Australian Chamber of Commerce and Industry
Submission to the Wallis Inquiry into Australia's Financial System
September 1996

Executive Summary

The following present the main conclusions of the Australian Chamber of Commerce and Industry's submission to the Financial Systems Inquiry.

1. It is essential that the Committee bear in mind the major complication that the financial system is not only the means through which savings are channelled into investment, but is also a major instrument of macroeconomic policy. Reserve Bank decisions to slow the flow of funds into financial markets have a major bearing on the ability of firms to borrow. Interest rate adjustments to control the flow of credit can occur with little warning but can have devastating effects on the operation of business.

2. The Commission is reminded of the need to keep the role of monetary policy in mind when it assesses the efficiency of the financial system. If monetary policy is conducted in a manner which creates instability then the financial system cannot be said to be operating "to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness".

3. ACCI has conducted a survey of its members on the operation of the financial system as it affects business. Preliminary results from the survey are incorporated into this submission. The full results will be provided to the Wallis Committee when they have been inputted and analysed.

4. Deregulation has improved the operation of the Australian financial system. The results of ACCI's survey indicate that since the deregulation of financial markets there has been an improvement both in terms of competitiveness and in terms of the services offered to the market.

5. There are concerns with the operation of the financial system in terms of its impact on business. The three most important areas of concern to business are the level of interest rates, the fees and charges of financial institutions and the collateral requirements of financial institutions. Notwithstanding these problems, there is no role for the government to regulate the fees and charges of financial institutions.

6. In regard to mergers of large financial institutions there is little reason to believe that the financial system would benefit from amalgamations. The result would be a concentration of financial assets in fewer institutions which would increase the riskiness of the financial system without necessarily providing benefits to consumers. The larger the institution, the more risk there is to the community in general of a failure.

7. There is little apparent advantage of there being a single regulator. Indeed, there are various costs in terms of instability in having a single regulator for all types of financial institution. The differences between institutions are probably as important as their similarities. A homogenised single regulator may not be sufficiently able to understand the differences between forms of financial institution and could create additional instability rather than diminish it..

8. One of the central aims of the regulatory system should be to ensure competitive neutrality between products and institutions. The form of regulation should not provide an institution with an advantage in the marketplace when competing against other providers of similar or identical

products. Balanced against considerations of competitive neutrality are, however, considerations of the most appropriate forms of prudential regulation which should be the dominant consideration. The legislative rules covering institutional regulators should be designed to ensure that products provided by different institutions and which are therefore regulated by different bodies are nevertheless regulated in the same way.

Australian Chamber of Commerce and Industry
Submission to the Wallis Inquiry into Australia's Financial System
September 1996

What follows is the submission to the Wallis Inquiry into Australia's Financial System presented on behalf of the Australian Chamber of Commerce and Industry (ACCI).

ACCI is the peak council of Australian employers, representing all of Australia's major State and Territory based associations and the majority of Australia's major national industry associations. Over 350,000 businesses across Australia are represented through the ACCI network.

ACCI, through its membership, represents businesses in all States and Territories, in all industry sectors and incorporating businesses of all sizes. ACCI is thus the most representative business organisation in Australia.

Introduction

The Australian Chamber of Commerce and Industry welcomes the inquiry into Australia's financial system. This inquiry will provide an important opportunity to review the operation of the financial system since the period of deregulation in the early 1980s and to make Australia an important financial centre in the Asian region.

The issues of particular importance to ACCI involve the operation of financial intermediaries as they affect business. In this submission, ACCI intends to respond to the Inquiry from the perspective of the users of financial services both in terms of services sought and in regard to the prudential requirements of the financial system.

As a preliminary to a fuller discussion of the issues, ACCI accepts the following:

- the deregulation of the financial system in the 1980s has been to the net advantage of the Australian economy and to Australian business;

- there is continuing need for appropriate prudential supervision of the financial system - the importance of getting the regulatory environment right is crucial to the business community;

- increased competition within financial markets benefits business and consumers;

- there is a need to balance risk against stability within the financial system.

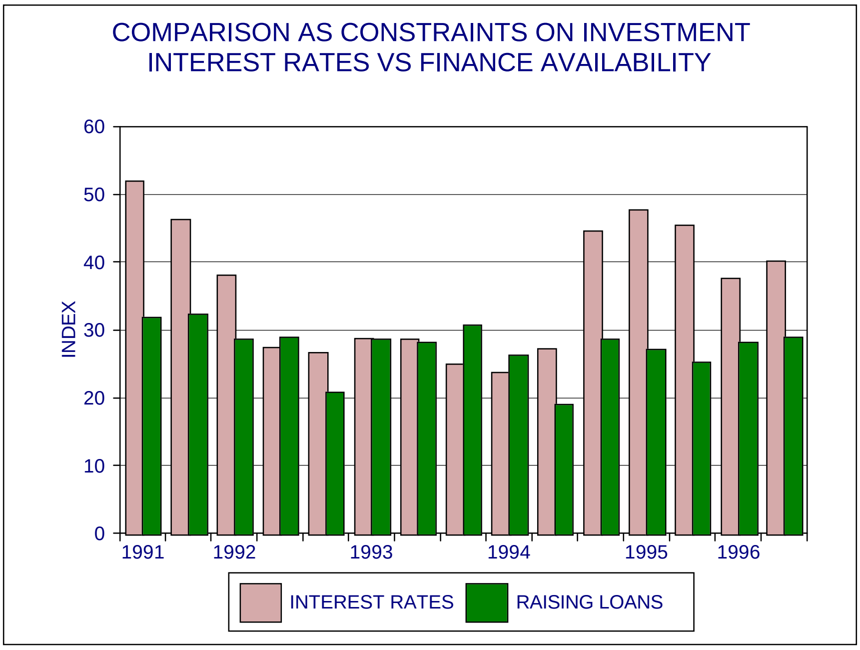
In the view of ACCI major changes to Australia's financial system are unnecessary both because there already exists a mature and robust largely deregulated financial sector and because of the need to minimise unnecessary disruption to the Australian economy. Whatever changes are introduced should create as little instability as possible.

Monetary Policy and the Financial System

In giving consideration to business concerns in regard to the Australian financial system there is the major complication that the financial system is not only the means through which savings are channelled into investment, but it is also a major instrument of macroeconomic policy. While the Inquiry's terms of reference have specifically ruled out the Committee making recommendations on the operation of monetary policy, it is nevertheless imperative that the dual nature of the financial system is appreciated and taken into account .

Interest rates and the flow of funds to the market are not determined solely by the supply and demand for funds within the economy. Public policy decisions to slow the flow of funds into financial markets, undertaken through the Reserve Bank of Australia, have a major bearing on the ability of firms to borrow. And as was demonstrated in the late 1980s, and again to a lesser extent during the past two years, interest rate adjustments to control the flow of credit can occur with little warning but can have devastating effects on the operation of business.

The figures in the chart below are from ACCI's ***Survey of Investor Confidence***. One of the sections of the survey seeks business perceptions on a number of constraints on investment amongst which are included interest rates and the availability of finance.



ACCI ***Survey of Investor Confidence***

From the economic point of view, one could say that interest rates and the availability of finance are the obverse of the other. The price and quantity supplied of any commodity, including credit, are related through the forces of the market.

Yet there is a deeper and more fundamental matter demonstrated with this business response. The use of interest rate policy to slow the level of activity and restrict credit is correctly perceived by the business community as a separate issue from the availability of funds. It is high interest rates which are perceived as the greater and more fundamental problem.

The data in the chart show that interest rates and the availability of funds fluctuate together but variations in interest rates have a much larger effect than the more muted effect of changes in the availability of finance. It is notable that when interest rates fall as a constraint, there is a similar degree of constraint as with the availability of finance. When, on the other hand, interest rates are considered to be a major constraint, availability of finance also rises as a perceived constraint but to a lesser degree. The fact that funds are there to be borrowed even when rates are high demonstrates that the financial system is able to efficiently allocate a diminished flow of funds even when credit conditions are tightened.

The Commission is therefore reminded of the need to keep the role of monetary policy in mind when it assesses the efficiency of the financial system. It is all very well to have a well regulated and open financial system, but if monetary policy is conducted in a manner which creates instability then the financial system cannot be said to be operating "to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness".

The question of interest rate policy is dealt with in an appendix taken from ACCI's pre-Budget submission this year.

Survey of the Business Community on the Australian Financial System

As part of its preparation of its submission to the Financial Systems Inquiry, ACCI has conducted a survey amongst its membership. The aim in conducting the survey has been to determine the level of business satisfaction with the current operation of the financial system. Also sought was an indication of the extent to which deregulation of the financial system has been perceived to have benefited business. Finally, the aim has been to provide an indication of where change within the financial system is needed.

It should be noted that the figures quoted are from the preliminary results of the ACCI Survey. The following provide the main conclusions from the survey data. The full results of the survey will be provided to the Committee when all the returns have been forwarded..

1. Deregulation has improved the operation of the Australian financial system. The majority of survey respondents find the level of competition and the level of service has improved relative to the past to a very significant extent. Only a minority believe that the financial system was more competitive or more service oriented in earlier years.

   The data in Table 1 are replies to the question: *Compare the* ***financial services you receive*** *today with the services received in the past.* The results show that the majority of businesses view the level of services provided by the market as an improvement on the past. It is of interest that the more distant time periods are seen as having provided a better level of financial services than the more recent periods. Even so, the present position in regarded as generally superior to the conditions which existed over the previous decade.

Table 1
Comparison of Financial Services Received
with Position One, Five and Ten Years Ago

	SERVICES RECEIVED				
	Far better	Better	No differen-ce	Worse	Far worse
	PCTN	PCTN	PCTN	PCTN	PCTN
AREA					
a) Comparison with					

one year ago	3.5	41.2	43.5	8.2	3.5
b) Comparison with five years ago	17.1	39.0	22.0	17.1	4.9
c) Comparison with ten years ago	28.4	23.5	21.0	12.3	13.6

ACCI **- Survey of the Australian Financial System (preliminary results)**

The benefits of deregulation are even more apparent in regard to competition. The questionnaire asked: *Compare the* ***level of competition*** *in financial markets today with the level of competition in the past.* In response (as shown in Table 2), there has been an overwhelming endorsement that the past decade has led to a far greater degree of competition in financial markets.

Moreover, the more distant the comparison, the greater the improvement is perceived to have been. Thus, the improvement in competition in comparison with a decade ago is seen to have been greater than in comparison with one year ago. And even over the past year, there is the perception that the financial system has become more competitive.

Opening the financial system to greater competition has ensured that innovation and technological change has been introduced more rapidly. There is more competition for customers. In most urban centres businesses can shop around for a lender and efforts are made to attract new business customers.

Table 2
Comparison of Level of Competition in Financial Markets with Position One, Five and Ten Years Ago

	LEVEL OF COMPETITION				
	Far better	Better	No differen-ce	Worse	Far worse
	PCTN	PCTN	PCTN	PCTN	PCTN
AREA					
a) Comparison with one year ago	13.1	51.2	33.3	2.4	.
b) Comparison with five years ago	15.9	57.3	23.2	3.7	.
c) Comparison with ten years ago	43.0	26.6	19.0	10.1	1.3

ACCI **- Survey of the Australian Financial System (preliminary results)**

2. There is little evidence that the financial system, as such, is impeding growth. That is, there is little indication that the financial system looked at apart from the question of macroeconomic policy adjustments to interest rates and credit availability, has been in itself responsible for holding back Australia's rate of growth. Reserve Bank decisions to raise interest rates, and government spending decisions which soak up a significant portion of the pool of available

savings, have impeded economic development. These have clearly slowed the economy and lowered the rate of private sector investment and employment growth.

However, on the narrower issue of whether the financial system is able to provide credit to business, on the whole the results show that it has been largely successful. The majority of businesses find that they are able to secure the funds they seek and that the loan or overdraft arrangements with their financial institution is generally satisfactory. According to the preliminary results of the survey, two thirds of respondents stated that their loan arrangements were either satisfactory or very satisfactory. More than three quarters indicated that their loan represented the amount sought from their financial institution.

This, of course, leaves a sizeable minority who were not satisfied with their loan arrangements and who received less credit than originally sought. These are commercial decisions. Proper scrutiny, by lenders, is required to ensure that financial institutions lend to those who will be able to repay their loans. Such judgements are the province of lending institutions whose commercial decisions must be the final arbiter in the lending process.

3. There are concerns with the operation of the financial system in its impact on business. The following data are in response to the question: *What parts of the loan or overdraft transaction could have been improved?* A large proportion of respondents specified the level of interest rates and the level of fees and charges as important areas where improvement could have occurred. The interest rate issue is rendered more difficult since interest rates are not just determined in the market place but are also used as a policy instrument to slow the rate of inflation. Bank charges, on the other hand, are determined as a commercial decision.

Table 3
Areas of Possible Improvement in Loan Arrangements

Interest rates	75.6
Fees and charges	63.4
Collateral requirements	24.4
Amount received	24.4
Length of time taken	22.0
Understanding of business	19.5
Pay back period	17.1
Communication	9.8
Manner of treatment	4.9

ACCI **- Survey of the Australian Financial System (preliminary results)**

The collateral requirements of financial institutions causes a significant degree of concern amongst business. Around one quarter of respondents expressed dissatisfaction to some degree with the collateral requirements imposed on them by their financial institution. The same proportion indicated concerns about the amount of finance received. There was a similar degree of dissatisfaction with the time taken to process loans and with the pay back period specified in the loan arrangement. Around one in five indicated that there was a failure on the part of the financial institution to understand the business. There was less indication of concern in regard to the processes of communication and in the manner of treatment by the financial institution.

Financial institutions are private sector businesses which offer financial services to the public in order to make profits for their owners and shareholders. Prudential requirements for the system as a whole should mean that few pressures, other than the forces of the market, are placed on the financial system in regard to interest rates and charges. The existence of a widespread perception that interest rates and charges are excessive needs to be recognised and dealt with. The most important issue must be to communicate with the users of financial services to explain why charges are at the level they are.

There is a possible role here for the banking ombudsman to examine the costs and charges of the banking system and to report periodically on their inter-relationship. There may be various forms of market failure involved which blunt the ability of market forces alone to rein in price movements. Since a relationship with any particular financial institution reduces mobility there is always the potential for charges to rise over time during an established relationship.

For all that, a banking relationship is a commercial dealing in which the overriding consideration should be the law of contract. There may be losses to the community in excessive charges and rates although the existence of such excessive charges is far from having been established. However, the losses to the community of institutional failure would be greater still.

To ensure that charges are kept to the minimum, the aim should be to create as competitive an environment as possible in which banks and other financial institutions operate. There is no role for the government to regulate the fees and charges of financial institutions.

4. In regard to mergers of large financial institutions there is little reason to believe that the financial system would benefit from amalgamations. The result would be a concentration of financial assets in fewer institutions which would increase the riskiness of the financial system without necessarily providing benefits to consumers. The larger the institution, the more risk there is to the community in general of a failure.

   The evidence in favour of amalgamation would have to be overwhelming for the rest of the business community to wish to encourage a reduction in the number of large financial institutions. Evidence that larger is better or more efficient is lacking. As a general principle, competition amongst lenders is better for the economy than is decreased competition.

5. There may be little advantage from an economy-wide point of view of there being a single regulator. Indeed, there are various costs in terms of instability in having a single regulator for all types of financial institution. The differences between institutions are probably as important as their similarities. A homogenised single regulator is unlikely to be sufficiently able to understand the differences between financial institutions where nuance and history are crucial in the development of a proper regulatory environment.

   The most important role of a regulatory agency is the creation of conditions favouring financial stability. The banking system is sufficiently different from other financial institutions to demand a regulatory authority which understands the complexities of banking operations. This is equally true of other areas of the financial system. It is important not only in terms of the performance of the financial system but also in terms of external perceptions.

Confidence in the financial system as a whole means there is also confidence in the form of regulation. A super-regulator which is unable to understand the detailed operation of the institutions it is regulating would lead to a fall in confidence in the financial system. The most prudent course is to continue with separate regulators for different financial institutions. Consideration may however be given to whether there is sufficient communication and discussion between regulators. Greater coordination between regulators may provide important advantages and enhance the stability of the financial system.

6. One of the most important advantages in a single regulator is the creation of conditions of competitive neutrality. Amongst the major aims of the regulatory system should be the creation of conditions which ensure the existence of competitive neutrality between products and institutions. The form of regulation should not provide an institution with an advantage in the marketplace when competing against other providers of similar or identical products. For example, if banks offer an insurance product they should be bound by the same controls in regard to those products as are insurance companies. Such competitive neutrality could obviously be best achieved with the introduction of a super-regulator.

The creation of a super-regulator would ensure that the label attached to an institution and therefore the relevant regulator would not lead to institutions being able to compete unfairly against other institutions under different regulatory regimes. Similarity in the rules of the game affecting all institutions would be an advantage along the lines of the arguments on level playing fields. Regulation should not have an impact on transactions which are made by or through different financial institutions. This is the critical argument in favour of a super-regulator and it is one which has a great deal of merit and warrants careful consideration.

However, more crucial than competitive neutrality are considerations of the stability of the financial system. ACCI's concerns in regard to a super-regulator stem from its view that a single regulator for all forms of financial institutions would not be sufficiently aware of the important differences between institutions. A one regulator fits all approach may increase the riskiness of the financial system rather than diminish such risks arising from a lack of focus on the particular prudential requirements of the different institutions.

Moreover, it seems from the question on perceived security in different forms of saving instruments, there is already a differentiation between existing financial institutions in the minds of business people. The marketplace provides information to individuals who make decision based on the perceived costs and benefits. Different assessments of risk are built into this calculation.

As part of ACCI's survey the following question was asked: *How confident would you feel about the safety of your money kept in the following forms?* The results (found in Table 4) show a clear discrimination between various forms of savings instruments.

The ranking of the perceived safety of different forms of savings are as follows, with the index level, as calculated by ACCI, attached:

. deposits at bank 87.9

- building society/credit union 72.1
- capital guarantee investment 56.6
- units in superannuation fund 55.6
- property trust 48.1
- market linked investment 42.9.

Table 4
Confidence in Different Forms of Savings Instruments

	CONFIDENCE OF SAFETY				
	Extremely confident	Very confident	Moderatly confident	Less confident	Not at all confident
	PCTN	PCTN	PCTN	PCTN	PCTN
AREA					
a) Deposits at your bank	64.0	32.0	2.0	2.0	.
b) Deposits with building society/credit union	6.8	50.0	27.3	15.9	.
c) Property trust	.	25.0	34.1	36.4	4.5
d) Capital guarantee investment	8.9	51.1	17.8	22.2	.
e) Units in superannuation fund	10.6	57.4	8.5	21.3	2.1
f) Market linked investment	.	33.3	31.1	28.9	6.7

ACCI **- Survey of the Australian Financial System (preliminary results)**

The difference in perceptions indicates the existence of a market in which distinctions are made. The market is able to differentiate at least to some extent between products with their different forms of regulation, and assessments are made accordingly. Whether the full difference in risk is incorporated in the decision making process is difficult to judge. But if the choice is between regulating institutions or products, the better course is to continue to regulate institutions.

If, however, the decision is made to introduce a super-regulator, then it would be imperative that the regulatory aspect of the Reserve Bank’s role be made entirely independent of the administration of monetary policy. This may in fact be an appropriate approach even if the current system of regulation is maintained.

There will be some competitive problems when different institutions offer similar, or even identical products. Where the problem is more likely to lie is in legislation rather than in the role of the regulator itself. But wherever the differences might occur, it is highly likely that the market will be able to discern differences and make decisions accordingly.

Appendix

Interest Rates and Inflation Control
Excerpted from ACCI's 1996 Pre-Budget Submission

In theory, variations in interest rates are used to control the rate of inflation. Interest rates, however, do not for the most part directly affect prices. Indeed, if rising interest rates have any direct effect at all it is to raise the price level since higher rates tend to increase the cost of production and are incorporated as part of consumer debt interest and mortgage costs in the CPI.

As a means of inhibiting inflation, higher interest must therefore slow the growth in other parts of the economy which do have a more direct influence on the price level. Over the past decade, interest rates have been used to contain the rate of economic growth, the current account deficit, movements of the exchange rate and movements in nominal wages as a means of controlling inflation.

Unfortunately, interest rates also directly affect the level of investment and the level of employment. Indeed, the means to control inflation is to slow the rate of economic growth. There is thus a high price to pay for using interest rates to slow the movement in prices.

The table below shows the cost in foregone output, over the course of a five year period, if the Australian economy maintains an average rate of growth one percentage point lower than it is capable of growing. The difference between growing by 3.5% a year and 4.5% a year over five years leads to a difference in output levels of more than $75 billion in constant 1994-95 dollars.

The cost to the economy is of course larger the larger is the difference in potential GDP and the actual. Thus if the economy grows at an average rate of three per cent or less, then the cost to the economy would be far larger than even the $75 billion shown. This loss of production is the apparently forgotten overall loss to the community of slowing economic growth.

Slowing the economy reduces, by design, the level of national production. These actions keep the Australian economy less wealthy than it might otherwise have been. They lower real incomes below levels that might otherwise have been reached. They lower the production of exportable goods and services below levels which would otherwise have been attained and make the repayment of international debt more intractable.

These considerations apply even more in regard to investment. Interest rate increases lower investment spending. Businesses are deterred from borrowing to invest not only by variations in interest rates, but also by concerns that rates might rise. Continuing discussion about the prospect for higher rates can and does deter business from investing when they might otherwise have done so.

There is thus an enormous cost in attempting to lower inflation through variations in interest rates. ACCI believes that the application of monetary policy in the absence of other policy instruments is too blunt and unfocused when used as a first resort. The Australian economy has slowed significantly over the past year in large part because of the tightening of monetary policy which occurred during the second half of 1994.

Comparison of the Effect on National Output of an
Average Growth Rate of 3.5% per Year Compared with 4.5% per Year

Period	Output Level	Output Level	Difference

	if Growth Rate is 3.5% p.a.	if Growth Rate is 4.5% p.a.	
	$m	$m	$m
Current	450000	450000	
1st year	465750	470250	4500
2nd year	482051	491411	9360
3rd year	498923	513525	14602
4th year	516385	536633	20248
5th year	534459	560782	26323
Cumulative difference			75033

There has been a slowing of the inflation rate, but this has come at a very large cost in terms of lost production. The growth in non-farm product at the end of 1994 was 6.5%. At the end of 1995 it had fallen to 2.6%. While the earlier growth rate in economic activity could not have been maintained, it is equally unlikely that growth would have fallen to the extent it has had interest rates not been raised.

In the view of ACCI, interest rate policy has been applied too hard and too soon. It has lowered economic growth and slowed the improvement in productivity. Employment has slowed as well and the unemployment rate has been significantly higher.

The issue at this time is whether it is acceptable to slow the level of economic activity, upon which Australia's prosperity depends, as the means to slow the movement in nominal wages. Business finds this approach to economic management unacceptable.

There are other less economically damaging methods to contain inflation. Inflation policy should be conducted through a combination of deficit reduction, decentralised wage determination and the careful management of the processes of credit creation. Interest rates should in general only be raised to counteract excessive increases in credit. There is little reason to believe that a speculative boom in the demand for credit exists at this time.