holdings of prime assets (PAR). Neither appears to entail significant costs for banks because, on average, they hold more capital and more prime assets than the RBA requires.

Currently, the capital ratio of the banking system is 11.6 per cent. Based on the standard minimum of 8 per cent, this translates to "excess" capital of about $15 billion. This is not, of course, to say that the requirements will not bite from time to time. If they did not, they would be serving no purpose in curbing risky behaviour.

113. Bank profitability has also remained high, on average, which is at odds with prudential constraints bearing heavily on operations. While recent high levels of profitability are now being challenged, this is more the effect of new competitors with lower operating costs than the banks have. The ability of mortgage securitisers to gain a significant slice of the housing finance market, at the expense of the banks, is perhaps the best recent example of that process. Although banks have a funding advantage over the mortgage securitisers their lending rate is higher. Even assuming (unrealistically) that banks would hold no capital and no prime assets in the absence of supervision, supervision costs for housing lending account for only 60 basis points of the bank margin.

114. There has been strong response to the further opening of foreign bank entry arrangements since 1992. Together with the conversion of building societies to banks, the number of banks has increased substantially - from 28 in 1980 to the present total of 52, and there is a handful of applications in the pipeline. (Only one foreign bank has left the Australian banking scene in that time.) This increase is not consistent with supervision being onerous or discouraging.

115. The RBA's overall assessment is that the supervisory burden on Australian banks is not excessive - and probably much less than in countries such as the US, Japan and Singapore. Even so, the RBA is conscious of the costs which undoubtedly come with supervision and aims to minimise these, consistent with its statutory obligations. Its on-site visit program, for example, is helping it to assess the relevance of data collections and to consider moving to new information which would be more useful and less costly to collect. In some instances, banks themselves have encouraged the RBA to collect and publish more aggregate data on their activities and risk exposures. With prudential requirements based more on banks' internal management systems and, where possible, harnessing the disciplinary forces of the market through encouraging better financial disclosure by banks, supervision should become more effective while also involving lower compliance costs.

"Regulations overlap and conflict"

116. Complaints are commonly made about overlaps or lack of co-ordination in supervisory requirements. As with "blurring", however, the substance in these complaints can be hard to pin down.

117. Overlaps involving prudential supervision could arise in two or three ways. The first is where an institution is subject to both prudential supervision and product regulation which will have it answerable to two agencies. This may be an irritant, but it is unavoidable just as it is unavoidable that financial institutions will be subject to the Corporations Law, to taxation law, privacy standards, anti-discrimination law, and

so on. Because the agencies' objectives are different, their requirements should not be duplicated to any great extent or be inconsistent.

118. Another area of overlaps arises with conglomerates, where the individual entities within the group have different supervisors. Again, it is inevitable that when a conglomerate is composed of different types of institutions - deposit-takers, insurance, funds management - different standards and reporting requirements will fall on those specialised entities. Generally these requirements will not overlap but in some cases they will - for instance, with intra-group exposures. It is an ongoing objective of the Council of Financial Supervisors to see that the responsible supervisors - two, in most cases, with Australian conglomerates - do not get in each other's way, requesting the same information from different parts of the group or imposing requirements in relation to group behaviour which are inconsistent. The proposed adoption of more formal lead regulator arrangements will help here, as the lead regulator could assume responsibility for group-wide data.

119. It has been suggested that the creation of a single prudential regulator may go some way to remedying problems of this type. A more extreme variant of this argument is that all regulatory agencies (prudential and otherwise) could be merged in order to improve co-ordination of financial regulation and supervision. There is, in fact, little evidence to support the contention that combining supervisory or regulatory agencies leads to any rationalisation of supervisory requirements or that co-ordination would be made easier by reorganisation of agencies. This is explored in more detail in Chapter 5.

"Capital requirements for banks are arbitrary"

120. Banks have argued from time to time that regulatory capital charges applied to individual or groups of exposures are not well aligned to actual (economic) levels of risk. The most commonly cited example is the 4 per cent capital charge applied to the bulk of banks' residential mortgage holdings, when there is strong evidence that the true risk in such assets is much less. More generally, it can be been claimed that the application of a standard 8 per cent capital charge on all corporate and related exposures takes no account of the wide spectrum of credit risk within the corporate sector. There are other examples.

121. One implication of the use of rule-of-thumb regulatory capital charges is that it may disadvantage banks with relatively low-risk corporate loan portfolios but work to the advantage of banks with higher-risk portfolios (since, other things being equal, both institutions face the same capital charge). The argument is that regulatory arrangements should not bias asset portfolio choices of institutions, as this leads to regulatory-induced competitive advantages and disadvantages which work against efficient resource allocation both at the macro and micro level.

122. The challenge of ensuring that supervisory capital charges are well aligned with actual risk is a difficult one, involving choices between accuracy and simplicity. Supervisory capital structures work best when they are relatively simple - the ready

acceptance of the international Capital Accord in 1988 owed much to its simplicity. Such simplicity does not aspire to measure risk accurately on an exposure-by-exposure basis. Only a dedicated methodology based on concepts of economic capital can fulfil that requirement. Banks have only recently begun to turn their attention to the measurement of their capital needs on this basis.

123. The new market risk guidelines referred to above take a step in this direction by recognising banks' own risk management models as the basis for a capital charge. The RBA is looking (over the longer term) at ways of incorporating more accurate risk measurement systems into other capital requirements. Major changes here will depend in part on developments internationally and the result would tend to be a much more complex system than the present one. Meanwhile, the broad approach to risk measurement does not preclude reassessments of particular risk weightings if it were clear that these had clearly become inappropriate from a prudential perspective. (Risk weights on housing-related exposures is one possible example, as is the recognition within the risk weight structure of insurance.) Such issues are discussed regularly with banks.

"Supervision is not ready for the future"

124. It has been argued by some that developments in communications and technology may render the present financial and prudential structure irrelevant. Implicit in this is the view that supervisors have not recognised the potential for change. In part, the argument is an elaboration on the blurring thesis discussed above. In part, it also reflects a concern about how existing financial institutions and their supervisors will cope with uncertain financial developments ahead.

125. In considering such concerns, it should be recognised that the Australian banking sector has not only retained market share but increased it significantly over the past decade. Banks have also been among the most active in utilising new technologies to transform the nature of their businesses and move into those newly expanding fields of electronic, branchless, computerised and telephone banking. The Australian community has become a relatively intensive user of such sophisticated technology. Prudential supervision has not constrained the capacity of banks to respond to, and harness, these innovations (most of which offer novel methods of service delivery for existing products, rather than new products). The challenge for banks will be to forge effective alliances with specialist technology suppliers. Ultimately these are commercial and competitive, rather than prudential, issues.

126. Non-finance firms have not intruded significantly into traditional banking areas. While some large overseas corporations have developed extensive card networks abroad, they have not impinged upon the intermediation or market-related activities of banks. Very importantly, they do not constitute part of the payments clearing and settlement system. Currently, all activities of such institutions require the presence of a bank to carry out any necessary clearing and settlement functions. It is impossible to come to definitive conclusions on where this broad issue of potential

involvement of non-finance entities in the financial system may be heading It is conceivable that, in time, technological developments could see "banking" activities conducted over international computer networks, bypassing traditional credit institutions and conceivably becoming part of the payments network. This possibility is discussed in Chapter 8.

127. The main point to make is that to the extent that any new players succeed in building a financial business which poses similar risk to savers and to the financial system as do banks, they would have to be supervised in the same way. These are issues for consideration by supervisors globally; they are not unique to Australia.

5. ORGANISATION OF PRUDENTIAL SUPERVISION

Introduction

128. Calls have been made for a re-arrangement of supervisory responsibilities as a response to the perceived deficiencies of present arrangements. These deficiencies were assessed in the previous Chapter. International experience does not provide a conclusive guide to the "right" way of organising prudential supervision. A variety of models exist, operating in the context of different countries' historical, political and cultural circumstances. This Chapter looks at some options for changes in Australia's arrangements and concludes that, in the RBA's view, there is no case for radical overhaul of the present system. Overseas arrangements are summarised in Appendix B.

A "Mega-regulator"?

129. Some commentators have suggested that all supervision be assigned to a single agency or "mega-regulator". The justification usually appeals to the phenomena of blurring and inconsistencies in regulation, which were discussed in the previous Chapter. The RBA believes the supposed advantages of a "mega-regulator" are illusory and that the approach poses significant dangers to the long-run stability of the system. The RBA would hold to this view, even if the proposal were to locate the "mega-regulator" in the central bank.[5]

130. The "mega-regulator" is a difficult concept to pin down. Presumably, it would not be responsible for competition policy or consumer protection, but would be responsible for prudential supervision somehow defined. This model would still leave financial institutions answering to at least three regulatory bodies, and so would not achieve the simplicity inherent in the title "mega-regulator". But this is not the main shortcoming of the proposal.

131. The main shortcoming is the belief that prudential supervision should be applied to such different activities as banking and insurance on the one hand, and funds management on the other. The analysis in Chapter 2 makes it clear that prudential supervision is an activity to be undertaken on an institutional basis, where the solvency of the institution is, at least potentially, at risk, ie where it will fail if it cannot meet its pre-determined commitments. It therefore makes sense to apply prudential supervision to banks and life offices. The type of regulation appropriate to funds managers and mutual funds is not prudential supervision because the solvency of the institution is not at risk - it is product disclosure and advice regulation. The two types of regulation are very different and the RBA does not believe there are any

[5] In fact, the moral hazard problem could become more severe if the "mega-regulator" was in the central bank.

synergies between them. This is one reason why, in most countries, they are carried out in different agencies.

132. There are, in fact, strong reasons why they should not be carried out by the one agency. Prudential supervision necessarily carries with it some official "comfort" for savers about the solvency of individual institutions and the maintenance of contractual claims. In Australia, the degree of comfort falls short of a guarantee. Support for an ailing institution may involve the use of public funds, but can also be achieved through the organisation of a takeover by a stronger institution or an officially-managed workout. There should be no expectation of such support in the case of managed funds. Yet investors might assume that some obligation for adequate investment performance is implicit if the same agency has responsibility for both types of institution, the more so when a capital-backed institution has an ownership linkage with the funds manager. Any arrangements which encourage the perception that managed funds are no more risky than deposits would distort the risk spectrum, increase moral hazard and the implicit "safety net", and reduce the efficiency of the mechanism by which savings are allocated to investments of varying characteristics, including risk.

133. Proponents of a "mega-regulator" argue that regulatory conflicts or overlaps would be eliminated, or at least significantly reduced, if individual regulators were absorbed within the one organisation and reported to the one chief executive. There may be some merit in this argument, but it is essentially one of managerial efficiency, rather than one based on economic principles. Large public sector organisations can suffer diseconomies of scale, and some disputes are better sorted out in public discourse between regulators than in private negotiation between departments of the same agency. In addition, the degree of overlap in the current prudential structure tends to be exaggerated. Even under the present arrangements, the statutory responsibilities of the existing prudential supervisors are clearly defined, and no single institution (as opposed to conglomerates) is subject to prudential supervision by more than one of them.

134. Another claim is that a single supervisor would mean more efficient supervision of financial conglomerates. The RBA accepts that conglomerates will generally be answerable to more than one agency because of the different jurisdictions to which constituent companies belong. However, any administrative economies from a single overseer will be limited as long as different supervisory standards apply to different parts of the group. The businesses of member companies and the types of risks involved remain sufficiently distinguishable to require different supervisory techniques and skills. For example, the capital adequacy rules applying to a bank will always be different to those applying to an insurance company and neither will bear any resemblance to the product disclosure rules for a funds manager.

135. It has also been suggested that a single supervisor would be better able to handle the related tasks of limiting the risk of contagion from one entity in a conglomerate to another, and of appraising the overall health of such a group. Again,

as long as different prudential standards apply across the group, this claim is questionable, particularly if communication and co-ordination among the relevant agencies is effective.

136. An international consensus is emerging that, for most financial conglomerates, a lead regulator should be nominated to organise group-wide financial assessments, to exercise authority over special-purpose holding companies and to co-ordinate remedial action in a crisis. As noted in Chapter 3, this approach has been proposed by the CFS for conglomerates headed by special-purpose holding companies and is likely to be extended to others. The need for formal lead regulator arrangements in Australia has been lessened by the fact that in most cases hitherto one (supervised) institution has dominated each conglomerate.

137. Among OECD countries, only Sweden, Denmark and Norway have a stand-alone "mega-regulator" which supervises banks, insurance companies and investment products. Japan is close to this model in that it has a "mega-regulator" with these responsibilities, but it is part of the Ministry of Finance.

138. The BIS Annual Report of 1993 contained a survey of financial distress among its member countries over the previous decade (see also Llewellyn (1992)). The countries singled out for poor performance in terms of financial instability and large losses of taxpayers' funds in bank rescues were Sweden, Norway, Finland, Japan and the US. Three of the countries that employ the "mega-regulator" model[6] are included in this small group. While it is difficult to spell out the precise chain of causation, this correlation should not be ignored. Proponents of the "mega-regulator" model need to explain why they are recommending an approach which has such a poor track record.[7]

Which institution should supervise banks?

139. The RBA believes that central banks are best placed to oversee the stability of the financial system. They are participants in that system - conducting a wide range of financial transactions in money, bond and foreign exchange markets, as well as often acting as banker to governments. And, they are the ultimate source of liquidity to the financial system. They may supply liquidity to the system generally (as in 1987 following the stock market crash), or they may be the "lender of last resort" to individual financial institutions which are in difficulty. Last resort lending refers to a direct loan usually from a central bank to a commercial bank unable to raise liquidity from other, more usual, sources; this would typically be because the bank was experiencing a run on deposits due to a loss of confidence. Last resort lending would

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[6] In the other two, Finland and the US, the banking system (or the part that incurred the losses - in the US case, the savings and loans institutions) was not supervised by the central bank.

[7] The bail-out of the banking systems in the Nordic countries was extremely expensive for taxpayers. In Norway and Sweden the cost was equivalent to nearly 5 per cent of GDP; in Finland it was 8 per cent of GDP.

usually involve loans to a bank which was still solvent. It should be distinguished from financial support for an insolvent institution which, if it were provided, would usually involve the Government. Last resort lending has long been seen as a function of central banks. Indeed, the origin of many central banks was as ultimate backstop to the financial system, with the name "reserve bank" indicating a role as custodian of the reserves of the commercial banking system.

140. While the RBA finds the case to remain the bank supervisor a convincing one, it is true that practice varies around the world. In some countries the central bank is the sole bank supervisor, in some countries it shares responsibility with another body and in some it has no supervisory responsibilities. In recent years, a number of countries have revisited the issue of who should supervise banks. In Norway, a parliamentary working party recommended that the bank supervisory authority be incorporated into the central bank, but was overruled by the full parliament who opted for the status quo. In South Africa, the Jacobs Commission made the opposite recommendation - namely, to take bank supervision away from the central bank - but again was overruled and no change has occurred. In the two cases where the recommendations were carried out - Finland and Hong Kong - the result was to move a formerly independent bank supervisor into the central bank (see Appendix B).

141. A number of arguments have been advanced against the central bank being the bank supervisor. The RBA remains unconvinced by these arguments and feels that, on balance, the arguments for having a dual role are much stronger. A summary of the relevant arguments is given below; a more detailed account is contained in Appendix C.

142. The most common argument for separation is that there is a conflict between responsibilities for bank supervision and monetary policy. That is, a central bank that is also the bank supervisor will place too much emphasis on financial stability, rather than concentrating single-mindedly on anti-inflationary monetary policy. This argument does not say that the combined institution will be a poor bank supervisor - it says that it is monetary policy that will suffer. But the argument is a curious one in another way, in that it implies that ignorance of the health of the banking sector is an advantage in conducting monetary policy. The RBA believes the opposite to be the case. A first-hand knowledge of whether the banking sector is robust or fragile is essential in order to understand whether a change in monetary policy will have a large or small effect on the economy. In essence, there are synergies between the two responsibilities, rather than conflicts.

143. A second argument for separation is that in the event of a "bail out" of the banking sector, the cost will be borne by the taxpayer and so the decision should be made by the government (or a body reporting directly to it). This is a rather academic argument in the Australian context as neither the RBA nor the Federal Government has

lost taxpayers' money through a bank rescue.[8] Nevertheless, it is a possibility. However, if the argument is to have validity it would have to be established that the central bank was likely to extend lender-of-last-resort credit unwisely when a stand-alone supervisor would decide against exposing the taxpayers to loss.

144. The question of which body - the central bank or the separate institution - would make the more prudent decision cannot be answered with any confidence. On the other hand, the question of which body could take the most timely action in the event of a crisis would have to be answered in favour of the central bank. It is transacting in the money, bond and foreign exchange markets virtually every day, and sits astride all the flows in the payments system. Whether it is the bank supervisor or not, it would have to be involved in any action designed to alleviate a financial disturbance or a crisis. It could do this either by adding liquidity to the market as a whole, in the course of its open market operations, or by extending lender-of-last-resort loans to a particular bank (or banks). If it felt that the problem in question was not a matter of liquidity but of solvency, it could arrange a merger or orderly closure. In principle, of course, it could do these things on the advice of an independent supervisor, but in practice this would be a clumsier arrangement. Time is of the essence in a crisis, and getting agreement between different institutions is often difficult in such circumstances. While it is usual to think of a bank failure as the event which precipitates a potential crisis, it is equally likely that the initiating event could be a disturbance in financial markets such as happened in the Penn Central case or following the share market crash of 1987 (see Appendix C). Thus, the skills required for crisis management may not only be those of the bank supervisor, but could also involve those of the financial market specialist within the central bank.

145. A third argument for separation is that a central bank could suffer reputational damage as a result of its bank supervision activities, which would reduce its credibility in conducting monetary policy. What gives this some force is that, even in an optimal system of bank supervision, an individual bank can (and must be allowed to) fail, but the public, the press and politicians invariably see this as evidence of incompetence on the part of the supervisor. This argument is widely used in the UK, where the reputation of the Bank of England has suffered as a result of the failure of Johnson Matthey Bankers, BCCI and, recently, Barings. Some commentators see this as

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[8] The RBA has never had the need to lend to a bank in liquidity difficulties, and therefore has never lost money through a last resort loan. In the early 1990s a number of banks in Australia made losses, but they were recapitalised by their owners. In most cases the owners were foreign banks, but in two cases the owners were State Governments which had guaranteed the liabilities of the banks they owned. The Commonwealth Government provided compensation to the Victorian and Tasmanian Governments for the tax equivalent revenue foregone following the sale to private banks of State-owned banks. This reflected government policy to encourage privatisation. The South Australian Government was also provided with assistance to help it reduce the debt burden associated with supporting the State Bank of South Australia (SBSA). This assistance was entirely discretionary and conditional on privatisation of SBSA; it occurred some two years after problems at SBSA were first revealed.

affecting its ability to conduct monetary policy, but it has been hampered on this score at least as much by an Act which gives it virtually no independence.

146. This argument, like the first, does not imply that the central bank will be a poor bank supervisor - it says that it will be monetary policy that suffers. In the RBA's view, any merit in this argument is outweighed by other factors which point to advantages from combining bank supervision and monetary policy. For a start, there is always a risk that a stand-alone bank supervisor would see its role rather narrowly. This is because it would be penalised severely in the case of a bank failure, but receive little or no reward for other desirable outcomes such as the efficiency, innovative capacity and growth of the banking sector. A central bank, by necessity, has a wider set of objectives and responsibilities and is less likely to narrow its focus in this way. In similar fashion, a stand-alone supervisor is more likely to develop a rules-based culture, with lawyers and accountants predominant. In a central bank, the bank supervisors have to argue their case with colleagues who are predominantly economists and financial market specialists. This has the effect of softening the dependence on rules and introduces a higher degree of "market friendliness".

Which institution should supervise insurance companies?

147. The insurance industry provides a number of products such as life insurance, annuities and defined-benefit superannuation which involve binding nominal contracts. Failure to meet these contracts would cause the failure of the institution. They therefore fall clearly into the category that should be prudentially supervised. In which case, they are much closer to banks than to the managers of investment products (although they are also in this business). Is there a case for combining their supervisor with the bank supervisor?

148. In the RBA's view, there is no good reason to do so. It would not raise moral hazard issues but there is no positive case either. Synergies are hard to find because it would not be appropriate to apply common supervisory rules and techniques to those entities, notwithstanding the fact that they are all capital-backed. Particular expertise is required for the different types of financial business that they undertake. As noted in Chapter 2, the risks in the insurance and superannuation businesses require a different type of analysis than those in a deposit-taking operation. The application of actuarial techniques to the liabilities side of the balance sheet is the central element in the prudential supervision of a life office, while assessing the adequacy of a bank's capital, on the other hand, is a very different matter. Overseas experience is that where the supervision of such fundamentally different financial activities is the responsibility of a single agency, the work generally tends to be allocated to separate departments or divisions and different capital adequacy rules are applied. The major examples are the Scandinavian countries, where a single supervisor covers the banking, insurance and securities industries, and Canada, where banking and insurance fall under the one agency.

149. Another argument for combining insurance and banking supervision is that it would, in fact, help to produce a consistent set of capital requirements. The capital requirements on banks and life offices are indeed different but so is the nature of the risks they face. No-one has yet established that the requirements on one set of institutions are more onerous than the other, given these different risks. If it were so, more consistent capital requirements could be applied, but that could be achieved just as easily by discussions between separate regulators as between departments within one regulator. Banks and insurance companies wishing to operate in more than one country would, of course, also be constrained by international rules.

Other deposit-taking institutions

150. At present, *building societies* and *credit unions* are supervised by State agencies under the umbrella of AFIC, in arrangements which involve some duplication of resources and inflexibility. While those institutions are subject to contagion risk, their small size makes it doubtful that even a widespread run on them would have systemic consequences.

151. Nonetheless, there may be a case for the RBA to take on their supervision on efficiency grounds. The community sees building societies and credit unions as safe havens for a significant part of their savings, in much the same way as they do banks. Further, their business is functionally similar to that of banks, with relatively liquid liabilities and a significant part of their assets comprising long-term, non-marketable loans. Consequently, the supervisory arrangements for building societies and credit unions are based closely on the RBA's supervisory regime for banks. There is some potential for greater efficiency and cost savings if these bank-like entities were also supervised by the RBA. However, it would not be practical to attempt to force building societies and credit unions into a bank "mould" as far as ownership rules, etc, are concerned.

152. If the RBA were to assume supervisory responsibility for both these groups, there would inevitably be some compression of the spectrum of perceived risk among financial intermediaries but, as noted, that would not be out of line with the community's assessment of these intermediaries. There could also be an extension of moral hazard risk. To mitigate this, it would need to be made clear that RBA supervision should not be regarded as a guarantee against institutional failure, even for a bank.

153. There is an anomaly in the present system in the treatment of *merchant banks*, which is a hangover from the days when banks were heavily regulated and foreign bank ownership was not permitted. Most of the firms in this sector are subsidiaries of foreign banks and their activities are difficult to distinguish from the wholesale banking activities of authorised banks. Indeed, many of the foreign-owned institutions which are now authorised banks converted from merchant bank status with little change to their operations.

154. The anomaly in these arrangements is that, although merchant banks are doing the same business as authorised banks, they are not supervised in the same way and are not subject to the NCD requirement. In other countries, it is normal for foreign banks to have to take out a banking licence if they wish to do banking business in another country's market. There is a case for imposing that requirement in Australia as well.

155. The continued existence of a significant merchant bank sector, with substantial foreign bank ownership, does not sit comfortably with international efforts to improve the supervision of the cross-border operations of international banks. In terms of the standards developed by the Basle Committee on Banking Supervision, there is an obligation on host authorities to exercise effective supervision of foreign banks operating in their territories. Host authorities are expected to be in a position to inform the home supervisor (who is charged with responsibility for exercising effective consolidated supervision of its banks) of any perceived shortcomings in the local activities of those banks. The RBA is not in this position with regard to merchant banks owned by foreign banks. It therefore favours a change in policy which would require such banks to become authorised under the Banking Act.

156. It is much less clear that *finance companies* should also be made subject to RBA supervision. This sector comprises about 100 entities with total assets of around $46 billion. Some two-thirds of their borrowings are from the wholesale markets. Some 20 finance companies borrow in the retail market, through the issue of debentures under the prospectus disclosure provisions of the Corporations Law and subject to the surveillance of the ASC. Many finance companies are equipment finance specialists, including some which support the sales activities of associated industrial concerns. Finance companies do not engage in maturity transformation to any significant degree as the bulk of their fund raising is in the form of term borrowings. Only about 5 per cent of their liabilities are at call, so the threat of a "run" is not an issue. Nor is contagion a concern and finance companies would not seem to be a threat to financial system stability. Several have failed in the past 20 years without causing wider problems and the community accepts that they are further out on the risk/return frontier than banks.

Regulation of investment products

157. Managed investments, whether sold directly to the public or to trustees of superannuation funds, should be subject to product regulation with the emphasis on disclosure requirements. There is no case to apply prudential supervision to institutions which manage investment products.

158. The authority responsible for the regulation of investment products should, of course, be separate from the authority responsible for prudential supervision of banks. Beyond that, the RBA has no strong views on institutional arrangements. At present, the ISC and the ASC regulate the products of the funds management industry, the superannuation industry as well as investment advisers. There have been reports that some firms have been able to shift products between the two regulatory jurisdictions in

order to gain more favourable treatment. This is not necessarily a deficiency of the system; it only becomes so if it can be established that similar risks are receiving different regulatory requirements.

159. For the special reasons outlined in Chapter 3, a form of prudential supervision is exercised by the ISC over accumulation superannuation funds. This puts such funds at a different point on the risk spectrum compared with the generality of investment funds. Because of the importance of preserving a risk spectrum for investors, the RBA would be concerned at any prospect of superannuation-type oversight being extended across the whole managed funds industry. At the same time, it could be socially undesirable to lessen the present oversight of superannuation. It might, therefore, be appropriate to have superannuation funds overseen separately by the ISC, an arrangement which entails certain synergies with the supervision of the life insurance industry.

Summary

160. The RBA does not see a strong case for radical overhaul of present responsibilities for prudential supervision. In the interests of efficiency, responsibility for building societies and credit unions could be transferred to the RBA, although there are no pressing reasons in terms of financial stability for doing so. There is a stronger stability argument that the anomalous situation of international banks operating here as non-banks should be resolved by requiring them to become authorised banks.

161. The RBA supports the continuation of a specialist insurance supervisor and a separate product disclosure regulator of the managed funds industry. Oversight of superannuation could be located in either of these agencies, but there seems to be no strong case to relocate it from the ISC where there are some synergies with supervision of insurance companies.

6. SOME OTHER PRUDENTIAL SUPERVISION ISSUES

Introduction

162. This Chapter discusses authorisation criteria for banks, arrangements for dealing with a bank "exit", the supervision of intermediation subsidiaries of banks and the licensing of foreign exchange dealers.

Authorisation criteria for banks

Ownership and control of banks

163. The *Banks (Shareholdings) Act 1972* seeks to promote a wide dispersion in bank ownership. To this end, it prohibits any one shareholder, or group of related shareholders, from acquiring in excess of 10 per cent of the voting shares of a bank. Exemptions can be granted by the Treasurer for shareholdings up to 15 per cent and by the Governor-General for shareholdings beyond 15 per cent. The Act requires that the Treasurer shall not refuse applications for exemptions for shareholdings up to 15 per cent unless he/she can demonstrate that this would be contrary to the national interest. For proposed shareholdings in excess of 15 per cent, the onus is on applicants to demonstrate that the exemption sought would be in the national interest.

164. The Act's objectives are to:

- protect depositors against the risk that a bank's resources could be used to serve the particular interests of a few dominant shareholders;
- ensure that a bank's viability is independent of the viability of a major shareholder;
- ensure reasonable independence and continuity of management; and
- facilitate the raising of additional capital when necessary.

165. It can be argued that, in promoting a wide dispersion of ownership, the Act also serves to protect existing management, restrict opportunities for takeover and impede market entry, which may, in turn, inhibit moves to promote competitive efficiency. In practice, the Act's restrictions have not proved to be a significant impediment to increased competition and reorganisation within the financial sector. This is due principally to the powers of exemption available under the Act and the discretionary manner with which these have been applied. For example, exemptions have been granted to foreign banks to enable them to establish/acquire local subsidiaries; for domestic banks to acquire other domestic banks; and for an insurance company to purchase a bank. As noted elsewhere, the number of authorised banks has almost doubled since the early 1980s.

166. For the reasons stated above, however, it has been Government and RBA policy not to support exemptions for corporations engaged in businesses outside the

financial sector. Nevertheless, it has been possible for these corporations to participate in the financial system in other forms such as finance companies or merchant banks.

167. Most developed countries impose ownership restrictions on banks, with thresholds for regulatory intervention generally ranging between 5 and 10 per cent.

168. The RBA believes strongly that the policy presumption in favour of a dispersion of shareholdings in banks, as embodied in the present Act, should be retained. The Act could, however, be amended to improve the efficiency of its operation by:

- adopting a single exemption procedure for shareholdings above a minimum, which could be set at 10 or 15 per cent. The two tiers of exemption have not proved to be useful, especially given the presumption in the Act in favour of granting exemptions to shareholders wishing to acquire interests up to 15 per cent; and

- allowing exemptions under the Act to be granted by the Treasurer alone, without Vice-Regal involvement.

It should also be made possible to attach conditions to exemptions under the Act, possibly facilitating a more liberal approach to some applications.

Minimum capital

169. Since 1992, the minimum level of Tier 1 capital required of a locally incorporated bank has been $50 million. This is broadly consistent with total balance sheet assets of around $1 billion. A relatively high level of minimum Tier 1 capital is one of the simplest and most effective means of discouraging unsuitable shareholders from attempting to gain a banking authority. On the other hand, it might be argued that a high minimum capital requirement unduly restricts competition.

170. In Australia, there are many avenues for those with access to only small amounts of capital to participate in the financial sector - for example, mortgage managers, small-scale finance companies, financial advisers and funds managers. To provide the relatively broad range of services expected of banks requires sufficient capital to acquire the necessary expertise and technology, and to generate the required degree of confidence. It is of considerable importance that confidence in the banking system as a whole is not undermined by the failure of small players lacking sufficient resources.

171. The RBA does not believe that the minimum capital requirement has ruled out prospective applicants who could have made a contribution to the Australian financial system. In a world where financial institutions of doubtful pedigree are always scouting for opportunities, the minimum capital requirement for a bank is an excellent screening device.

Foreign banks

172. Since 1992, foreign banks have been able to apply for banking status in Australia either as subsidiaries or as branches. When entry was first opened up in 1984, after a long prohibition, foreign-owned banks had to operate as subsidiaries, reflecting in part the objective of competitive neutrality with domestic banks. More fundamentally, there was a concern that with branches the RBA would not be able to carry out effectively its ultimate "depositor protection" responsibilities which depend on its taking control of, and managing, a bank in difficulties.

173. As the new foreign bank subsidiaries gained experience in Australia, they increasingly specialised in wholesale markets. In this business, they felt constrained by prudential requirements; they argued that they could be more effective competitors if they could operate as branches and take positions which were related to the global strength of their parent, rather than the size of their capital in Australia.

174. Nevertheless, the fact remained that the Australian authorities could not accept responsibility for the solvency of a foreign bank which operated in Australia through a branch. Accordingly, when branches were allowed, they were excluded from the depositor protection provisions of the *Banking Act*. It was thought appropriate, however, to preserve that protection for all household depositors and foreign bank branches were consequently precluded from gathering retail deposits - specifically, initial deposits under $250,000 from persons and unincorporated entities.

175. Foreign bank applicants must establish that they are subject to *adequate standards of supervision* in their home country. The approach followed in Australia is consistent with the internationally agreed Minimum Standards for the supervision of international banks described in Appendix D. Banks from countries where supervision is inadequate should not be permitted to operate in Australia.

176. A key issue in branch applications has been the requirement that banks wishing to branch into Australia be able to make a convincing case that they will be able to make *a worthwhile contribution* and "not just add to the number of banks". Generally, banks which are willing to commit resources to obtaining a banking authority believe they will able to deliver their range of services more effectively as a bank and thus have been able to argue that they will be more competitive (although there have been a couple of cases where the scale of the proposed branch operation in Australia has been too small for the RBA to believe the applicant should be encouraged). If foreign banks were to be compelled to have banking authorities to operate here as discussed in Chapter 5 - that is, if the "merchant bank" option were retracted - the RBA may need to be more tolerant of those foreign banks which wanted to operate in Australia on a small scale.

177. Foreign banks are also required to have *an ownership structure* which is generally consistent with the objectives of the *Banks (Shareholdings) Act*. This requirement is necessary for competitive equity with Australian-owned banks, and because the underlying principle is sound for both local and overseas entities.

Nevertheless, some flexibility is required in administering this requirement to reflect differences in practices and supervision overseas. For example, in many Asian countries, large individual or family shareholdings in a bank are quite common. The RBA has also been prepared to accept banks owned ultimately by foreign holding companies where the holding company itself has a dispersed spread of shareholders, and there is provision in the home country for the supervisory oversight of the holding company. In such cases, however, the RBA prefers that a bank in Australia be owned directly by an authorised foreign bank, rather than directly by the ultimate holding company. This ensures that the Australian bank has the backing of a shareholder with the full resources of an authorised bank.

178. One of the lessons from the BCCI case was that unnecessarily complex ownership structures should be a warning sign that it will be difficult for the supervisor to monitor activities of the group. The RBA recommends retention of requirements on prospective foreign bank applicants which are broadly consistent with Australia's models for domestic banks.

179. The 1992 policy on foreign banks has permitted a steady flow of new entrants. Discussions with foreign banks operating non-bank subsidiaries in Australia indicate that most have not been discouraged from conversion to bank status by the prudential standards, but by the costs of interest withholding tax on a branch's borrowing from its parent (which a subsidiary can escape with properly structured borrowing in its own right) and the below-market interest rate on NCDs.

The process of authorisation

180. Under the *Banking Act*, applications for authority to carry on banking business are made to the Treasurer and authorities are granted by the Governor-General. In practice, prospective applicants are encouraged to first discuss their proposals with the RBA so it can identify aspects which might not be consistent with policy. If a proposal is able to be developed to the point where it meets all entry criteria, a formal application is forwarded to the Treasurer with the RBA's recommendation that an authority be granted. Treasury will have been kept informed of the RBA's discussions with potential applicants and given the opportunity to offer any views. On no occasion has Treasury not supported the RBA's view.

181. The concept of authorising banks to conduct banking business in Australia was first proposed by the 1937 Royal Commission into the Monetary and Banking Systems. The Royal Commission recommended that the Treasurer should grant such authorities. The *Banking Act 1945* introduced the Governor-General into the process and subsequent *Banking Acts* retained this arrangement. It is not evident that the involvement of the Governor-General is warranted and this requirement makes the process more cumbersome.

182. One option would be for the RBA to be assigned responsibility for granting banking authorities, with unsuccessful applicants having a right of appeal to the Treasurer. As the RBA sets the entry criteria for banks, and is responsible for their

ongoing supervision, it would seem appropriate for the RBA also to be responsible for their authorisation. It is common practice overseas for supervisory authorities also to issue licences. The RBA would support such an arrangement which would be more in line with comparable provisions in the insurance industry. Under the *Life Insurance Act 1995* the power to register life offices is given to the Insurance and Superannuation Commissioner, but the Treasurer is required to endorse any decision by the Commissioner to refuse an application. A similar arrangement applies under the *Insurance Act 1973* for general insurance companies. Alternatively, the power to authorise could lie with the Treasurer.

Outward authorisation

183. As noted in Appendix D, the second of the internationally accepted Minimum Standards for the supervision of international banks provides that "the creation of a cross border banking establishment should receive the prior consent of both the host country and the home country authority". Australian banks are advised to consult the RBA prior to overseas acquisitions, because it is clear that such acquisitions can have a significant impact on the soundness of the local operation. This consultation presently occurs on a voluntary basis. It is usual practice for the host country authorities to ask to see evidence of home country approval for new cross-border banking operations, and this of course encourages Australian banks to consult the RBA prior to proceeding with new acquisitions or operations overseas. Nevertheless, there would be merit in including a requirement for RBA approval of such initiatives in the *Banking Act*. This would demonstrate that the Australian prudential regime meets international best practice in this area.

Crisis management

184. Prudential supervision aims to reduce the probability that a bank will fail. It will never be possible (or even desirable), however, to reduce this probability to zero. As the failure of a bank would have major consequences for financial system stability, supervisors inevitably become involved in managing failure situations. The *Banking Act* clearly contemplates the possibility of bank failure and makes provisions for this eventuality. If a bank is unable to meet its obligations the RBA has power to assume control of its business.

185. These provisions reflect the recommendations of the 1937 Royal Commission, which envisaged that the RBA could appoint a receiver for the depositors if it assumed control of an unsound bank. For example, the Commission recommended that one of the first acts of the central bank, after it assumed control of a bank, should be to estimate and announce the amounts likely to be available for distribution to depositors. The implication was that depositors might not, in these unlikely circumstances, recover the full value of their money.

186. Consistent with this, the RBA has always maintained that the “depositor protection” provisions of the *Banking Act* do not amount to a guarantee. Unfortunately, the reflection of the Royal Commission’s recommendations in the

current wording of the *Banking Act* gives rise to some ambiguity. The Act says (Section 14(5)) that where the RBA has assumed control of a bank, it shall remain in control of, and continue to carry on the business of the bank, until the deposits with the bank have been repaid (or provision is made for their repayment, or the RBA believes it is no longer necessary for it to remain in control). The wording used does not appear to allow the RBA to act as, or appoint, a liquidator to wind up the bank. As well, the reference to deposits being repaid might be taken by some to imply that they would be repaid in full.

187. In practice, the RBA would attempt to deal with a troubled bank by arranging for its recapitalisation by shareholders or its merger with a stronger bank. The possibility that the RBA might exercise its powers to assume control of a bank could persuade management of the distressed bank to co-operate in seeking merger partners. However, its hand would be further strengthened if the legislation made it clear that, once it had assumed control of a bank, the RBA might sell the bank to other parties. This would give strong incentives for a bank's board to arrange a sale so that it could achieve the most favourable possible terms. Of course, any actions by the RBA to sell or wind up a bank, should be subject to appeal to the courts.

188. The RBA favours amendments to the *Banking Act* to clarify the powers of the RBA should it assume control of a bank. The Act might also be amended to make clear that "depositor protection" does not imply an official guarantee.

Supervision of non-bank subsidiaries of banks

189. Among advanced economies, Australia appears to be unique in allowing banks to conduct financial intermediation in subsidiaries which are not authorised as banks and which operate outside the ambit of supervised financial institutions. The reasons for this are historical. Prior to Australia's decision to deregulate financial markets in the 1980s, non-bank financial intermediaries (principally building societies, finance companies and merchant banks) experienced rapid growth in market share. This was to the detriment of authorised banks, whose capacity to compete was hindered by controls and regulations.

190. Since deregulation, the share of the finance company and merchant bank industry assets controlled by banks has been in decline. This has been due to a number of factors, including:

- many non-bank subsidiaries had been formed to enable banking groups to circumvent direct controls, such as interest rate ceilings and limits on lending, which did not apply to non-banks. With deregulation, much of the rationale for such subsidiaries has been removed;

- spectacular losses suffered by banks' non-bank subsidiaries earlier this decade, which in turn rebounded significantly on the performance of their parents. These included losses of $2.7 billion by the State Bank of Victoria's subsidiary Tricontinental Corporation, around $1 billion by State Bank of South Australia's

Beneficial Finance Corporation, and a $726 million loss by Westpac's AGC. The losses experienced by Tricontinental and Beneficial did major damage to the viability of SBV and SBSA, and caused heavy losses for their State government owners. Another dramatic addition to this list in 1994 was the collapse of the UK's Barings Bank due to the activities of its non-bank subsidiary in Singapore.

Many of the operations of banks' non-bank subsidiaries have been wound back into the parent banks, while others have brought their subsidiaries' operations under closer control.

191. Eleven Australian banks own finance companies and 25 own merchant banks. These finance companies currently have assets of around $23 billion (representing 50 per cent of the finance company industry) while the merchant banks have assets of around $13 billion (representing 22 per cent of the merchant bank industry). Of the 25 merchant banks, 6 are special purpose vehicles established solely to enable foreign bank branches to raise tax-effective funds under Section 128F of the *Income Tax Assessment Act*.

192. The following table indicates that much of the business now conducted in banks' non-bank intermediaries could be done within the authorised bank. Bank-owned finance companies have moved away from their consumer finance origins: their balance sheets are now dominated by business loans and commercial leasing. The balance sheets of bank-owned merchant banks also consist largely of business loans; they are also active in traded instruments and corporate advisory work.

Table 6: Assets of Bank Subsidiaries
Per cent of total - June 1996

Finance Companies		Merchant Banks	
Business lending	46	Business lending	36
Consumer finance	23	Liquid assets	33
Commercial leasing	25	Loans to related companies	21

193. Despite these trends, some banks retain finance company/merchant bank subsidiaries because:

- they perceive marketing advantages in subsidiaries which have developed valuable goodwill and customer recognition in specific market niches;

- the subsidiaries can access longer-term retail funds through debenture issues;[9]
- they can access tax-effective offshore funding, as noted above;
- more suitable depreciation arrangements are available for taxation of leasing; and
- some regulatory requirements, such as the Prime Asset Requirement and NCDs, can be avoided.

194. The RBA has no direct legislative responsibility for, or powers to supervise, non-bank financial institutions, whether or not they are subsidiaries of banks. Nor does it believe that subsidiaries such as finance companies need to be supervised in their own right for financial system stability purposes. Nevertheless, it has been long recognised that the difficulties of a subsidiary can pose a threat to a supervised parent. Consequently - and despite the legal limitations - the RBA has sought to conduct its supervision of banks in such a way as both to take account of and contain risks which may emerge in such subsidiaries. This is achieved primarily by adopting a consolidated approach to the prudential supervision of banks: while the RBA does not have legal power to obtain separate information on each subsidiary, it applies key prudential requirements, including capital adequacy and monitoring large exposures, on a consolidated group basis.

195. At the same time, the RBA seeks to contain the extent to which a bank can be exposed to risks undertaken by an associate by ensuring that the subsidiary's business is kept distinct from that of the bank. Among other things, this limits exposures from parent to subsidiary and requires that, in so far as a bank feels implicit responsibility for a subsidiary, it should exercise that responsibility by ensuring that its associate has sound and prudent management which is aimed at achieving undoubted viability within the capital resources of the associate itself.

196. Experience has, however, demonstrated how difficult it is for banks to insulate themselves fully from troubles arising in a subsidiary. They inevitably face some pressure - either moral or commercial - to prop up ailing businesses with which they are associated, thereby weakening their own capital positions. There is no doubt that the task of supervising banks would be easier if they had no unsupervised subsidiaries. Nevertheless, while banks see a commercial rationale for these subsidiaries, the RBA is not inclined to pursue their prohibition. Rather it will continue to encourage banks to carry out all intermediation business within the bank. For those subsidiaries which remain, the RBA would prefer to have more formal powers to require their sound and prudent management, and to prevent a bank's support of a subsidiary where that could weaken the bank.

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[9] The Banking Act does not prevent debenture issues by banks but it requires that, in the event of the liquidation of a bank, depositors would have priority over secured creditors.

Authorisation of foreign exchange dealers

Current framework

197. Arrangements in the Australian foreign exchange market are administered under the *Banking (Foreign Exchange) Regulations*. Financial institutions wishing to be dealers in foreign exchange must seek authorisation by the RBA and must adhere to certain guidelines. The establishment of authorised dealers is intended both to promote the liquidity and depth of the market by having a core group of institutions which stand ready to quote prices to customers, and to provide a means of ensuring the integrity of the market through the authorisation process.

198. When the exchange rate was floated in December 1983, only the existing 14 trading banks were authorised. In April 1984, non-bank financial institutions which met certain criteria were also invited to apply for authorisation. The main criteria - that dealers be incorporated locally, and have at least $A10 million in capital, adequate systems and experienced dealing staff - were designed to ensure that dealers were of some standing and expertise. The RBA also sets net overnight position limits on their foreign exchange exposures and contingent loss limits on their options business.

199. The extension of authorisation to non-banks greatly assisted the growth of the market through the second half of the 1980s. In recent years, however, many of the major non-bank dealers have converted to bank status. The 41 banks now authorised to deal in foreign exchange account for almost 90 per cent of total market turnover, so the liquidity added by the 33 non-bank dealers is fairly limited. Furthermore, the top ten of these account for most of the remaining turnover; the smallest 23 non-bank dealers account for less than 1 per cent of turnover. The case for having non-bank authorities is therefore no longer as strong as it was in the 1980s.

200. The authorisation of non-bank financial institutions meant that the RBA's supervisory net widened slightly in that it began to oversee the foreign exchange activities of these organisations. Although this has never carried any assurances about the financial soundness of the institutions involved, it has put RBA in the potentially awkward situation of supervising one aspect of the operations of institutions not otherwise covered by Australian supervision.

201. The authorisation process has some useful by-products. It gives the RBA a direct say in the foreign exchange operations of dealers, which on occasion has been helpful in developing the Australian market. The requirement that all foreign exchange transactions should be channelled through authorised dealers also makes implementation of United Nations sanctions and the tracking of money laundering easier; and it allows the RBA to collect comprehensive statistics on the Australian market. The importance of this has, however, diminished now that regular BIS surveys of foreign exchange markets are in place and, overall, these benefits are of second order importance.

International practice

202. Australia's arrangements are somewhat unusual by world standards. Most countries follow one of two models. One is to have no specific restrictions on foreign exchange dealing, with foreign exchange treated as just another financial product. This approach is followed by the US, UK and Canada. The second model is to restrict foreign exchange dealings to banks. This is common in Europe, and no doubt reflects these countries' history of universal banking. Italy comes closest to the Australian model, having a two-tiered authorisation process - one for banks and one for other credit institutions. Japan, which used to restrict foreign exchange dealing to banks, has recently announced an extension to some other institutions as a result of pressure to deregulate its market.

Options for change

203. Given the changing roles of banks and non-banks in the market, there is a case to review current authorisation arrangements. Two options may be considered:

(i) restrict foreign exchange licences to banks

One option is that only banks be authorised to deal in foreign exchange. Under this approach, responsibility for supervision of their foreign exchange activities would become a part of the RBA's overall supervision of banks. The arrangement would result in a lifting of supervisory standards in the foreign exchange market. It would also lessen any perception that may exist at present that the RBA supervises non-banks. On the other hand, it could be interpreted overseas as a move to restrict participation in Australian markets. As noted, Japan, which used to follow such a policy, has recently widened authorisation to non-banks as a step towards market liberalisation.

(ii) deregulation of foreign exchange market

The other option is to remove the need for authorisation altogether, allowing any entity to buy or sell foreign exchange without limitation. This would also resolve the present awkwardness of having the RBA prudentially supervise one component of a non-bank dealer's operation, as well as being consistent with the RBA's approach to other markets (eg for bond dealers). It might also increase competition and efficiency by allowing others to participate but such effects are unlikely to be large when there are already many dealers in the market, who compete not only with each other but also with dealers in other foreign exchange centres.

204. An important consideration is whether there would be a significant loss of integrity in the foreign exchange market if the authorisation process were abolished. Under current arrangements, there have not been problems in the wholesale side of the market, which may be because the authorisation process acts to ensure that participants are of high integrity. But, neither have there been problems in the bond market where no such authorisation process exists. If the second option were accepted, it would be

necessary to remove the current exemption in the Corporations Law for foreign exchange dealing, so that non-bank dealers in foreign exchange would require a securities dealers licence and would be subject to the investor protection aspects of the law. This would be important in order to safeguard the integrity of the retail side of the market.

205. The RBA's view is that there is a strong case for the second option - that is, for terminating the current separate licensing regime for foreign exchange dealers. If merchant banks owned by foreign banks are required to become authorised banks in Australia, as discussed in Chapter 5, most foreign exchange dealing would continue to be supervised.

7. FUNDING BANK SUPERVISION

Introduction

206. Banks in Australia do not pay a licence fee for authorisation or a levy for the cost of RBA supervision. Supervision costs form part of the general expenditure of the RBA. Banks are, however, required to lodge with the RBA Non-Callable Deposits (NCDs) equivalent to 1 per cent of their liabilities (excluding capital) in Australia. They attract an interest rate set 5 percentage points below the average yield at tender in the previous month on 13-week Treasury Notes. By this route, banks contributed some $185 million in 1995/96 to RBA profits and thereby to Commonwealth budget revenue.

207. NCDs do not serve any monetary policy or prudential purpose. Although the revenue derived has been described as a kind of payment for the "benefits" which come with bank authorisation and supervision, the re-introduction of a discounted interest rate in mid 1995 was essentially a revenue-raising measure.

Is there a case for a bank licence fee?

208. The case for a licence fee depends on there being identifiable net commercial benefits from banking status. If such benefits exist, the "user pays" principle suggests those institutions enjoying them should make a payment in return, otherwise they enjoy a public subsidy.

209. Market perceptions of the safety and soundness of authorised banks are undoubtedly enhanced as a result of official screening, ongoing prudential supervision and access to any lender of last resort facilities that may be extended to them. Banks are also permitted to accept deposits without the need to issue prospectuses. While the depositor protection provision in the *Banking Act* does not provide a guarantee of bank deposits, bank depositors have historically enjoyed a high level of security. As a result, banks may be able to fund themselves at a lower cost, or to attract business which would not otherwise be available.

210. The commercial (as opposed to community) benefits flowing from supervision can, however, be overstated. Banks do not always enjoy cheaper funding than non-banks, especially in wholesale markets where local banks face significant competition from foreign banks operating as (unsupervised) merchant banks in Australia, or from offshore funding. More generally, an increasing range of financial institutions can provide particular banking-type services without being authorised as banks, lessening the economic value of a banking authority vis-a-vis other forms of operation. Any benefits to banks associated with direct access to the payments system has also been reduced as the system has been opened (indirectly) to building societies and credit unions in recent years. Furthermore, banks do not have a right of access to RBA emergency support facilities during times of liquidity crises. Liquidity support is purely at the discretion of the RBA and will not be provided to ensure the continued operation of an insolvent institution.

211. Bank authorisation also entails costs to banks. They are required to meet ongoing supervisory requirements; provide data and other information; and pay for external auditor reporting to the RBA. The RBA does not consider these costs to be unduly burdensome. However, insofar as they exceed the standards which would otherwise be imposed by financial markets, banks will be competitively disadvantaged at the margin vis-a-vis unsupervised institutions.

212. Many non-bank institutions in Australia (such as life offices, building societies and credit unions) are also subject to official screening on entry, and are either directly or indirectly supervised and regulated. These entities enjoy some enhanced status as a result, and none is subject to a licence fee.

213. There would be various disadvantages in imposing a licence fee. It could compromise the pursuit of systemic stability by discouraging large non-bank financial institutions, such as foreign bank-owned merchant banks, from converting to authorised bank status. It could discourage other applications for banking authorities (and possibly cause some authorised institutions to contemplate surrender of their authorities). At the margin, a fee could also act as a barrier to entry into the banking sector, which would be at odds with the thrust of policy to reduce entry barriers and encourage greater competition in Australia.

214. A licence fee would also risk producing distortions within the financial system of the type seen under old Statutory Reserve Deposit arrangements. The extent to which this occurred would depend, of course, on how the fee was structured. More importantly, however, application of a licensing fee based on the notion of access to favoured treatment may reinforce expectations of official support for a bank encountering difficulties, so heightening the problems of "moral hazard" associated with authorising and supervising banks.

215. In summary, while the benefits and costs of banking status are not readily quantifiable, it is not at all clear that there are substantial net commercial benefits. There would be considerable difficulty in putting a value on a banking authority and setting any licence fee would be arbitrary and subject to much debate. A fee which exceeded any net benefits gained by banks would have an adverse impact on the banking industry. There would appear to be no major gains to be made from imposing a general licence fee on banks.

A charge for the costs of supervision?

216. Arguments for and against levying a charge on banks to meet the specific costs of RBA supervision are similar to those outlined in the previous section. The main argument in favour is competitive neutrality, since most other financial institutions pay the costs of their supervision. It can also be argued that supervisors provide a service for depositors, notably small depositors, in monitoring the condition of banks on their behalf. A payment for this service could be made by these beneficiaries, through their banks.

217. Against this is the argument that the RBA supervises the banking system primarily for the general benefit of the community. Banks stand at the core of the Australian financial system - they continue to be the main depositories of community savings and play a central role in the operation of the payments system. Supervision of banks provides benefits which spread across the whole economy, and do not accrue just to banks (and their depositors and shareholders). On this view, bank supervision is a "public good", contributing importantly to maintaining financial system and economic stability, as well as to protecting individual depositors. The annual costs of RBA supervision, which are in the order of $10 million, are low overall, particularly so when compared to the implicit tax imposed by NCDs.

218. There are some other reasons not to pursue a levy:

- as argued above, payment by banks for their supervision may be perceived by the community as a *de facto* payment for "guaranteed" RBA support, either to individual banks or to their depositors. Any encouragement of the perception that banks are guaranteed by the RBA would be highly undesirable; and

- if required to pay for their supervision, banks may seek to place pressure on the RBA and Government to reduce the costs by curtailing supervision. This could tend to impair the independence, and compromise the integrity, of supervisors. Other countries have experienced such pressures (eg the supervision of savings and loan associations in the US during the 1980s). While such pressures can be resisted, considerable time and effort might be diverted to debating supervision charges, rather than to supervision itself.

Overseas practice

219. Practice in overseas countries in levying fees and charging for supervision is mixed. Most countries do not levy licence fees. Where they do, the amounts are relatively small and do not appear to attempt to recoup any net advantages accruing from the authorisation of banks. Licence fees, more often than not, are viewed predominantly as fees for supervision.

220. As a general rule, central banks do not charge for supervising banks. They regard supervision of banks as a public good which forms part of their general operations and the costs as part of their overall operating expenses. Where specialist supervisors are responsible for supervising banks, they generally do charge for supervision. This is largely out of necessity given the absence of alternative funding sources available to them. The charge for supervision ranges from partial to full cost recovery. Supervisors who undertake extensive examinations of banks (and other institutions) often charge to help cover the substantial costs of this process. The structure of supervisory charges levied on banks can, in some instances, be complex and unwieldy from an administrative viewpoint.

8. PAYMENTS SYSTEM ISSUES

Introduction

221. This Chapter describes some important innovations in the payments system and the policy issues they raise. Australia's payments system is a critical part of the economic infrastructure. It is the "hidden plumbing" through which financial values flow around the economy. An efficient and reliable payments system can make an important contribution to economic growth and to Australia's international competitiveness. The payments system is also the mechanism through which financial shocks can be transmitted more widely through the financial system and into the broader economy. International payment system linkages can carry shocks quickly across borders.

222. Flowing from its concern for financial system stability, the RBA's main interests in the payments system relate to its soundness and reliability - ensuring that risks are well identified and controlled and that, if a problem arises, its spread is limited. It is now working with the industry on a system which will significantly reduce interbank settlement risk. The RBA is also keen to promote efficiency, competition and fairness in the payments system and has pursued these objectives in various ways, including through the Australian Payments System Council[10] and the Australian Payments Clearing Association[11].

Wholesale payments

Main developments and prospects

223. The potential for financial system instability in the payments system lies primarily with wholesale payments, including high-value payments between financial institutions, net settlements from retail clearing streams and settlements from securities trading systems. The potential arises because of the large amounts involved, and because under current arrangements there can be up to a 24-hour delay between the incurring of interbank liabilities and their extinguishment (settlement) across Exchange Settlement Accounts (ESAs) at the RBA. Failure to make a settlement payment will create a major disruption because the bank due to receive funds will have entered into various other transactions on the expectation that funds will arrive. If this expectation is disappointed, the subsequent transactions would be virtually impossible to unwind.

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[10] The RBA chairs and provides the secretariat for the Australian Payments System Council (APSC) which was formed in 1984 by the Federal Treasurer to encourage efficiency and stability in the Australian payment system and advise the Treasurer on relevant matters. It has no operational role in the payments system.

[11] The Australian Payments Clearing Association (APCA) is the industry body with responsibility for managing payments clearing arrangements between members. The RBA currently provides the Chairman and a voting Board member to APCA.

Real-time gross settlement (RTGS)

224. In mid 1995, following consultation with the banking industry, the RBA announced plans to introduce a RTGS system for high-value payments by the end of 1997. Under RTGS, high-value interbank payments will be settled across ESAs as they are exchanged between banks during the course of the day. This will replace the existing practice of clearing high-value payments and netting interbank obligations, under which final settlement does not take place until the morning of the following business day. The RTGS system will be built on the RITS[12] securities transfer and settlement platform operated by the RBA. Payments will also feed into this from the settlement system operated by Austraclear, and from a delivery system whose operations will be co-ordinated by APCA.

225. The introduction of RTGS will substantially lessen risk in the domestic payments system because over two-thirds of the total value of daily payments activity will be settled during the course of the day, sharply reducing overnight credit exposures between banks. By requiring each high-value payment to be pre-funded, RTGS will eliminate the potential for one bank to cause liquidity (or solvency) problems for other banks by failing to settle for its high-value payments.

226. Not all interbank settlement risk will be eliminated by RTGS because retail payment systems will continue to settle on a deferred net basis. However, the amounts at stake are relatively small and much of this risk is covered by loss-sharing agreements among the main participants in those systems.

227. Further, the RTGS system will not remove normal credit risks between banks and their customers. But it will focus attention more sharply on those credit exposures, many of which are not clearly identified under current arrangements. The immediacy of an RTGS payments environment will heighten the need for customer credit exposures to be well understood and controlled; a bank making a payment on behalf of a customer will know that its instruction to the central bank will be acted on as soon as it has funds in its ESA available and will be irrevocable. Thus it must take an explicit credit decision about its own customer before issuing the instruction - will it provide credit, if so how much and on what terms, or must the customer have cleared funds before the bank will initiate the transaction on its behalf? Banks are responding to the need to more tightly control their credit exposures in an RTGS environment. Many have substantial back-office development projects underway.

Securities settlements

228. RTGS will allow all securities settlements in Australia to be made on a full delivery-versus-payment basis. This ensures that final transfers of securities will occur

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[12] RITS is an electronic registry, transfer and settlement system for Commonwealth Government securities. A similar facility, FINTRACS, is operated by Austraclear Ltd for semi-government and private sector debt securities.

if, and only if, the payment side of the transaction is performed simultaneously. This applies to all Commonwealth Government securities settled using RITS, as well as to all other debt instruments settled through Austraclear. Settlements made through the ASX's equities clearing system will also settle on this basis, but as an entire batch of transactions once a day, not as individual items as they occur.

Foreign exchange settlement risk

229. The international banking industry is now examining how to apply similar principles to reduce the risks associated with settlement of foreign exchange transactions, where the commodity being delivered is not a security but an amount of foreign currency. As payments are made in two different countries, with different participants and often during different business hours, achieving payment-versus-payment by synchronising the two settlement legs becomes much more difficult. With the encouragement of central banks, a number of large international banks are seeking to establish systems to link the payment in one currency to the receipt in another, thus reducing the risk that one party to a transaction will pay out but not be paid by its counterparty. Establishing either direct or indirect linkages between national RTGS systems will be critical to the success of such endeavours.

Policy issues: access to the wholesale payments system

230. Until 1994, the RBA granted ESAs only to institutions which it supervised and which were considered unlikely to expose other institutions (including the RBA) to credit risk through failure to settle. Since then, in addition to the banks, two Special Service Providers (SSPs), one representing permanent building societies and one representing credit unions, have been given settlement facilities after the RBA was satisfied with the quality of their supervision by AFIC. They are permitted to settle only a limited range of low-risk transactions.

231. Policy on access to ESAs reflects their central role in the payments clearing and settlement system. Historically, settlement accounts were established as a convenient way for providers of payment services to discharge their liabilities to each other. Entries to accounts at a trusted third party were cheaper and more convenient than exchanging gold or banknotes. The main role of ESAs continues to be the extinguishing of obligations which banks incur to each other through their specialised role as providers of payment services. Payment providers transfer customers' balances held on their balance sheets to customers of other institutions. In the process, they incur liabilities one to the other. By settling these clearing system obligations using settlement accounts with the central bank, creditor banks exchange claims on other commercial banks for a risk-free claim on the central bank. RTGS will prevent the build-up of settlement exposures by settling each high-value payment at the central bank continuously throughout the day.

232. Banks are the main providers of payment services in Australia, in part because they hold the bulk of customers' deposit accounts from which payments are made. In recent years building societies and credit unions have successfully competed for a

share of retail payments. These are the only types of institutions which currently have ESAs - either directly as do banks or indirectly in the case of building societies and credit unions.

233. The prospective introduction of RTGS has led some to question whether access to ESAs could be broadened beyond banks and SSPs because, with the removal of settlement risk between ESA institutions - at least for high-value payments - new players would not expose existing participants to losses. It is true that unsettled payment system exposures will be less of a problem with RTGS. However, the RBA does not accept that the introduction of RTGS would justify giving ESAs to commercial organisations which might make large numbers of payments on their own account, but which are not providers of payment services generally to others. To do so would change the essential nature of one of the RBA's core central bank functions as supplier of settlement services to commercial payments providers. It would also mean that the RBA was providing a banking service to private sector users of the payments system in competition with the commercial banks.

234. In principle, institutions other than the existing members of the payments system could become large-scale providers of payment services to customers holding transaction balances with them and thereby generate settlement exposures to other payment providers. If this happened, it could be appropriate for the RBA to help extinguish these risks and prevent them creating exposures for other participants by giving the new providers access to ESAs. Each case would need to be considered on its merits, in light of the business being transacted and the potential exposures being generated. Of course, such institutions would need to have customers prepared to hold significant transaction balances with them; if they were to develop this business to any significant size they would almost certainly have to become a bank or other supervised deposit-taker.

Retail payments

Main developments and prospects

235. The vast bulk of retail payments pass through well-established retail payment systems - cash, cheques, direct entry, credit cards, debit cards and EFTPOS. These systems have evolved over many years. While each has features that need improving - such as cheque clearance times - all are well accepted by the public and do not raise new prudential or system stability issues.

Emerging systems

236. A number of technological innovations have attracted considerable attention, including payments over the Internet and stored-value cards (SVCs). These create opportunities for firms supplying communications and computer software services to play a role in payments.

237. This has excited assertions that the payments system as we know it is under challenge and that banks will become irrelevant. These claims are not at all well-founded. Many confuse the fundamental nature of payments - a transfer of value from payer to payee - with the operations of the payments process. Some of the common claims are discussed in the following paragraphs.

Unsupervised non-banks are competing unfairly with banks

238. One common complaint is that non-bank companies, not subject to banking regulation, are unfairly eroding banks' credit card business. The case of GE Capital, an internationally operating finance company, is often cited. GE Capital has purchased the inhouse credit account business of the Coles Myer Group to give it a card base of around 2 million in Australia. Many department stores have provided similar store card services for many years, funding themselves on the wholesale market and advancing credit to their customers. GE Capital operates many similar specialist businesses which it has purchased from department store chains around the world. It appears to be successful mainly because it is very efficient. It is difficult to see that it has a regulatory advantage - the company has a capital ratio of 15 per cent, well in excess of most banks, and it is not a significant retail deposit-taking institution.

239. GE Capital's card competes directly with those offered by banks every time a customer makes a choice about which card to use in a Coles Myer store. There is no evidence that it has either a new or privileged position in that competitive environment. The structure of the business is similar in many respects to that of the long-established charge card companies, American Express and Diners Club, which offer their cardholders a means of payment at participating merchants, and credit until the monthly account falls due. At this stage, the merchants covered by GE Capital's Australian operations are all stores in the Coles Myer Group. Ultimate settlement of obligations incurred on these cards takes place through the banking system.

The Internet is making banks irrelevant

240. Another claim is that by breaking geographic boundaries, the Internet is making conventional banking and payments irrelevant. An example quoted is someone with Internet access logging on to a Web site for a bookshop in the US, selecting a book and paying for it using his/her credit card without leaving home. But banks are involved in this transaction. The Internet is being used principally as an efficient "search engine". Ordering and paying for goods remotely has been possible for many years, using mail order catalogues, fax machines and the telephone. Credit card payment is convenient because the customer simply cites his credit card number to make the payment (the merchant and his banker have arrangements covering losses due to fraud). Most Internet payment works in the same way - it is simply another way of authorising a conventional credit card payment. The payment is processed through the credit card clearing and settlement system as are cards authorised by signature in a shop. The same will apply to debit card transactions when Internet security is satisfactory.

241. Many other Internet-based banking products are also merely a more efficient means of access. A “home page” with details of a bank's products is an electronic brochure. One Australian bank already allows customers to move funds between their accounts by issuing instructions over the Internet, rather than over the counter. Security considerations have so far prevented banks from accepting instructions over the Internet to debit a client's account and make payment to another party. When security problems are overcome, the debit will be a conventional banking operation and the covering credit will be processed through a conventional payments system, such as the direct entry system used to make salary payments. In all these transactions, banks or other financial institutions or credit or charge companies, carrying out conventional payments business, are directly involved. The only new element is the means of issuing instructions to them, which will probably be cheaper for banks and more convenient for customers.

242. There is, however, an emerging class of Internet facilities which could reduce the role of banks. Some companies (such as Digicash) are promoting the use of Internet “tokens”. Tokens are purchased from the issuing company using conventional payment means - a debit to a bank account or credit card account - and then used to make payments to third parties. Under some scheme designs the tokens have to be returned directly to the bank or the issuer to be redeemed, while in others they could be passed from one holder to another over the Internet, just as currency notes are passed from hand to hand. It remains to be seen whether consumers will be prepared to hold significant balances in this form. It is more likely that only supervised financial institutions with a track record in payments (such as banks) will have the standing and credibility to become large players.

The telecoms, network and software suppliers are taking over

243. There is a concern that the companies providing telecommunication, network and software facilities to banks and their customers - such as AT&T, Telstra and Microsoft - will somehow take over banks' payment business. Banks clearly depend on outside suppliers for a range of services they need to conduct their payments activities. When the technology was simple, specialised and relatively inexpensive it was controlled by individual banks, but this is no longer possible. Competition among banks might force them to outsource processing and communications to the specialised service providers. But this does not mean outsourcing the basic financial services of holding balances and arranging for their transfer on request.

244. Banks fear that they will lose their direct relationship with their customers. As an example, as home banking becomes more popular, customers may choose banks that can be accessed using the software with which they are familiar (such as that provided by Microsoft) rather than first choosing their bank. With the next generation of bank customers more familiar with keyboards and the Internet than bank services and prudential standings, banks might well find they need to approach their customers through third parties. Software and network suppliers might become the gateways to banks - as the doors of a bank branch used to be. These are indeed difficult issues for

banks to grapple with. But they are commercial issues, not issues of public policy as those fearful of change often claim.

Policy issues

245. The emergence of new payment instruments, such as Internet services and SVCs, do raise various new issues for public policy. Most of these are about consumer protection, prevention of money laundering, potential erosion of tax bases and privacy protection and so fall outside the RBA's main area of responsibility. Even the potential loss of seigniorage from SVCs is ultimately more a matter for the Government than for the RBA.

246. Systems involving the issue of electronic tokens will allow payments to take place on the Internet. Consumer regulators may wish to establish standards for security and for disclosure, the latter so that consumers know with whom they are dealing. Should the use of such tokens become widespread there may be a need to increase public protection, in part by establishing sound and reliable clearing and settlement arrangements. To date, with only a few exemptions, banks remain the source of the value being transferred and the point of redemption. This position may be challenged in the future, but issuers who cannot guarantee integrity of the source of funds are unlikely to find widespread public acceptance, especially for high-value payments.

247. While the Australian authorities can apply standards to issuing institutions based in Australia, a major attraction of the Internet is the access it gives to organisations based abroad. Australian agencies cannot control who issues tokens or establishes systems abroad, nor could they realistically prevent residents from opening accounts abroad and accessing them via the Internet. These issues will be faced by all countries. The RBA is liaising on these issues with other central banks, particularly through the Bank for International Settlements.

248. SVCs aim to replace currency for consumer payments, both domestically and in foreign currencies for travellers. Achievement of this aim would pose concerns for central banks and other agencies, because any loss of confidence in the soundness and security of this new payments instrument would be very disruptive to business activity. The regulatory environment to be applied to SVC products internationally is still to be decided. The US Federal Reserve has taken the view that it does not want to impede development by premature regulation. It has identified the matters which potential issuers need to address, and stressed their obligations to disclose fully to potential cardholders the risks they bear. In contrast, the European Monetary Institute has recommended that only authorised "credit institutions" (banks, building societies and credit unions in Australian terminology) should be able to issue SVCs in European Union member states.

249. The RBA has drawn a distinction between development projects and full-scale introduction of SVC products. Its approach has been to monitor closely international developments and the domestic trials of SVC products. Two have involved banks

directly and two have been operated by non-financial companies. All have involved only a small number of cardholders and merchants and relatively small exposures for cardholders.

250. Arrangements might be made for unsupervised institutions issuing SVCs to provide a degree of assurance that card holders could redeem value in cards. However, failure of a major broadly-based scheme could have damaging effects on consumers and merchants and on general confidence in other similar products. Given this risk, the RBA is inclined to the view that SVCs which are likely to be widely issued and accepted, and whose use generates significant liabilities which must be cleared and settled, should be issued only by supervised financial institutions.

251. In discussions with banks about SVCs, the RBA has sought not to stifle innovation, but has identified issues which scheme designers need to address, and invited them to demonstrate how they would do so. For instance, institutions issuing SVCs need to demonstrate that they have the financial resources to match the risks and claims that could arise if the card security is compromised. This could include adverse affects on the bank's reputation in other markets, raising the possibility of flow-on effects. The schemes will also need to address adequately the concerns of the law enforcement agencies and consumer interests.

9. COMPETITION AND CONSUMER REGULATION

Introduction

252. This Chapter comments on some areas of policy which are not "core" issues for the RBA, but in which it takes an interest both because of their intrinsic importance and because they can overlap with its responsibilities for prudential supervision. The Chapter also discusses briefly the RBA's own customer services.

Competition policy

253. In the RBA's view, a coherent set of competition policy principles should apply to all industries, and be administered by the ACCC with economy-wide responsibilities. The same broad principles which are used to evaluate mergers in other industries should be applied to the financial sector. They should focus on three issues:

- Would the merger lessen competition?
- Would the merger change the cost structure of the industry concerned?
- Does the merger have public policy implications beyond those that relate to competition and costs?

254. The Trade Practices Act prohibits mergers that are likely to significantly lessen competition in a "substantial market" in Australia unless the ACCC judges the merger as providing net public benefits. The Act has sufficient scope for these principles to be addressed. In its judgements, the ACCC needs to recognise that competition policies cannot be implemented in a vacuum and that other considerations, such as financial stability, are also important. It will need to consult widely with relevant parties.

255. Notwithstanding the liberalisation of entry into banking, two separate policies have principally determined the core structure of the financial sector over the past five years. These have been the "six pillars" policy, which has prevented mergers between the four largest banks and large life offices, and the "four plus one" interpretation of the provisions of the Trade Practices Act by the ACCC in its consideration of bank mergers.

256. The "six pillars" policy has its origins in the decision of the previous government, in May 1990, to block a proposed merger between the ANZ Bank and National Mutual, the second largest life insurer in Australia. The merger would not have breached any legislative or prudential guidelines and was not seen as a threat to stability of the financial system. Rather, the government took the view that the merger would have reduced the "diversity of institutions and effective competition in banking, in life insurance, and more generally the provision of financial services". Its judgement was that such a merger would reduce competition more than was in the national interest. In reaching this view, the government made it clear that it would not

entertain proposals for mergers between any of the four largest banks or the two largest life insurers. It argued that large financial institutions should develop their own business or make smaller acquisitions.

257. The policy has never had a legislative basis and it is timely that it is being reviewed. The RBA believes that the ACCC should evaluate the competitive impacts of proposals for mergers and acquisitions in the finance sector on the same basis as proposals in any other sector. In doing so, the ACCC will have to grapple with difficult issues of market definitions and the extent to which other institutions are potentially effective competitors.

258. These issues were also raised by the "four plus one" interpretation the ACCC placed on Section 50 of the Trade Practices Act when evaluating the proposal by Westpac to acquire Challenge Bank in September 1995. In allowing the acquisition to go ahead, the ACCC focussed on the market for banking services in Western Australia, rejecting arguments that the relevant market was national. The ACCC argued that regional banks were an important source of competition to the majors in most states, and allowed the acquisition to proceed only because BankWest would remain independent, as the "plus one" providing effective competition to the majors. The ACCC extrapolated this analysis to possible future proposals, arguing that any purchase by a major bank of the last remaining regional bank in any state would be likely to substantially lessen competition and that the ACCC would "need highly persuasive evidence to be convinced otherwise". Under this policy, acquisition of a number of regional banks by a major bank is effectively ruled out.

259. The RBA believes that the focus on a state market may be overly restrictive. In its view, competition in the market for banking and other financial services should be analysed at the national level. While institutions with a regional focus may be important in some markets, particularly for some retail services and lending to small businesses, where local knowledge is useful, these factors are becoming less relevant. Delivery systems such as ATM and EFTPOS networks are making regional markets more readily contestable by institutions without a strong physical presence in those areas. Electronic banking enables customers to access a number of banks through post-office tellers. Telephone banking and, increasingly, the Internet, allow bank customers to conduct many transactions such as paying bills and moving funds between accounts, balance inquiries and obtaining product information without visiting a branch.

260. The forces operating on the financial services sector are mostly national in scope. Despite inter-state differences in industry structure, there is little difference in the interest rates charged and paid by the same financial intermediary in the different states. As in the global market, ongoing changes in information technology and in delivery systems are lessening the importance of geography in defining markets for financial services in Australia.

261. The benefits to customers and shareholders of any merger between a major bank and a regional bank will obviously need to be assessed on a case-by-case basis. The RBA believes that outright prohibition would be too strict an interpretation. That said, the RBA is not advocating a spate of bank mergers. There is no compelling evidence that economies of scale exist in banking either in Australia or abroad. Large banks do not typically have lower average costs than smaller banks, and both specialised and multi-product banks appear to be commercially viable.

262. A frequent argument is that bank mergers would reduce costs by facilitating a rationalisation of banks' extensive branch networks. This argument has some merit, although rationalisation is already under way and will continue whether or not mergers take place. Mergers of banks operating in the same geographic areas are likely to promise the greatest savings through branch rationalisation.

263. Another argument is that even the largest Australian banks are too small to offer a full range of international services to all their customers, putting them at a competitive disadvantage. However, large corporate customers generally maintain relationships with a number of banking entities, reflecting the fact that different banks have expertise in different areas. No bank can be the most efficient in all activities. Australian financial institutions need to decide whether international expansion requires sheer size, or expertise in specialist areas which offer strong potential for growth.

264. Finally, improvements in information technology are increasing the scope for cost savings through the centralisation of information processing and payments. Economies of scale clearly exist in such activities. The issue is how best to realise them. One option is the merger of institutions. Another is for the development of organisational structures (alliances, outsourcing etc.) which allow institutions to take advantage of the potential savings without merging.

Industry structure and prudential issues

265. As well as being subject to the Trade Practices Act, mergers among banks and substantial acquisitions by banks of other financial institutions require RBA approval, because of their possible consequences for the prudential soundness of the banks involved. In the normal course, the RBA would not seek to interfere with the judgment of banks' senior management and board about the commercial viability of an acquisition proposal. If, over time, the financial system were to become much more concentrated, or if there were proposals which would themselves produce a substantial increase in concentration, the RBA might need to take into account such questions as:

- Would a heavily concentrated banking system be more or less vulnerable to financial shocks?

- Would the RBA's options for managing serious weakness in one large bank be significantly reduced if there were only one or two others?

266. Australia's banking system, in which four major banks account for around three quarters of most banking business, is not excessively concentrated by international standards. A reduction from four large banks to three would not greatly increase concentration nor would it necessarily reduce competition significantly. The Netherlands, for example, has had three dominant banks competing vigorously since 1990. However, commentators suggest that the market dynamics in Australia are such that there would quickly be pressures to move from three to two. If this were to occur, it would give Australia the most concentrated banking industry in the industrialised world, and would take us into unchartered prudential waters. (How could a merger be arranged if one of the two banks got into difficulty?) This is a very big step to take and would require community support, but it should not be ruled out of order altogether.

Consumer protection regulation

267. All companies must conform to a range of consumer protection regulations under the Corporations Law and the Trade Practices Act. Financial institutions are subject to a wide range of additional consumer protection requirements. Many of these are set out in Chapter 3. These requirements are due, in part, to the increasing complexity of many financial products and services and to the sometimes ad hoc regulatory responses to them. The Consumer Credit Code, due to commence on 1 November 1996, is intended to replace inconsistent State Credit Acts which applied different standards to products and institutions from state to state. However, even after decades of work there are still doubts about the consistency of implementation.

268. In addition, codes of practice for banks, building societies and credit unions, expected to be adopted at the time of the commencement of the Credit Code, require that institutions fully disclose fees and charges and establish internal and external dispute handling processes. Similarly, life offices and general insurance companies have codes of practice that emphasise disclosure.

269. Table 7 highlights the consumer protection requirements and the range of "regulations" with which financial institutions must comply, over and above the usual requirements of the Corporations Law and Trade Practices Act. The current extent and variety of consumer regulation in the financial sector and the lack of consistency in application is excessively costly. There is considerable scope for rationalisation which could improve the position of consumers and reduce compliance burdens on institutions.

Table 7: Consumer Protection Measures

Requirements	Banks, Building Societies and Credit Unions	General Insurance	Life Insurance	Superannuation	Unit Trusts
Legislation	Credit Code	Insurance Contracts Act	Life Insurance Legislation	Superannuation Industry (Supervision) (SIS) Legislation	Sections of Corporations Law
Codes & Disclosure	Codes of Practice (voluntary, but contractually enforceable)	Code of Practice (voluntary) and by Circular	Code of Practice (compulsory), ISC Disclosure Circulars that provide for a Key Features Statement	SIS legislation, Key Features Statement for retail products	Sections of Corporation Law
Regulator	State Consumer Affairs, APSC (monitors codes of practice)	ISC	ISC	ISC	ASC
Complaints Body	ABIO, separate schemes for building societies and credit unions	Enquiries and Complaints Scheme and Insurance Brokers Dispute Facility	Life Insurance Complaints Services	Superannuation Complaints Tribunal	Financial Planning Association Complaints Resolution Scheme

270. Centralising and harmonising consumer protection regulation on a product basis would go a long way towards overcoming the distorting effects of inconsistently applied regulations. As discussed earlier in this Submission, it need not conflict with prudential supervision on an institutional basis. The responsibility should be vested in a single national authority - perhaps along the lines of the Personal Investment Authority in the UK. Such an authority would take over the various finance sector consumer-related activities of the states, the ASC and the ISC. It should also become responsible for the work undertaken by the RBA, through the Australian Payments System Council, on the Electronic Funds Transfer Code of Conduct and the codes of practice for banks, building societies and credit unions.

271. If a national consumer authority were to be established, the RBA believes it should adopt a flexible, non-statutory approach, with close working links with service providers and consumers, and rely where possible on self-regulation supported by a high degree of transparency. This would minimise the impact of regulation on costs and innovation and encourage industry to lift service standards beyond minimum requirements. The APSC and the Banking Industry Ombudsman Scheme have found

this approach particularly valuable in carrying out their work. A new consumer authority should also establish a mechanism for close communication and consultation with the prudential supervisors of the institutions it deals with, to reduce the likelihood that consumer-related requirements will constrain institutions in a way that might damage their financial soundness. This could be achieved through regular consultation with the Council of Financial Supervisors.

The RBA's "commercial" activities

272. In addition to its responsibilities for monetary policy and prudential supervision and its role as banker to the commercial banks, the RBA participates in the financial system as a provider of services. Under its legislative charter, *insofar as the Commonwealth requires it to*, the RBA acts as banker and financial agent of the Commonwealth. It does not have this business, or any other business, as of right - it must provide quality services at competitive prices.

273. The RBA provides specialised banking, cash and registry and settlement services to the Commonwealth and a limited range of other clients. It recognises that these services compete with private sector providers. In line with the principles of competitive neutrality endorsed by the Council of Australian Governments for such competition (the "Hilmer principles"), the RBA aims to recover fully the cost of these services largely through fees and charges. Within the RBA's structure, banking, registry and settlement and cash services are organised and managed separately; accounting systems are structured so as to facilitate separate reporting of the full costs and revenues of the various commercial activities.

274. Although denied the opportunity to cross-subsidise from other income sources, the RBA is able to be a competitive supplier of transactional banking services by concentrating on systems dedicated to government needs. The RBA works actively with its government customers to improve cash management practices, especially through the joint development of electronic services designed to improve the efficiency of payments and collection systems.