Submission to the Financial System Inquiry

9 September 1996

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Content

Executive Summary

Responding to the challenges brought about by deregulation, the financial services sector has become more understanding of, and responsive to, their customers. Greater competition has placed profits and margins under constant pressure, and improved productivity has been a key objective for all players. Innovation has focused on technology, with rapid advances in capability allowing financial institutions to provide a higher level of service and convenience while driving costs down.

Technology will continue to have a major impact on the way financial services are provided, for example ‘value networks’ are emerging (see page 8). With easier access to worldwide service providers, consumers will experience an unprecedented level of choice, and will never have been so at risk.

The challenge moving forward is to develop a regulatory framework which balances the need for system stability and the need to allow financial institutions to compete at a global level, with the need to provide some basic protection for consumers.

Australia needs a regime that is consistent with, and no more onerous than, that of our major trading partners. Any regulation, for which the consumer ultimately pays, must be seen by the consumer to be adding value.

The current regulatory regime in Australia works reasonably well, although some compliance costs could be reduced. Any refinements should be made iteratively, whilst maintaining sufficient flexibility to accommodate the market and technology-driven changes that are likely to benefit Australian financial institutions in the foreseeable future.

Overall, deregulation has been a success. A further reduction in regulation can assist Australian financial institutions to become global players, able to take full advantage of technology and also lower their costs. If this process is impeded by inappropriate regulation, overseas institutions will gain an increasing share of Australia’s financial services business.

However, a radical change to the regulatory structure of the system is not necessary. Any radical change to regulation based on an attempt to forecast future industry structure and conditions would only be as appropriate to the forecast on which it was based, and in the meantime, is likely to impose unnecessary inefficiencies and costs on the system.

In specific terms, we believe the current Australian regulatory model is fundamentally sound. It needs to be refined at the margin to accommodate market developments (such as the emergence of value networks) and maintain enough flexibility to cope with the speed of such developments.

Our recommendations are:

1. Regulation necessary for consumer protection should be balanced with the need to reduce regulation where possible to lower costs.

2. Barriers which restrict global competition should generally be removed.

3. In order to cope with technological developments and the emergence of 'value networks', the regulatory framework should be flexible and enable flexibility in the financial system. Refinement and iterative change, rather than a single radical change to the current regime, is required.

4. Government guidelines or industry codes of practice should be adopted where possible, as opposed to introducing regulation.

5. Regulation (including taxation imposts) should be consistent around Australia and, where possible, in line with major overseas jurisdictions.

Introduction

On 30 May 1996, the Government announced its decision to establish an Inquiry into the financial system, to undertake a stocktake of financial regulation, seek to establish a common regulatory framework for overlapping financial products, and to propose ways to deal constructively with further financial innovation.

The Inquiry

The Treasurer directed the Inquiry to analyse the forces driving further change within the financial services industry, in particular, technological development. The Inquiry is to make recommendations on the nature of regulatory arrangements that will best ensure an efficient and competitive financial system, balanced with financial stability and fairness.

Ernst & Young's Submission

Since 1991, Ernst & Young has undertaken an annual survey into technology in banking, with the objective of evaluating the role of technology in enabling the bank of the future, 'The Virtual Bank', to become a reality. The last two surveys (1996 and 1995) were conducted at an international level, involving 40 of the top US banks, (including 5 of the top 10), 14 of the top 15 Canadian banks, 9 of the top 13 Australian banks, and 27 banks from the UK, Germany, Austria and Switzerland.

In light of Ernst & Young's expertise in this area, our submission focuses on technological developments and the resulting implications for the regulation of the Australian financial system. It raises key issues which have influenced the implementation of new technology.

The Choice, Quality and Cost of Financial Services

Any analysis of government regulation must have regard to both the costs and benefits of the regulation. The cost of regulation eventually falls on consumers through higher prices and charges, or on taxpayers through increased taxation. Government regulation also tends to restrict competition and innovation.

The costs of regulation include:

- the direct costs to Government of imposing regulation;
- the costs to companies in complying with regulation;
- the opportunity cost to companies when restricted in the way they are able to conduct business; and
- reduced competition when entry barriers allow monopoly situation and artificially high profits to be taken.

The benefits of regulation include:

- a stable and secure market in which to conduct business;
- consumer confidence in the financial system, necessary for the generation of savings;
- increased information enabling consumers to make more informed choices;
- protection of the weak; and
- losses as a result of company failure are spread over a wide cross section of the community, and not simply borne by the policyholders or depositors directly involved.

The value of these costs and benefits is difficult to measure. Some consumers rely heavily on the benefits regulation provides, while others do not. The level of regulation established should have regard to community expectations and values, yet be balanced with the costs of imposing it. Higher charges for financial services which are caused by regulation are resented by consumers if there is no perceived benefit.

The effect of regulation can be achieved with less cost through the use of behaviour guidelines issued by Government to industry, or by industry associations introducing Codes of Practice aimed at self regulation by members. Government regulation should be seen as a last resort and only introduced after other options have failed or been rejected.

Complex compliance rules can greatly increase the cost of regulation, so too can duplicate or overlapping regulation. An example of poor Government intervention in the marketplace is transaction taxes, discussed further on page 16 of this Submission.

New regulations introduced without an effective evaluation of the costs versus the benefits can add substantially to cost of conducting business. An accumulation of costly, ineffective regulation results in higher prices and consumer dissatisfaction in the local market, and the likely failure of Australian financial services companies to be competitive in overseas markets.

Irrespective of who regulates the various players in the financial system, regulation should be flexible and regularly monitored to ensure it reflects community attitudes and needs.

The Factors Likely to Drive Further Change

Ernst & Young's annual survey on Technology in Banking issued in May this year, titled *Creating the Value Network*, revealed that **one** viable virtual banking model has begun to emerge.

Many banks took their first steps towards building 'value networks' and, in the process, discovered the massive potential of virtual banking.

Value Networks

'Value networks' are formed when banks and other financial services providers collaborate to offer their customers comprehensive packages of financial services, which are delivered by branch officers and various electronic channels.

Value networks take their name from the fact that they offer valuable financial solutions to customer groups. Most often these value networks involve alliances between different financial services providers or business units, each focused on one of the key financial service competencies (eg transaction processing, assets management, customer/market management and network management itself).

Technology makes the network of multiple organisations possible, but it does not guarantee that it will be valuable. To do that, value network participants must know who their customers are, what they need, and how they wish to be served. With these questions answered, management can focus on their core competencies and partner with other organisations to acquire the necessary competencies they do not possess.

This revolutionary trend is being driven by electronic commerce and the potential it gives enterprises to form alliances and create value networks of competencies.

In tomorrow's marketplace, the best chance of survival is to join with other financial services providers to build value networks that deliver the full spectrum of financial services to customers through an array of delivery channels. Total financial service is the goal and value networks are the best means of reaching that goal.

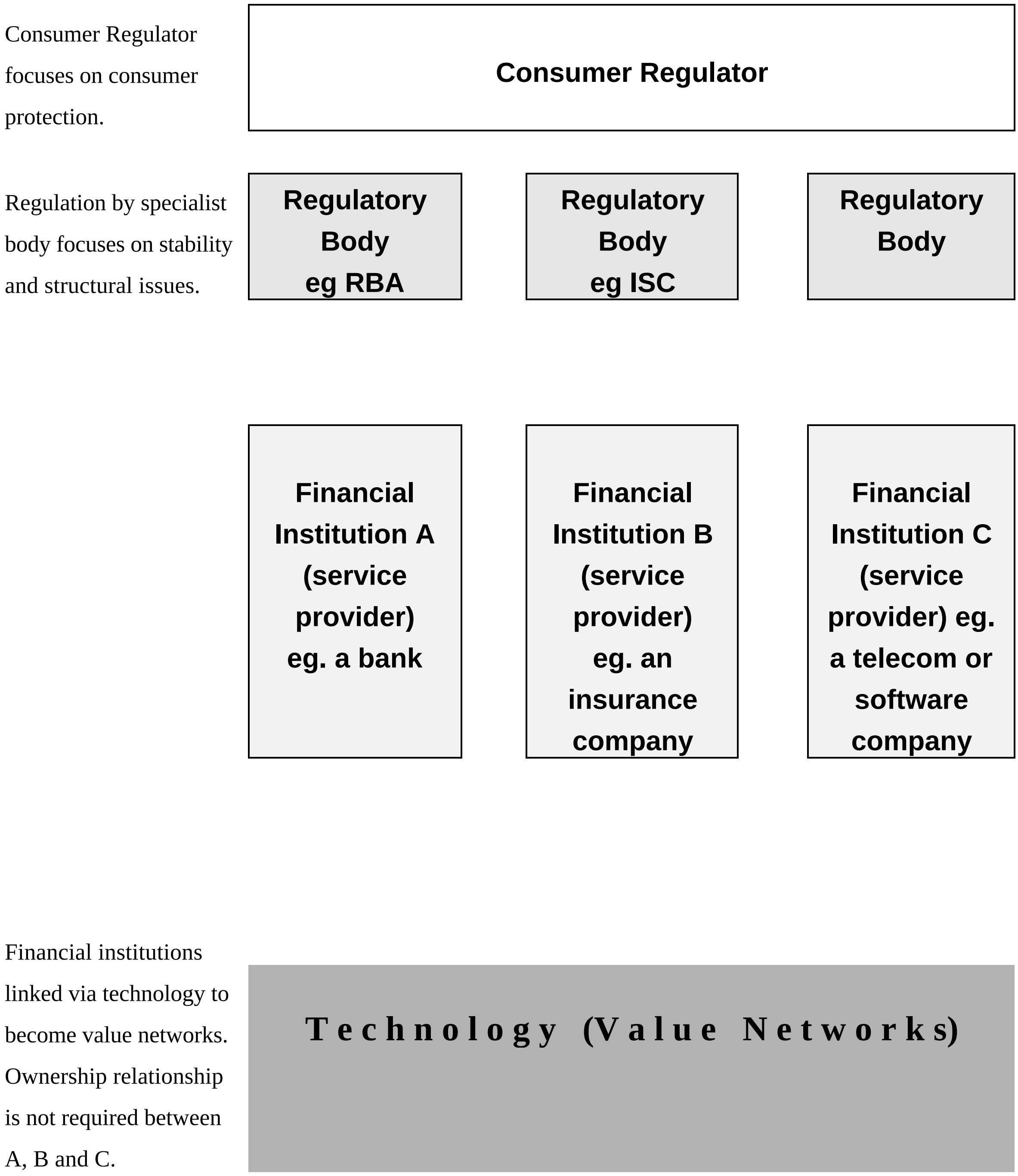
The Implications for Regulation

Value networks serve to simplify the regulatory framework required to ensure a stable financial system, as the formal link between service providers is mostly technological, as opposed to a more complex ownership structure. (In some cases, service providers may chose to invest a small amount of equity in the provider with whom they have established a value network, but this is not essential.) Basically, service providers focus on their **core business** and can be regulated by a body which is equally focused on its speciality.

Australia's existing regulatory framework can cope with the development of value networks. A radical change is not required. The necessary adjustments would primarily be to ensure the system is flexible enough to accommodate change efficiently and effectively.

An important point is that the common ownership of service providers (for example, a bank and an insurance company owned by a holding company) should not affect the kind of regulation that is most effective and efficient for each of those service providers and the system. While the individual regulators should be able to share regulatory information, for example though a lead regulator for each institution, consolidated capital adequacy measures are not necessarily relevant and may lead to inappropriate levels of capital and cost.

A framework for regulation of value networks



Value Networks in Australia

The value network is clearly developing in Australia, where cross-selling of a wider range of banking and financial services is assuming growing importance in retail banking strategies and infrastructure development. However, the trend so far is towards the bancassurance model of delivery, rather than a partnership of different providers linked together by technology.

The 'go it alone' approach of the larger banks will likely force banks to compete with the specialised providers of new bank services in terms of core competencies, cost, quality of service, and customer expectations. For this reason, many banks may ultimately need to evolve into virtual banks and establish integrated partnerships with best practice providers. This evolution will support the development of an efficient, highly customer-responsive financial services market in Australia, able to compete locally and internationally. Value networks will make this evolution both technically and financially feasible.

Customer Perceptions

Customers are demanding a wider range of services and expect 24 hours a day services. They are prepared to shop around for the lowest price. They are increasingly aware of, and accepting of, non-bank products and services, and are constantly seeking better service, at lower cost.

In light of their virtual banking capabilities, financial experience, long standing customer relationships and widespread retail franchise, banks have an opportunity to build successful, profitable value networks. At this point in time, banks are still viewed as **safer** than other institutions by the majority of consumers, but this perception is changing, evidenced by the quick acceptance of mortgage originators and their growing share of the home loan market.

However, the regulatory regime should not of itself create inappropriate customer perceptions. For example, this could occur if the Reserve bank regulates building societies and credit unions under the same system as the banks, without some appropriate distinctions being maintained between different kinds of institutions.

Many other non-bank financial institutions are addressing these very same issues. They need to become full service organisations offering a much wider range of financial services and products if they are to retain the long term loyalty of their customers. If banks do not take advantage of their legacy and expertise to establish primary roles in the coming networks, they will continue to face dwindling market share.

Customer demand for global reach is helping to eliminate remaining national boundaries. On-line, real time banking across all time zones now appears to be only a question of resources and political barriers, which are likely to be overcome in the near future.

Globalisation

Significant developments are expected within the global banking industry within the next few years. A new era in banking will begin with the spread of international virtual banking and electronic financial transactions. Banks will be a position to broker electronic commerce over global area networks.

The real time nature of these technologies will allow banks to configure and re-configure their capabilities, associations, products and services to meet customer needs.

While electronic commerce exists in many forms today, full banking global capabilities have yet to come into being. They await technological maturity and regulatory reform. However, evidence of the transformation to a cosmopolitan, integrated marketplace can already be found within many bank organisations.

Meanwhile network and systems architects are working to quickly expand electronic commerce and virtual banking capabilities. Unconstrained by traditional banking regulations, such companies may significantly encroach on the traditional market and role of banks.

Implications for Australia

The issue of globalisation will have a significant impact on Australian banks and the Australian market. Australia is positioned to be an important country for global banks operating within the world's fastest growing region - the Asia Pacific region.

Technology provides an attractive means of enabling large global banks to position themselves as powerful players in serving international organisations throughout the entire Asia Pacific region, as well as throughout the world.

Huge knowledge networks, together with powerful alliances and value networks, will facilitate the provision of a wide range of products and services in the most efficient and cost effective way. However, this is an evolving scenario and its ultimate shape cannot be meaningfully forecast with enough precision to allow a regulatory model to be designed with it as a basis.

The current regulatory regime in Australia works reasonably well, although some compliance costs could be reduced. Any refinements should be made iteratively, whilst maintaining sufficient flexibility to accommodate the market and technology-driven changes that are likely to benefit Australian financial institutions in the foreseeable future. A radical change to the regulatory structure of the system is not necessary. Any radical change based on an attempt to forecast future industry structure and conditions would only be as appropriate as the forecast on which it was based, and in the meantime, is likely to impose unnecessary inefficiencies and costs on the system.

In specific terms, we believe the current Australian regulatory model is fundamentally sound. It needs to be refined at the margin to accommodate market developments (such as the emergence of value networks) and maintain enough flexibility to cope with the speed of such developments.

The Efficiency of the Financial System

Less Regulation - Less Cost

Many consumer protection rules are directed at processes rather than outcomes. They dictate the method by which an objective is to be achieved. Such rules hamper the development of new and improved procedures or systems, and add to consumer costs.

Technology has the potential to significantly reduce industry costs making Australian companies more competitive in domestic and overseas markets. If regulation continues to be restrictive, it will inhibit the pace of change.

Technology can effect the costs and the benefits flowing from regulation. For example, new technology may lead to a reduction in the direct cost of supervision by government authorities.

Balanced with Protection

With the introduction of new technology comes concern over privacy issues and the community may seek to induce the Government to offer some forms of protection in this regard. Limitations on the extent and nature of information available to companies and how companies could use such information could have a significant effect on how new technology could be used.

Community and consumer groups may also wish to limit the impact of technology, to ensure a minimum standard of finanical services is available to the entire community. Technology will enable financial services providers to identify profitable market segments and also high risk groups. This could lead to a situation where the less fortunate find it difficult or expensive to undertake even basic financial transactions.

However, these issues need not always be solved by increased government regulation. Consideration could be given to less interventionist methods, such as the Government industry guidelines or the introduction of Codes of Practice.

Transaction Taxes

Complex compliance rules can greatly increase the cost of regulation, so too can duplicate or overlapping regulation. A clear example of this, is Australia's transaction taxes, namely Financial Institutions Duty (FID) and Debits Tax (BAD). The issues surrounding FID and BAD show how government regulation in respect of taxation can cause administrative difficulties for companies and hamper the development of new technology.

FID and BAD are transaction taxes that are generally considered to reduce the efficient operation of the banking and finance industry in Australia.

FID is charged to financial institutions and other similar entities in the various States and Territories of Australia, excluding Queensland. The duty is charged on selected 'receipts' of the financial institutions and other entities and is imposed at varying rates including a concessional rate for short term dealings.

BAD legislation has been enacted in all States and Territories. BAD is imposed in taxable and eligible debits in excess of $1 made to cheque accounts held either with a financial institution or a non-bank financial institution.

In terms of FID, the NSW FID Committee, chaired by Bruce Buchanan, Executive Director of the Office of State Revenue (OSR), issued a discussion paper in 1990 'FID - A Better Way'. The Committee found that:

> *'FID cannot be collected in an efficient way because of the uncertainties and difficulties in the interpretation of the legislation as it applies to individual transactions...*
>
> *'Comprehensive computerisation of... collections of FID also is hampered by many exemptions and the different treatment in the legislation of short term dealing receipts...*
>
> *'Neither taxpayers not tax collectors understand fully the FID legislation'*

The banking and finance industry has evolved extensively since the introduction of the FID legislation in 1982. FID was originally imposed on a 'paper' based system relating to the receipt of cash and cheques, when banking transactions and relationships were simple.

The growth in number and complexity of financial products, as well as the removal of traditional banking structures (for example, Savings Banks), has meant the imposition of FID has become arbitrary. The tax was created when electronic and paper-less banking transactions rarely occurred and the significant growth in this area has caused a range of difficulties.

Some of the problems that are encountered in complying with the legislation include:

- Australia is the only country to levy FID. This has been identified as a major barrier to entry into the Australian market for foreign banks.

- No jurisdictions have the same set of exemptions (for FID or BAD) and Queensland customers must be treated differently by bank systems as there is no FID imposed in that State.

- The concessional rate of duty is calculated differently in each State and Territory and compliance costs are high, for example,

  NSW - the duty is calculated as 0.005% on 1/3 of the average daily short term liabilities during the month of the dealer or group in respect of Australian based operations.
  VIC - the fraction is 1/3
  WA - the fraction is 1/10
  SA - the fraction is 1/12
  ACT, NT and TAS, the liability is restricted to their particular State or Territory

  Sophisticated systems need to be developed to identify short term liabilities and appropriate programs developed for the concessional rate of duty to be calculated according to the seven designated formulas.

  Consequently, any amendments to the FID legislation affect the compliance and reporting systems of institutions, resulting in considerable compliance costs.

- Some exemptions are available if the customer obtains a certificate of exemption from their Revenue Authority, but many other exemptions do not require a certificate. This necessitates a large historical tracking system which is cumbersome.

- The development of electronic banking (EFTPOS, Store Value Cards, the Internet) offers new challenges for the FID legislators, as the transfer of funds can occur without the need to pass through a financial institution. This will ultimately result in a reduction in amount of tax revenue collected. It will also result in the tax being imposed on a smaller portion of the community (ie those persons who cannot afford sophisticated banking arrangements to reduce FID and BAD and who are locked into cash/cheque transactions).

- Both taxes also, within the scope of their application, encourage inefficient banking practices, for example lodging ‘bundles’ of cheques to an account to take advantage of the $1,200 cap, rather than a series of electronic transfers which would be efficient.

FID and BAD are seen domestically and internationally as outdated practices which impede the efficient operation of the banking and finance industry in Australia.

Recommendations

1. Regulation necessary for consumer protection should be balanced with the need to reduce regulation where possible to lower costs.

2. Barriers which restrict global competition should generally be removed.

3. In order to cope with technological developments and the emergence of value networks, the regulatory framework should be flexible and enable flexibility in the financial system. Refinement and iterative change, rather than a single radical change to the current regime, is required.

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Appendix I

Ernst & Young Credentials

Ernst & Young is one of the world's leading professional services firms.

Our client base extends to 25% of the world's major corporations and we employ over 70,000 people in more than 660 offices in over 130 countries. We offer clients industry expertise through dedicated focus groups, including a global banking and financial services group.

Internationally, Ernst & Young serves the head offices of more commercial investment and merchant banks than any other Big Six firm. In commercial banking, we audit 18% of the top 100 banks and 19% of the assets of the top 100. In investment banking, we audit 40% of the top 20 banks.

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