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Australian Bankers' Association

Submission to the Financial System Inquiry

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Overview of Key Issues

The submission provides a foundation—a core of common ground in the industry around which each bank will have its own views based on its individual judgement, commercial interests and perspective. It is not possible to cover comprehensively the views of all institutions across such a diverse and competitive industry as is banking in Australia today. A number of the ABA's members will make their own submissions to the Inquiry.

Focus on Banking

While the ABA's members have interests that range widely across the financial system, their common core business is banking. The prime focus of this submission is thus banking—although considered in the context of the financial system as a whole, and with comment provided as appropriate on issues arising in that wider context.

Sources of Change

The Government's initiative to review the financial system is timely. The financial system has seen considerable change since the last major round of review, undertaken by the Campbell Committee and followed up by the Martin Review Group. Over the past two decades, pressures for change have come from the customers of financial institutions, deregulation and other policies (notably on superannuation), technological change and the globalisation of financial markets (in some market segments).

These changes have interacted with one another to produce wide–ranging and at times quite rapid evolution in the marketplace. There has been both 'convergence' as different kinds of financial institutions have diversified into each others' traditional market segments, and disaggregation (or 'deconstruction') as new competitors have entered particular component activities (e.g. loan origination). Change will continue to pose challenges to institutions and the regulatory framework.

Essentially, the challenge for both is to be *adaptive to change*—so that the Australian financial system remains at the forefront in how, and how efficiently, it meets the needs of Australians and the Australian economy, and in so doing is globally competitive.

Key Objectives for the Inquiry

In the ABA's view the key objectives for the Inquiry are, therefore:

(i) To remove impediments to, and provide stimulus for, *enhanced competitiveness and efficiency*;

(ii) To *maintain safety and stability* of the system; and

(iii) To provide a framework for *increased flexibility*, so that financial institutions can meet the needs of their customers in whatever way delivers best value to those customers.

The objective of maximum flexibility to adapt to change requires that financial institutions be as free as possible to determine the configuration of their businesses and that the regulatory framework is not prescriptive about this.

Privacy regulation and regulation of the electronic provision of financial services are two further areas where flexibility, efficiency and competitiveness need to be given substantial weight, primarily in the interests of providing better services to customers, enhancing efficiency and utilising the full potential of technology as it evolves.

Need to Maintain Integrity of Payments System, Security of Deposits

In ABA's view, a most fundamental requirement in the pursuit of the objectives stated above is to maintain the *integrity of the Australian financial system* and in particular, to maintain the *integrity of* its core—*the payments system*—both in substance and in perception. Few parts of the nation's infrastructure are as important to the efficient conduct of modern commerce and to the confidence of all members of our society and its institutions in their financial inter–relationships as is the payments system.

ABA therefore considers that high standards must be maintained for permitting access of institutions to the payments system and its close adjunct, the provision of deposit facilities to the public. Deposits are a major point of access to the payments system for consumers; people must be able to use them with confidence without having constantly to make laborious checks about their security. Their protection, and protection of the integrity of the payments system itself, are integrally related.

Competition and Open Entry to Banking

ABA does not argue for a closed shop in payments transactions and deposit–taking—which are, together with lending, the core of banking. On the contrary, ABA welcomes competition—noting for example that the deposit market is already a wide market for a diverse range of products. ABA believes that in the interest of customers, participation in this market and in the payments system itself should be open to any financial institution which can meet the necessary tests—sufficiency of capital, the ability to access substantial liquidity in a very short timeframe, and other prudential requirements.

Those institutions which can meet these tests and do participate should all come under a single Federal system of prudential supervision. Banks, building societies and credit unions would come under that single national system.

How the standards for access to the system are met and, therefore, status of the institution will need to be different for a mutual organisation. This may involve constraints on its ability to access capital or liquidity, but this is a matter that can be left to the regulator.

Depositor Protection

Depositor protection is an important rationale for prudential regulation of banking—to correct for the asymmetry of access to relevant information as between banks and their customers, and simply to make it feasible and efficient for depositors and transactors to do business without the need to constantly check on the soundness of all of the institutions involved.

Depositor protection while needing to be an explicit objective of regulation does introduce an element of risk (in public policy terms)—in terms of opening up the possibility of people mistaking that protection objective for a ‘guarantee’ and encouraging a degree of ‘moral hazard’ behaviour—i.e. encouraging people to take less responsibility for making an informed choice about the institutions with which they do business; and institutions to take on more risks than they otherwise would.

ABA believes that ‘moral hazard’ is a manageable issue and that the overriding need to maintain confidence in the system warrants the continuation of an explicit depositor protection objective in the regulatory framework, along with the objective of maintaining the integrity of the payments system.

Specialisation in Prudential Regulation in a Converging Financial System

ABA notes that since it is *institutions* which either stand behind their products or fail, institutions must be the prime focus of prudential supervision and how it is organised, rather than generic functions. While convergence and disaggregation are occurring in the financial system, nevertheless at present, and for a considerable time to come, most banks and indeed most other distinct types of financial institutions (such as insurance companies) will most likely continue to be identifiable in terms of which is their dominant business. Moreover, the skills of regulators supervising different types of financial institutions, particularly banks on the one hand and insurance companies on the other, will continue to be quite different—given the very different nature of their balance sheets.

With banks, the asset side requires very distinct expertise; with insurance companies, this is true of the liabilities side. ABA therefore considers that prudential specialisation basically by institutional type continues to be appropriate. For banks, the Reserve Bank’s responsibility for stability of the currency makes it the natural regulator.

There is, however, a need to recognise that many financial institutions in the 1990s are diversified financial services businesses or ‘conglomerates’, even if most still have a dominant core business. There is therefore a need, which the

Inquiry must address, to ensure that the regulatory framework provides for close and effective coordination between the respective regulatory specialisations which oversee the different activities (banking, insurance etc) of a financial institution with diverse interests.

The Lead Regulator Model

ABA believes that the best balance is struck by the 'lead regulator' model, under which there are distinct regulators for banking, insurance/superannuation and related activities, and securities markets—with one of the specialist regulators being designated as the lead regulator for each particular institution. That lead regulator should be responsible for applying regulations at the top, or holding company, level whatever the structure of the institution concerned below that; and, importantly, for ensuring close and effective consultation so as to monitor the aggregation of risk from all component businesses to the level of the group as a whole. In the event of difficulty, a critical role of the lead regulator will be to ensure a timely, well coordinated and effective response.

The direct costs of prudential supervision can be legitimately passed on to all participants in the sector concerned, and thence on to users. At present, however, banks pay far more through the 5 percentage point reduction from market rates paid on their non–callable deposits. This is not warranted as a charge for regulation but is largely a tax.

Competition Policy in the Financial System

In the unfolding environment for the Australian financial system, it is clear that every player is exposed to strong competitive forces. Further, there is no obvious reason not to apply in this sector the general principles of national competition policy—with proper regard to what are the relevant markets, something which will always be evolving. ABA sees a need, however, to apply competition policy in an expedited way in situations where a financial institution may be in difficulty. The Treasurer should have the power to allow, or disallow, a merger between banks or between a bank and another financial institution. This power should be used only for prudential reasons, on the advice of the relevant regulatory authorities, and not to pursue competition policy objectives where no significant prudential issue is at stake. Such an approach would among other things make the 'six pillars' policy of the previous government redundant.

In the body of this submission, ABA canvasses a number of more detailed issues, making recommendations where appropriate. A fuller summary of this submission follows this overview, and a consolidated list of recommendations follows that summary.

Executive Summary

1. The Australian Financial System

Introduction

The financial system is a vital part of the economy. Financial institutions and markets serve three main functions. First, they enable businesses, individuals and governments to trade financial claims, so that economic resources are allocated efficiently to where they are most needed. Second, financial institutions manage and ensure the integrity of the payments system, the core of commerce in any modern economy. Third, they facilitate the management and mitigation of risk. In carrying out each of these functions, financial institutions and markets benefit both individuals and the economy as a whole.

The customers of the financial system include households, firms and governments. Different forces for change have operated on each of these groups, and they themselves have created pressure for change.

The Australian financial system has seen major changes in recent decades. Pressures for better products and services from customers, deregulation and other policies (including on superannuation), technological change and the globalisation of financial markets (in some market segments) have interacted with one another to produce wide-ranging and quite rapid evolution.

There has been both ‘convergence’ as different kinds of financial institutions have diversified into each others’ traditional markets, and disaggregation (or ‘deconstruction’) as new competitors have entered particular component activities, e.g. loan origination.

Change seems set to continue; it poses challenges to both institutions and the regulatory framework. Australia is, of course, unique only in the detail; other countries’ financial systems are experiencing comparable change.

The State of Play

The financial system may be divided into two distinct sectors: the *financial intermediaries sector* (comprising banks, merchant banks, ‘non-bank deposit taking institutions’—building societies and credit unions—and finance companies) and the *managed funds sector* (comprising superannuation funds, life insurance companies and other funds managers). Participants in these sectors, and their customers, interact through important *market mechanisms* (e.g. exchanges for securities and derivatives; over–the–counter markets).

The market shares of institutions in the financial *intermediaries* sector have changed significantly over time. Since the mid 1980s, for example, banks’ share of the assets of financial intermediaries has increased substantially, while the share of building societies has declined—in part due to the migration of many of the societies to bank status.

The assets of life insurance companies and superannuation funds have grown rapidly in recent years as a result of preferential tax treatment, industrial award provisions for superannuation and the *Superannuation Guarantee* legislation, and demographic changes.

The primary regulator of the banks is the Reserve Bank of Australia. Building societies and credit unions are regulated by the Australian Financial Institutions Commission. The primary regulator for life companies and superannuation funds is the Insurance and Superannuation Commission.

2. The Banking Industry

The Role of the Banks

Banks are the major class of financial institutions in Australia, holding directly almost 50 per cent of the total assets held by such institutions, and substantially more through subsidiaries. As such, banks are crucial to the functioning of the economy. By specialising in the collection and assessment of credit information about their clients and in monitoring and ensuring the observance of their obligations, banks enable borrowers and lenders to overcome the information asymmetries and search costs which prevent or significantly impede their dealing with each other directly.

Central to banks' importance to the economy is their role in the payments system. By ensuring a safe and reliable payments and settlement system, banks enable payers and payees to be confident that they can exchange value through financial intermediaries without worrying that the transaction may not be completed due to the failure of an intermediary. The banks play a critical role not just in domestic payments but in international payments, supporting Australia's trade and investment links with the rest of the world economy.

As well as benefiting the economy generally, banks also benefit their own customers, shareholders and employees, and pay substantial taxes to governments. To meet the needs of their customers, Australia's banks have made significant investments in service channels and in new technologies. They have also succeeded in providing competitive returns for shareholders, and together they are major providers of employment.

The number of banks operating in Australia has changed over time. At present, there are 51 licensed banks operating in Australia in 44 banking groups, comprising four major banks, ten regional banks, 27 foreign banks and a few government and specialist banks.

Regulation

The banks are regulated by the Reserve Bank and the Treasurer under the *Banking Act 1959* and *Reserve Bank Act 1959*. The Reserve Bank is chartered to maintain "the stability of the currency" and pursue "the maintenance of full employment" and "the economic prosperity and welfare" of the people of Australia. The Reserve Bank has adopted the guidelines of the Bank for International Settlements (BIS) for the maintenance by banks of adequate capital reserves. Accordingly, banks are now required to maintain capital of at least 8 per cent of risk-weighted assets. Compliance with BIS standards provides an essential signal which helps Australian banks compete in international markets.

3. Deregulation of Financial Services: Benefits and Costs

Why Deregulation?

By the late 1970s, a variety of pressures were making financial deregulation inevitable. Regulations that had been designed to protect consumers and insulate the domestic economy were becoming ineffectual, indeed counter-productive. Australia could not effectively shut out international forces, and one cost of attempting to do so would have been a more and more insular economy. Domestically, new products and competitors were springing up outside the regulations in response to customer demand.

Major deregulations included the floating of the Australian dollar, the abolition of exchange controls, implementation of market determined rates of interest and the entry of foreign banks. Regulation had served to reduce the competitiveness of banks compared to non-banks (although banks themselves were able to compete to some extent via non–bank subsidiaries). When allowed to compete on even ground, the banks regained market share. This also strengthened the channels for effective monetary policy.

Benefits and Costs of Deregulation

There have been a host of innovations in the post-deregulation period. An enhanced choice of banking products and technological advances to enable more time and cost effective transactions, have been of great benefit to customers. For example, there is now a choice of over 500 cheque accounts, most paying interest and many of them charging no fees; in 1980 there were only 10 products, none paying interest and all charging fees. Access to services has expanded greatly; opening hours are much longer and there are over 6000 ATMs and 93,000 EFTPOS terminals, all hours telephone services and so on.

Customers now have the choice of a far larger number of institutions from which to source banking and financial services, due to the migration of non–banks into banking status, the entry of foreign banks and other players and the diversification of existing financial institutions. Competition in the sector has risen considerably and the cost of financial services has consequently fallen. In the 1980s, bank net interest spreads averaged over 4.5 per cent. Since 1990 the annual average spread has not exceeded 4 per cent.

Controls over interest rates, and quantitative controls on lending, had the effect of limiting the availability of credit to borrowers. When these and restrictions on the international movement of capital were lifted, the allocation of capital in the market could be determined more effectively by market forces. While difficult to quantify, the benefits of these allocative efficiency gains appear to be significant.

The end of the rationing of credit, and the advent of market determined rates of interest, has been of benefit to most users, although not necessarily to all of those who were formerly subsidised as borrowers. Adjustment to ‘user pays’ pricing is necessarily a lengthy process but inevitable in the new competitive environment. Pricing services in relation to their true cost encourages more economically efficient usage patterns and is inherently fairer, but considerably more education and communication is needed in the transition.

4. Trends in the Provision of Financial Services

Drivers of Change

Deregulation, customer demand, globalisation (in some market segments) and technological advance are the four key, interacting trends that are changing the structure and environment of the financial services industry—as they have done for more than a decade past. Perhaps the most influential driver is the customer—with banks and other institutions taking initiatives in response and technology playing a key enabling role.

These trends have led to the emergence of both niche players and ‘financial conglomerates’ which have taken advantage of the easing of entry barriers and blurring of boundaries between segments of the financial sector. All types of financial institutions are under increasing pressure to respond to increasingly demanding consumers who require mobile, flexible access to financial services at low cost.

There is an increasing trend to disaggregation (or ‘deconstruction’) of banking into component activities, with new players entering some such parts (e.g. loan origination or administration) without becoming banks.

Globalisation and Technology

Globalisation has been evolving since the mid 1970s, and has seen enormous growth in the flow of capital between nations. Financial groups need to achieve competitive scale in the delivery of financial services, particularly in the most internationally open areas. However, competitive scale is not necessarily synonymous with large scale, as in some activities technology allows more customised or smaller scale operations to be efficient. Improvements in technology have indeed proven critical to financial institutions in achieving and maintaining competitive advantage. Computer and communications technology have helped the industry become less labour–intensive and less reliant on ‘bricks and mortar’ networks.

Technology is enabling consumers to access services ‘anywhere, anyhow, any time’. It is now possible for retail banks to offer customers phone, automatic teller machine, fax and telebanking facilities—all of which offer alternatives to personal contact, while that also remains an option. But the technology based options enable potentially significant cost savings which improve competitiveness and deliver better services to consumers at lower cost.

Electronic and on-line banking are already here, but have yet to change the face of banking. However they have the potential for their effects to snowball and to affect financial service provision—to re-shape distribution, to provide further opportunities for new competitors to enter, and to open up cross-border banking far more widely to retail customers.

The take-up of on-line banking is at present more constrained by the rate of penetration of personal computers with modems than by the rate of provision of higher bandwidth, but will grow. Other technologies, such as smart cards, are currently being used as alternative forms of data and credit storage. While more expensive than magnetic strip credit cards, declining technology costs and convenience mean that multi–purpose cards have the potential to compete widely with cash for small value purchases in the relatively near future.

In the US, remote delivery channels for financial services have enabled institutions without extensive branch networks to enter areas of business traditionally restricted to retail banks. The most obvious cases are major funds managers who now offer transaction services via computers and the telephone. Software and telecommunications companies are also in the wings, indeed along with new players with no close past involvement with the sector or the technologies it uses. Some of these developments are emerging in Australia.

5. A Vision for the Financial System and Current Constraints

The Challenge

The market for financial services is now more competitive locally and globally than at any time in the past, and the one certainty for the period ahead is that the environment will be one of continuing change and increasing competitiveness. The challenge for Australian financial institutions will be to remain proactive, and to stay at the forefront of continuing change. Consideration of the nature of change, and how institutions can respond, leads to a vision of how the Australian financial system can be successful in the unfolding environment, and a focus on what constraints presently stand in the way.

Clearly, the way in which financial institutions utilise the emerging technologies and adapt their business configurations flexibly to focus on meeting their customers’ needs as the environment evolves will be critical to success. Not all changes will be the predictable outworking of present trends; some will be unforeseen and the key to success will be the ability to adapt.

Financial service providers are in the best position to identify their own key competencies and develop their own business strategies. Because one of the trends which seems likely to strengthen is the disaggregation of banking into component activities, these key competencies are likely to be best viewed in generic terms—for example, competencies in information processing or relationship management—rather than in 'banking' as such. Banks will nevertheless continue to be for many people the first point of contact with the payments system.

Current Constraints

Current constraints impeding banks (and other financial institutions) include some of the present prescriptive regulations, particularly those (e.g. some of the Reserve Bank's Prudential Statements) which restrict the configuration of businesses through which financial services are provided. Market forces should be allowed the major role in determining those issues, particularly in an environment of competition and continuing change subject to preserving safety and stability.

Given the rising need for flexibility, there should be an increased reliance on objectives–based regulation rather than rules–based regulation. That is, regulation should be designed and conducted to accept a variety of means from market participants, so long as they meet the ultimate objectives of the regulation.

The existing taxation environment in Australia also significantly restricts the ability of financial institutions to deliver products and services competitively; Australia's heavy reliance on transactions taxes drives away internationally mobile business. Australia's system of taxation of financial products also presents significant disincentives to saving and contributes significantly to an uneven 'playing field' among savings products and providers.

The regulatory and tax environment for financial services will impact directly on the economic efficiency of the domestic economy itself, but equally importantly, on the international competitiveness of the economy. Thus the framework of regulation for the financial services industry needs to be both competitive and dynamic—to ensure that Australia, in an ever–changing environment, fosters and maintains a comparative advantage in markets like banking, funds management and capital and encourages saving.

6. The Role and Objectives of Regulation in Financial Services

The Need for Regulation

Regulation provides the legal framework within which commercial exchange takes place. While some regulation is necessary in many markets, free and competitive markets generally provide the most efficient allocation of physical resources. Regulation always itself imposes costs, so the existence of some market failure does not on its own justify regulation.

In financial services, the case for regulatory intervention now rests largely on the existence of a market failure, viz asymmetric information between the purchasers and suppliers of financial services.

The main elements of the regulatory response are capital adequacy, risk management and disclosure.

A well-designed regulatory structure for the financial system should:

- maintain the stability and safety of the system;
- minimise the costs of regulation and maximise the consumer benefits consistent with the efficient allocation of scarce resources;
- be compatible with international regulation;
- be consistent with equality of competitive opportunity in respect of institutions, products and services; and
- adapt to market change.

Financial Regulation in Australia

The present financial services regulatory structure involves five primary regulatory agencies: the Reserve Bank, the Australian Financial Institutions Commission (coordinating State–based regulators), the Insurance and Superannuation Commission, the Australian Securities Commission and the Australian Competition and Consumer Commission. In addition, State authorities regulate miscellaneous types of institutions. Consumer protection includes State-based consumer credit legislation. The banks are subject to various legislation such as provisions of the *Financial Transaction Reports Act* and the *Privacy Act*, as well as various voluntary codes of conduct.

Despite the costs and inefficiencies of Australia's system of financial services regulation, the existing system has worked reasonably well to date. Nevertheless, the accumulation of changes in the market environment since the Campbell Committee Review, including ongoing globalisation and technological change, require an in–depth review of current regulation. The aim should be to make the regulatory system as adaptive as possible to further change, much of which may be unforeseen, and not simply the outworking of present trends.

Vigorous competition in financial services can deliver great benefits to consumers, business, the financial services industry and the economy as a whole. The same merger and acquisition provisions as are applied by the Australian Competition and Consumer Commission generally across the economy should be applied equally to the financial services industry, noting that what are the relevant financial markets—in terms of products, institutions and geography—will evolve over time. The Treasurer should have the power to allow, or disallow, a merger between banks or between a bank and another financial institution. This power should be used only for prudential reasons, on the advice of the relevant regulatory authorities, and not to pursue competition policy objectives where no significant prudential issue is at stake.

The previous government's informal 'six pillars' policy would become redundant.

7. The Prudential Supervision of Banks

Particular Attributes of Banks

Banks have three particular attributes that make a degree of regulatory oversight necessary. They are at the heart of the payments system; banks' creditors do not always have a clear understanding of each bank's financial position, so that adverse events or news can lead to crises of confidence and runs on banks; and banks are very important in providing credit to small and medium-sized businesses and individuals.

While some regulation of the banking system is desirable to avoid systemic risk, not all regulations, including a number of the Reserve Bank's Prudential Statements, are desirable. Regulation of banks has become more intense than is necessary, interfering with the legitimate commercial activities of banks and not taking into account the new operating environment faced by banks.

Depositor Protection

The system of depositor protection in Australia helps prevent runs on banks and ensures a 'safe' form of investment for risk-averse small savers. ABA believes that the arguments in favour of an explicit depositor protection objective in legislation outweigh the arguments against it.

ABA further recommends that depositor insurance schemes—of the kind seen in the US—should not be introduced, because they unduly encourage 'moral hazard' behaviour. Nor should a New Zealand–style disclosure regime, which many depositors may not find easy to understand and act upon on a day–to–day basis.

The Payments System

The Reserve Bank is charged with the maintenance of the integrity of the payments system. This objective is vital given the essential role of the payments system in national and international commerce. The requirements for a safe and efficient payments system outlined by the Campbell Committee are still valid and are endorsed by ABA with one proviso: that access to the payments system by qualified new entrants—that is, entrants who can meet the required standards—be granted on fair, commercial terms.

Participation in the settlement system, including access to RTGS, should be limited to financial institutions subject to the same level of prudential supervision as banks. This is because only such institutions are *sure* to be able to raise a large amount of liquidity in a very short (same–day) timeframe. For reasons of public confidence, those institutions which comply should be called "banks" so they can be readily identified in the community.

Other Issues

The regulation of banks' participation in financial conglomerates should be modified to allow institutions greater freedom to configure themselves in ways which best meet customer needs, and to recognise banks' internal risk management systems.

Banks are presently required to lodge an amount equal to one per cent of their non-capital liabilities with the Reserve Bank (non–callable deposits), an amount for which they are paid a non-commercial rate of interest. This requirement is highly costly to banks and is acknowledged by Government to be nothing other than a revenue raising measure ($185 million in 1995). Lacking any prudential function, this requirement should be abolished.

The *Banks (Shareholdings) Act* sets limits on the proportion of shares in a bank that can be held by one person or entity. These ownership requirements should apply at the level of holding companies owning banks.

Only supervised deposit taking institutions should be permitted to issue multi–purpose stored value cards. There should be no restrictions, however, on the issue of specific–purpose pre–paid cards such as telephone cards.

8. Consumer Regulation—Current Issues

Objectives of Consumer Regulation

Consumer regulation should ensure that:

- consumers are appropriately informed of their rights and obligations;
- those rights and obligations are consistent with common law, international practice and public policy;
- consumers are educated as to effective and efficient banking;
- customer confidentiality is protected; and
- regulations are imposed on a national scale, and do not impede domestic competition or the ability to transact business offshore.

Consumer regulation should avoid:

- being overly prescriptive; overloading consumers with unnecessary information;
- imposing excessive costs on service providers;
- penalties on service providers which are disproportionate to any wrong committed; and
- constraining market outcomes between service providers and consumers who are sufficiently sophisticated to make their own judgements, and who do not need to be protected.

Consumer Credit Code

Consumer protection laws in Australia contain too many of this second set of undesirable characteristics. This is particularly true of the Consumer Credit Code, scheduled to take effect in November this year. The Code comprises 184 sections and a further 74 subordinate regulations, requiring twelve forms for use in consumer credit transactions. The Code provides for various sanctions in the case of a breach, including civil penalties, criminal penalties, compensation to the consumer and the setting aside of the relevant contract. It also proscribes numerous existing financial products. It allows the reopening of transactions, a characteristic inconsistent with the principle of disclosure.

The initial set–up cost to the banking industry of preparing to comply with the Code's provisions has been estimated at around $100 million, with significant ongoing costs. The ultimate incidence of this, in a competitive environment, is likely to fall on customers.

Other Regulations

Banks are subject to various legislative provisions with which compliance is unduly burdensome. Numerous problems can be identified, for example, in connection with the *Financial Transaction Reports Act*. The *Act* is very expensive to administer, and imposes substantial costs on cash dealers. The 'know your customer' rule should replace current identification requirements, and the *Act* should be refocussed solely toward countering money laundering objectives, rather than covering social security and tax fraud.

9. Regulatory Form

Future Prudential Regulation

Maintenance of confidence in the integrity of the financial system, and in particular of the payments system and the deposit–taking institutions through which the public accesses it, requires an effective prudential regulation framework. No disclosure and competition regime on its own can substitute for this, given the realities of access to information.

The future prudential regulatory framework needs to be applied by a number of independent specialist regulatory bodies due to significantly different risks involved and hence regulatory skills needed, for example a banking supervisor, a life and general insurance supervisor and a securities and capital markets supervisor. In such an environment there would however, be a need for very close and effective coordination among the specialist regulators, particularly in the event of an institution being in difficulty. The Council of Financial Supervisors reflects a recognition of this need, but its role needs to be enhanced to better deal with the issue—particularly the supervision of conglomerates (diversified financial services groups). Diversified financial services groups exist already and even with some 'firewalls' between the banking, insurance and other businesses within such institutions, loose informal coordination between their regulators will not give satisfactory assurance of the soundness of an institution as a whole.

The two main models for achieving sufficiently close coordination among specialist regulators are the *lead regulator* model and the *single umbrella regulatory organisation* model. Given the very different specialist expertise involved in banking and insurance supervision, ABA favours the lead regulator model, with explicit attention being given to risk aggregation within conglomerates and systemic risk.

The ideal banking supervisor is the central bank, which should be responsible for all banks, building societies and credit unions, which should come under a single Federal system of prudential supervision, with the regulator having flexibility to determine how the objectives of capital and liquidity regulation are met by mutual organisations.

There should be no separate regulation of competition issues in the financial sector; rather, the general rules of competition policy should be applied by the Australian Competition and Consumer Commission (ACCC) to financial institutions.

Future Consumer Regulation

Consumer regulation should be based on the principle of the least possible regulation consistent with the objective of consumers understanding the products they are buying and understanding their rights and obligations in connection to purchasing those products.

Consumer regulation should be unified across the financial sector, with regulation graduated functionally according to the nature of promises made to consumers (and relevant attributes of institutions making the promises). Regulation in this area should be less *rules*–based and more *objectives*–based than at present, allowing institutions maximum flexibility in how they meet the objectives.

10. Commercial Activities of the Reserve Bank of Australia

The Role of the Reserve Bank

The principal roles of the Reserve Bank are prudential supervision of licensed banks and the implementation of monetary policy. The Bank also acts as banker to the government, requiring it to operate in the financial marketplace which it regulates. This has the potential to cause conflicts of interest.

While the Reserve Bank operates with a large degree of autonomy from the government, many other nations have chosen a greater degree of autonomy for their central bank. Acknowledging the potential for conflicts, the New Zealand Government has tendered out most of its central bank's 'banker to government' functions, which was won by Westpac.

The Reserve Bank's Commercial Activity

The Reserve Bank is currently involved in a number of areas of commercial activity. A review should be conducted to determine, against relevant policy principles, whether this is appropriate. There is a possibility that the Reserve Bank cross-subsidises services to government of a type which are available from other providers. Such activity would be inconsistent with national competition policy. The Reserve Bank, given its official position, should make transparent the information needed to determine whether and to what extent such activities are cross–subsidised.

In carrying out commercial activities the Reserve Bank has numerous advantages over private financial institutions. The Reserve Bank is not required to earn market rates of return, nor does it face market tests, nor is it subject to the prudential requirements imposed on the licensed banks. The Reserve Bank is also generally exempt from FID, debits tax and sales tax. To restore competitive neutrality ABA suggests that where relevant the Reserve Bank's commercial activities be carried out in a separate commercial subsidiary, subject to the same rules that apply to all government business enterprises.

ABA suggests that all banker to government services be opened to competitive tender, to ensure the most efficient provision of services. There are sufficient private sector providers to ensure that banker to government services would be provided on a competitive basis.

ABA also suggests that non-essential commercial Reserve Bank Information and Transfer System (RITS) services be put out to tender. Again, there is sufficient private sector capability in this area to ensure that such services are delivered competitively on a fully commercial basis.

Recommendations

Recommendation 5.1

The ABA recommends that Financial Institutions Duty (FID) and Debits Tax be abolished as part of a reform of the taxation of financial savings products generally, designed to produce a regime which is more neutral and conducive to saving; and preferably in the context of wider taxation reform.

Recommendation 5.2

That existing laws be reviewed and amended to permit digital signatures in appropriate circumstances.

Recommendation 5.3

That existing laws be amended to permit the electronic delivery of notices and documents with the agreement of the customer concerned.

Recommendation 5.4

That national uniform legislation covering evidentiary issues related to electronic delivery of financial services be enacted.

Recommendation 5.5

It is critical that a coherent national approach to privacy regulation emerges from the current consultative processes. This may require cooperation between the Federal and State governments. It is also important that a reasonable balance be struck between consumer protection, consumer choice, and the legitimate needs of financial institutions to use information in a manner which promotes effective and efficient delivery of financial services to Australian consumers. The financial services industry should be consulted at all stages as policy evolves, and changes in policy should be continuously tested for their effectiveness.

Recommendation 5.6

ABA considers that the Electronic Funds Transfer (EFT) Code has been extremely successful. It has achieved wide ranging acceptance at all levels within the EFT industry. If it becomes necessary to provide specific consumer protection provisions in relation to the developing technologies such as telephone or on–line banking, the EFT Code has the capacity to be extended in scope to deal with this need.

Recommendation 6.1

Regulation Impact Statements, following the guidelines set by the Office of Regulation Review, should be issued in the future whenever changes to the regulation of financial institutions are contemplated by any regulatory agency.

Recommendation 6.2

As for other industries, proposals for mergers and acquisitions should be subject to scrutiny by the Australian Competition and Consumer Commission (ACCC).

Recommendation 6.3

The Treasurer should have the power to allow, or disallow, a merger between banks and between a bank and another financial institution. This power should be used only for prudential reasons, on the advice of the relevant regulatory authorities, and not to pursue competition policy objectives where no significant prudential issue is at stake.

Recommendation 6.4

The 'six pillars' policy should be discarded, and all mergers should be evaluated on their economic merits under the same competition policy principles as are applied across the economy, with an expedited process of consideration via exercise of the Treasurer's powers available where there are significant prudential concerns.

Recommendation 7.1

Any financial institution subject to the same prudential requirements as banks should be able to accept deposits.

Recommendation 7.2

The explicit provisions for depositor protection should be retained in the *Banking Act*. Depositor insurance schemes should not be introduced and neither should New Zealand–style disclosure regimes.

Recommendation 7.3

For reasons of public confidence, direct access to both clearing and settlement systems, including access to the Real Time Gross Settlement System (RTGS), should be limited to banks, and other financial institutions subject to the same prudential supervision as banks. New entrants who can meet prudential (capital and liquidity) requirements should pay an access fee on fair commercial terms.

Recommendation 7.4

Direct access to clearing systems such as EFT (with only indirect access to settlement facilities) should be available on fair commercial terms to those financial institutions meeting the technical and administrative criteria, and the level of prudential standards required of banks.

Recommendation 7.5

All financial institutions which meet minimum prudential and technical criteria under APCA rules should have indirect access on fair commercial terms to the payments system.

Recommendation 7.6

The Reserve Bank should adopt a more flexible approach and allow banks to use internal risk management systems to allocate capital according to *actual* credit risk, as assessed by those systems, for prudential supervision purposes, in a way which is consistent with the objectives of the Basle framework.

Recommendation 7.7

Prudential Statement C2 should be amended to cover disclosure issues only.

Recommendation 7.8

A wider range of high quality liquid assets should qualify for inclusion in the Prime Assets Ratio.

Recommendation 7.9

Given the new risk weights attached to banks' off–balance sheet activities (in Prudential Statement C1), Prudential Statement F1 is now redundant and should be withdrawn.

Recommendation 7.10

Prudential Statement G1 requires, at least, substantial amendment to allow banks the competitive freedom to meet their customers' needs, in an environment where:

- **the traditional boundaries between different types of financial institutions are becoming increasingly blurred, with banks, for example, increasingly becoming general financial service providers; and**
- **rapid technological developments are creating new synergies between financial businesses and some types of non-financial businesses.**

Recommendation 7.11

Since non-callable deposits are now simply a special tax on banks, for which there is no prudential justification, they should be abolished, with the direct cost of prudential supervision recovered by other means.

Recommendation 7.12

Ownership requirements under the *Banks (Shareholdings) Act* should be applied to holding companies. There should be no requirement that a holding company must be a bank.

Recommendation 7.13

Only supervised deposit taking institutions should be permitted to issue multi-purpose stored value cards i.e. cash replacement cards. Such a restriction will enhance the integrity of the market for stored value cards, maintain consumer confidence that they can access the value in the cards, and minimise systemic risk associated with the failure of an institution to settle its debts.

Recommendation 7.14

There should be no restriction on any fees that the issuers of SVCs may charge. This should be left to the market.

Recommendation 7.15

There should be no restrictions on the issue of pre-paid cards for specific purposes (e.g. telephone cards).

Recommendation 8.1

The Consumer Credit Code should be substantially simplified and revised to emphasise education of consumers rather than prescriptive process, and all civil penalties for breaches of the Code should be removed.

Recommendation 8.2

The 'know your customer' rule should replace current identification requirements, and the *Financial Transaction Reports Act* should be refocussed to money laundering objectives only, and not cover social security and tax fraud.

Recommendation 9.1

Regulation of banks, building societies and credit unions should be unified under a single Federal prudential supervisor. The Reserve Bank would be the appropriate supervisor. That regulator should have flexibility to determine how the objectives of capital and liquidity regulation are met by mutual organisations and the consequent status of those institutions.

Recommendation 9.2

Regulation should be prescriptive about the structure of financial services groups only to the minimum extent necessary.

Recommendation 9.3

That a system of lead regulators be established to deal with the prudential supervision of financial conglomerates, with explicit attention to expertise in risk aggregation and systemic implications; and with strong coordination arrangements in place, especially for situations of difficulty.

Recommendation 10.1

Commercial activities undertaken by the Reserve Bank should be reviewed to determine which are inappropriate for the central bank. Where it does continue to engage in commercial activities, this should be transparently on a full commercial (not cross–subsidised) basis and on neutral terms of competition with other providers.

Recommendation 10.2

All commercial activities undertaken by the Reserve Bank should be separately and transparently costed, so that they can then be charged individually on a fully commercial basis.

Recommendation 10.3

All of the commercial activities of the Reserve Bank should be undertaken by a separate commercial subsidiary subject to *the Commonwealth Authorities and Companies Act 1994*.

Recommendation 10.4

Any move to tender out services as 'banker to overseas bodies and agencies' (e.g. the World Bank) which are currently undertaken by the Reserve Bank should be subject to prior consultation with the bodies and agencies concerned.

Recommendation 10.5

In accordance with the guidelines set out in the Report to the Commonwealth government of the National Commission of Audit, the Reserve Bank should be required to implement transparent accounting arrangements for its operations, so as to provide genuine accountability for its commercial (and other) activities.

Chapter 1

The Australian Financial System

Key Points

- This chapter describes the Australian financial system; its role, participants, regulation and customers. Forces for change in financial services are briefly introduced. This examination suggests some key issues which are explored in greater detail in later chapters.

- The financial system is a vital part of the economy. Financial institutions and markets serve three main functions. First, they enable businesses, individuals and governments to trade financial claims, so that economic resources are allocated efficiently to where they are most needed. Second, financial institutions manage and ensure the integrity of the payments system, the core of commerce in any modern economy. Third, they facilitate the management and mitigation of risk. In carrying out each of these functions, financial institutions and markets benefit both individuals and the economy as a whole.

- The customers of the financial system include households, firms and governments. Different forces for change have operated on each of these groups, and they themselves have created pressure for change.

- The Australian financial system has seen major changes in recent decades. Pressures for better products and services from users, deregulation and other policies (including on superannuation), technological change and the globalisation of financial markets (in some market segments) have interacted with one another to produce wide-ranging and quite rapid evolution.

- There has been both 'convergence' as different kinds of financial institutions have diversified into each others' traditional markets, and disaggregation (or 'deconstruction') as new competitors have entered particular component activities, e.g. loan origination.

- Change seems set to continue; it poses challenges to both institutions and the regulatory framework. Australia is, of course, unique only in the detail; other countries' financial systems are experiencing comparable change.

- The financial system may be divided into two distinct sectors: the *financial intermediaries sector* (comprising banks, merchant banks, non-bank deposit taking institutions—building societies and credit unions—and finance companies) and the *managed funds sector* (comprising superannuation funds, life insurance companies and other funds managers). Participants in these sectors, and their customers, interact through important *market mechanisms* (e.g. exchanges for securities and derivatives; over–the–counter markets).

- The market shares of institutions in the financial *intermediaries* sector have changed significantly over time. Since the mid 1980s, for example, banks' share of the assets of financial intermediaries has increased substantially, while the share of building societies has declined—albeit largely because of the migration of many of the societies to bank status.

- The assets of life insurance companies and superannuation funds have grown rapidly in recent years as a result of preferential tax treatment, industrial award provisions for superannuation and the *Superannuation Guarantee* legislation, and demographic changes.

- The primary regulator of the banks is the Reserve Bank of Australia. Building societies and credit unions are regulated by the Australian Financial Institutions Commission. The primary regulatory body for life companies and superannuation funds is the Insurance and Superannuation Commission.

1.1 Introduction

The financial system is unlike most other areas of the economy in that the markets for financial products—indeed the products themselves—are largely intangible. Yet the financial system is of central importance to the economy. Charged with the management of assets with a value of more than twice the nation's annual GDP, the financial system influences the lives of millions of people directly—as customers, shareholders and employees—and countless others indirectly.

The Intermediation Function

Financial institutions and markets perform a number of functions which are fundamental to the efficient functioning of the economy. First, they transfer economic resources—through time, across political borders, among industries—to where they may be most efficiently employed. Gains from this trade in finances are realised by bringing together those who have surplus funds and those whose funding requirements exceed their current income.

In the absence of significant impediments to this trading—such as search costs and information asymmetries—borrowers and lenders (in the broad sense, ignoring debt/equity distinctions) may deal without the assistance of intermediaries, by way of *direct financing*. The key market mechanisms in the financial sector (the exchanges for equity and debt securities and derivatives, and over–the–counter markets) facilitate a large area of direct financing where such impediments are minimised.

Alternatively, where impediments are prohibitive, *financial intermediaries* bridge the gap and obviate the costs of finding compatible partners—costs which in their absence would prevent many borrowers and lenders from dealing with each other. Financial intermediaries—pre–eminent among which are banks—achieve this by specialising in collecting and assessing information about their clients (their credit worthiness etc) and in monitoring the observance of their obligations. Financial intermediaries also overcome any mismatch between the needs of borrowers and lenders by pooling and subdividing financial claims.

Note that the use of the term ‘financial intermediaries’ here is more specialised than in common speech, being essentially restricted to those institutions whose balance sheets are interposed between suppliers and users of funds—as distinct from the other major class of institutions, funds managers, which do not do this but rather marshal funds into investments on their clients’ behalf.

The Payments System

A second major role of financial intermediaries is the operation of the payments system, performing for example cheque settlement and clearing operations. In Australia, the banks (and to a lesser extent, building societies and credit unions) are the principal providers of payments services. The role of banks in the payments system is discussed in more detail in the following chapter, and in a regulatory context in Chapter Seven.

Risk Management

Third, financial institutions manage and assist in the transfer of risk, for example through the provision of insurance services and derivative products.

Providing services whereby risks may be traded so that they are borne by those best able to, and so that they are reduced overall, enhances the operation of the economy and thus benefits not only specific individuals but the economy as a whole.

Accordingly, given all of these functions, the financial system is an integral part of a modern economy and, not surprisingly, has over time been the focus of much regulatory activity.

1.2 Customers of the Financial System

The customers of the financial system may be divided into households, businesses and governments. Each of these three sectors has had its own impact on the shape of the financial system.

Households’ holdings of bank deposits have been relatively stable over the past thirty years, remaining at around 30 to 40 per cent of GDP. At the same time, households’ holdings with life companies and superannuation funds have increased rapidly, suggesting that households distinguish between short-term or transaction deposits with intermediaries and balances with fund managers. On the other side of the balance sheet, bank lending for housing has grown rapidly over the last three decades, and particularly in the early to mid

1990s. Banks regained market share from building societies in this area, though this is in large part because the building societies themselves have converted to bank status. More recently, specialist mortgage loan originators and life offices have become serious competitors, taking market share from the banks and helping to create an environment in which consumers are enjoying a significantly better response from all institutions.

Business demand for corporate lending services has considerable scope to increase, with the leverage of Australian companies relatively low by international standards, despite their ‘gearing up’ in the late 1980s. The absence in Australia of a well developed market for corporate debt securities has led major Australian corporates to issue directly in deeper, more liquid and sophisticated markets overseas; while small and middle size companies tend to rely on bank–provided debt finance. The movement to direct issue by major corporates occurred largely in the mid–1980s after deregulation; the balance between direct debt financing and bank financing has subsequently remained broadly stable.

The level of outstanding government debt has broadly declined over time, relative to GDP, with the Federal government in particular achieving significant budget surpluses in the late 1980s and switching partly from the issue of debt securities to the issue of equities via several large privatisations. The return of the Commonwealth Budget to deficit in the early 1990s temporarily reversed the downward trend relative to GDP, but under present fiscal consolidation policies it should resume over the late 1990s. Abstracting from the very recent period, financial intermediaries’ holdings of government debt have declined, and accordingly household and corporate debt has accounted for an increasing proportion of financial intermediaries’ debt assets.

1.3 A Brief Topography of the Australian Financial System

This section briefly describes the major changes in the Australian financial system in recent years, and the shape of the system now.

The Australian financial system has seen a number of quite dramatic changes over the past decade and indeed the beginnings of significant change even earlier than that. Rising demands from users for better services and better value have been a fundamental driver, in combination with technological changes which have provided the means for institutions to respond; and with new products and competitors maintaining pressure on existing players to do so. Together, these forces have resulted in changed patterns of financing and blurred the boundaries of different species of financial institutions.

A number of separate influences have been driving change.

First, although the drive from customers for better value has been fundamental, the deregulation of the financial system has been an important catalyst and agent of change—or at least of its timing and specific form. Other policies have also been influential, notably policies for compulsory superannuation, significantly affecting the pattern of flows of funds from households to institutions.

Second, new technologies have perhaps been more fundamental than deregulation—widening the scope of financial products available to increasingly demanding customers, and presenting challenges for the financial system in general and its regulators in particular.

Third, and related to those, the globalisation of markets (in some market segments) and of institutions has been a consistent trend. Australia's major financial institutions presently have significant businesses in numerous markets outside Australia, and Australia's financial markets are very much influenced by foreign players and markets. Business concepts travel rapidly in the financial sector to wherever markets are relatively open (i.e. most of the world), even without actual entry of new players to those markets.

These changes have interacted with one another to produce wide–ranging and at times quite rapid evolution in the marketplace. There has been both 'convergence' as different kinds of financial institutions have diversified into each other's traditional market segments, and disaggregation (or 'deconstruction') as new competitors have entered particular component activities (e.g. loan origination). Change will continue to pose challenges to institutions and the regulatory framework.

Essentially, the challenge for both is to be *adaptive to change*—so that the Australian financial system remains at the forefront in how, and how efficiently, it meets the needs of Australians and the Australian economy, and in so doing itself remains competitive in the global context.

Table 1.1 summarises the main types of institutions in the Australian financial system. The financial system may be divided into two distinct sectors: the *financial intermediaries sector* and the *managed funds sector*. The defining functions of the financial intermediaries sector are intermediated borrowing and lending. The main institutions in this sector are banks, finance companies, merchant banks, credit unions and building societies. Banks come under the regulatory aegis of the Reserve Bank of Australia (RBA). Finance companies and merchant banks receive no prudential supervision but are regulated by the Australian Securities Commission (ASC). Credit unions and building societies are regulated by State authorities coordinated under the Australian Financial Institutions Commission (AFIC).

The main institutions of the managed funds sector are life insurance companies and superannuation funds, together with unit trusts and the like. The managed funds sector is regulated primarily by the Insurance and Superannuation Commission (ISC), with the ASC covering most of the remainder, together with State authorities (regulating eg. friendly societies).

From the point of view of the customer, a degree of overlap exists between these sectors, with institutions in each sector offering some products which have quite similar characteristics (consider the similarities between cash management trusts and term deposits, for example). In addition, other service providers, such as elements of the securities industry, provide some services which compete directly with those offered by intermediaries or managed funds institutions.

TABLE 1.1

THE MAIN TYPES OF INSTITUTIONS IN THE FINANCIAL SYSTEM

Type of Institution	Main Supervisor	Main Characteristics	No. of Institu–tions	Total Assets ($b)
Banks	RBA	Provide banking and a wide range of other financial services including funds management and insurance services (through subsidiaries).	44	482
Merchant banks (money market corporations)	ASC	Operate primarily in wholesale markets, borrowing from, and lending to, large corporations and government agencies. Other services are corporate finance, foreign exchange and investment management.	83	60
Building societies	AFIC/State authorities	Organisations providing retail deposit services and primarily housing lending, some of which are cooperative.	25	13
Credit unions	AFIC/State authorities	Cooperative organisations providing retail deposit services and lending for consumer durables, motor vehicles and housing.	255	15
Life insurance companies	ISC	Provide life, accident and disability insurance, investment and superannuation products. Assets are managed in statutory funds, and are mostly invested in shares, debt securities, property and deposits.	43	119
Superannuation funds and ADFs outside life companies	ISC	Superannuation funds accept and manage contributions from employers and employees to provide retirement income benefits. Funds generally use professional funds managers, and invest in a diverse range of assets (predominantly tradeable equity and debt securities plus property and deposits).	101,000	113
Public unit trusts	ASC	Unit trusts pool investors' funds, usually into specified types of assets (eg. shares, property, fixed interest securities, overseas securities). Most trusts are managed by subsidiaries of banks, insurance companies or merchant banks; for some, funds management is the major operation in Australia.	420+	46
Trustee companies	State authorities	Trustee companies pool into common funds money received from the public, or held on behalf of estates or under powers of attorney. Funds are invested in specified asset types.	14	5

Friendly societies	State authorities	Are usually small fraternal organisations offering health, funeral, and other benefits to members. The larger friendly societies also offer insurance bond products to investors.	200+	9

Sources: Appendix B, Council of Financial Supervisors, *Annual Report* 1995;
Reserve Bank Bulletin, July 1996; KPMG 1996 Financial Performance Survey.

The Financial Intermediaries sector

The following table shows how the market shares—in terms of assets—of different types of financial intermediaries have changed over time.

TABLE 1.2
ASSETS OF FINANCIAL INTERMEDIARIES: PROPORTION OF TOTAL

Institution	1953	1970	1980	1985	1990	1995
Banks	88	70	58	59	69	77
Building societies	3	5	12	10	5	2
Credit unions	-	1	1	2	2	2
Money market corps.	-	3	6	11	11	9
Pastoral financiers	4	3	1	2	0	0
Finance companies	3	15	18	13	9	6
Other	1	3	4	3	4	3

Source: Edey and Gray, 1996.[1]

Table 1.2 shows that there has been considerable variation in the market shares of financial intermediaries over recent decades.

It is clear from the table that the most important financial intermediaries remain the banks. Together, they account for almost 80 per cent of the assets of financial intermediaries. The table shows a shift in intermediation from banks to others up to about 1980, with banks' share of assets declining by about 30 per cent (noting that some of the rising categories, e.g. finance companies, were bank subsidiaries).

This decline was primarily due to a system of bank regulation that was particularly heavy compared to that faced by other intermediaries. Once these regulations were reformed, following the recommendations of the Campbell Committee, banks regained market share, though the recovery by banks of market share was in large part due to the bringing back on balance sheet of some (eg. finance company type) business; conversion of a number of building societies to bank status; and the entry of a number of foreign banks—rather than a dramatic improvement in the fortunes of the established banks. Banks are discussed in greater detail in Chapter Two.

Finance Companies

Initially finance companies were established in Australia to provide automobile finance, later moving into hire-purchase and (mainly second mortgage) housing finance. Finance companies grew rapidly up until the early 1980s, however since that time their importance as a separate source of financial services has declined. This is not surprising given that much of their

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[1] Edey, Malcolm and Brian Gray, "The Evolving Structure of the Australian Financial System", Reserve Bank of Australia, Conference on the Future of the Financial System, July 1996.

growth was due to particular restrictions on the activities of banks—restrictions in the main removed in the 1980s, leading to a considerable shift of intermediation back to banks, as just noted.

Merchant Banks (Money Market Corporations)

Merchant banks (also called money market corporations) engage in a diverse range of activities including the provision of short term credit facilities via the money market, corporate lending services and a variety of other fee-based services such as corporate advice and equity underwriting. In Australia, the largest merchant banks are in the main either foreign-owned or subsidiaries of the major banks. By their nature, merchant banks provide few services to households, specialising instead in certain niche markets.

Building Societies and Credit Unions and Other Intermediaries

Building societies are financial organisations that specialise in the provision of housing loan finance. The history of Australia’s building societies has seen a rapid rise and equally rapid decline as is evident from Table 1.2. In the early 1980s, building societies played an important role in the financial system, accounting for over ten per cent, of the assets of all financial intermediaries. Today their separate influence has all but disappeared, with institutions remaining in building society status now accounting for less than two per cent of intermediaries’ assets.

Underlying this reversal was the removal of the differential regulatory treatment of building societies relative to banks. The regulatory ‘level playing field’ which arose as a consequence of the tightening of the AFIC regulatory regime has led the majority of those building societies which had not already done so to convert to bank status. (Another motivation to convert was the restrictiveness of the co-operative structure compared to the company status of banks.)

Despite their similarities with some building societies—sharing a co-operative structure and a focus on retail business—credit unions have succeeded until now in maintaining their market share, which has changed little since the 1980s.

Pastoral financiers, once a significant source of finance, are another class of intermediaries that has declined significantly since the 1980s.

While some forms of intermediation have declined, others have grown rapidly. The table does not convey the recent rapid growth of mortgage loan origination providers of housing loans funded by the issue of mortgage-backed securities. The growth of institutions of this type is an element in a trend toward increasing specialisation in financial services. Paradoxically, this trend to emergence of specialists focusing on particular niches has been accompanied by another trend not obvious from the table—increased diversification across financial categories by the larger financial business groups.

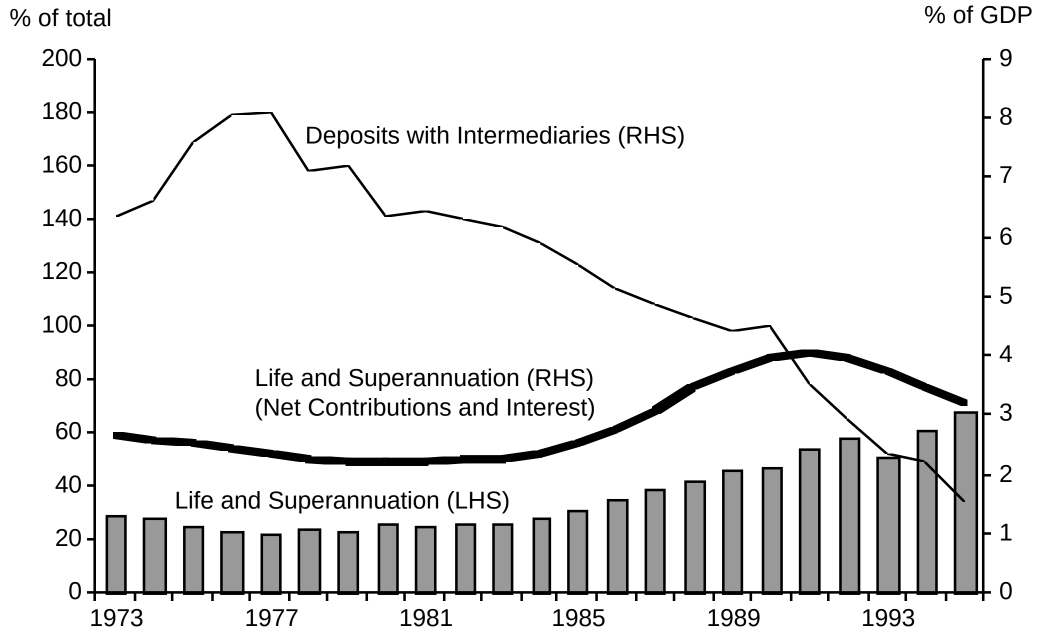
The Managed Funds Sector

Life insurance companies and superannuation funds in Australia are of a size and importance second only to the banks. Together with the four major banks—ANZ, Commonwealth Bank, National Australia Bank and Westpac—the largest insurance companies in this group, the AMP Society and National Mutual, make up the 'big six' financial institutions. In recent times they have been joined in the managed funds sector by specialist funds managers (who may, like the major banks, have life office subsidiaries and operate a range of superannuation funds, unit trusts etc as well as wholesale pools).

Life Insurance and Superannuation

Life insurance companies and superannuation (equivalent to pension) funds are long-term savings vehicles which obtain their funds from premiums paid on life insurance policies or contributions to superannuation. An engine for growth in this sector has been the preferential tax treatment in Australia of insurance and, particularly, superannuation funds, together with the emergence ten years ago of widespread provisions for superannuation in industrial awards; and then legislated minimum contributions in the early 1990s. Nevertheless it should be noted that other OECD countries have experienced a similar rise in managed fund saving. Common factors include rising personal wealth and demographics. As Figure 1.1 shows, flows of saving from households into life insurance and superannuation (predominantly the latter), have overtaken flows into deposits with intermediaries including banks—noting of course that banks as financial services groups are in both businesses.

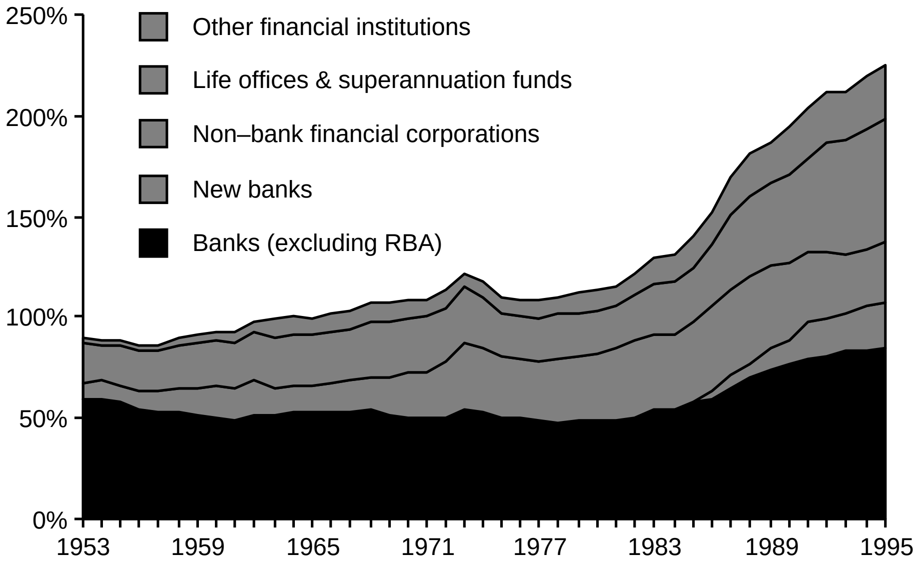
FIGURE 1.1
HOUSEHOLD SECTOR SAVING



Source: RBA Flow of Funds (various issues), ABS Financial Accounts and National Accounts

The profile of the funds of the life insurance and superannuation sector has, with these drivers, changed significantly in recent years. Growth in superannuation business (see Figure 1.2) has vastly outstripped growth in ordinary insurance products. Single premium products—purchased with a one-off payment rather than regular contributions—have been favoured at the expense of annual premium products; similarly investment-linked products have tended to replace whole-of-life and endowment products.

FIGURE 1.2
TOTAL ASSETS OF FINANCIAL INSTITUTIONS (PER CENT OF GDP)



Source: Edey and Gray, 1996.

Note that the figure classifies assets strictly by type of institution regardless of whether the institution forms part of a diversified financial services group. Thus, for example the assets held by the funds management and other businesses within banking groups are shown under the respective categories.

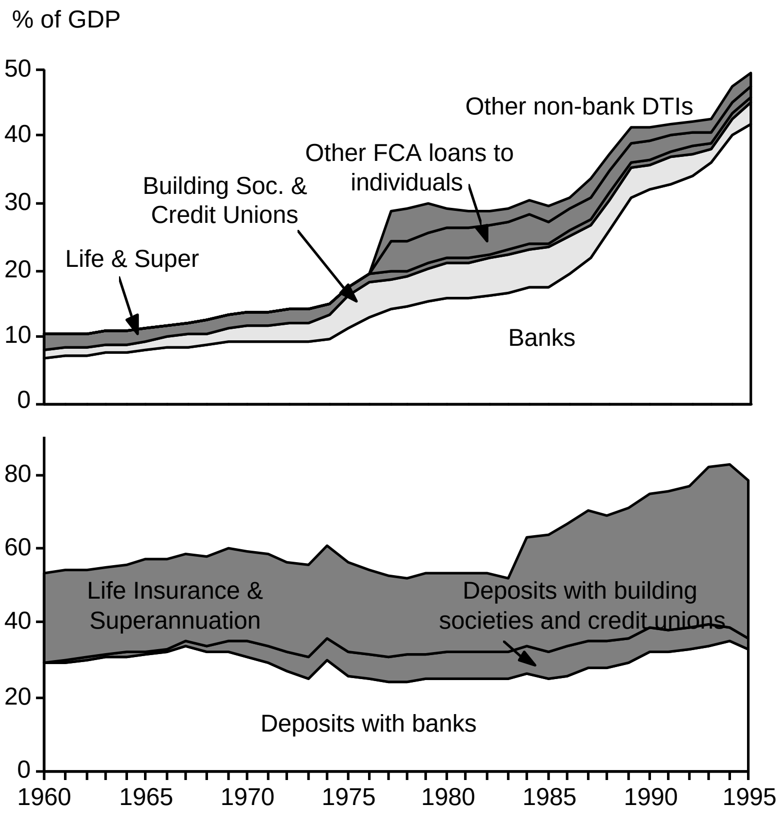
Unit Trusts

The growth of cash management trusts (as well as listed unit trusts) has brought considerable competition to financial intermediaries that have specialised in retail lines of business. These vehicles are something of a hybrid, sharing some characteristics with traditional bank deposit products while also resembling managed funds. Cash management trusts collect retail funds which are then invested in short-term debt securities such as bills of exchange. Unit trusts invest in equities, property or similar assets. The returns received from all these investment vehicles are linked to the performance of the underlying assets. While these products appear similar from the point of view of the consumer to traditional intermediated products, they differ importantly in that these vehicles do not create fundamentally new financial instruments but are essentially pools of investments in existing assets.

In recent years the managed funds sector overall has grown more rapidly than the financial intermediaries sector, as Figure 1.3 shows.

FIGURE 1.3

HOUSEHOLD SECTOR SELECTED LIABILITIES (TOP) AND ASSETS (BOTTOM) TO GDP



Source: Edey & Gray, 1996. DTI : Deposit Taking Institutions; FCA: Financial Corporations Act.

Note that while there has been a fall in the share of household assets with banks as such (as distinct from banks as financial services groups, which have broadly held share), banks remain dominant as lenders to households.

1.4 Regulation of the Financial System—A Brief Summary

The financial intermediaries sector and the managed funds sector are subject to different and generally non-overlapping regulatory authorities. The primary regulator of the banks is the Reserve Bank. Other intermediaries including building societies and credit unions are regulated by AFIC. The primary regulator of life companies and superannuation funds is the ISC.

Table 1.1 above listed the main types of financial institutions and indicates the main supervisor for institutions of each type. Specific legislation gives each of these bodies its regulatory authority. Table 1.3 summarises the key legal foundations of each of the main regulatory bodies which have authority over parts of the financial system.

TABLE 1.3

LEGAL BASIS AND RESPONSIBILITIES OF FINANCIAL SYSTEM REGULATORY BODIES

Regulatory Body	Legal Basis	Responsibilities
Reserve Bank of Australia	• Reserve Bank Act 1959 • Banking Act 1959 • Banks (Shareholdings) Act 1972 • Financial Corporations Act 1974	Regulatory oversight of banks, general oversight of building societies, credit unions, merchant banks, and all other financiers and intermediaries.
Australian Financial Institutions Commission (and State authorities)	• Financial Institutions Code Act 1992 (Queensland)	National coordinating and standards setting body for state supervisors of building societies and credit unions.
Insurance and Superannuation Commission	• Superannuation Industry (Supervision) Act 1993	Prudential supervision of the life insurance and superannuation industries, to protect policy holders and fund members, and ensure compliance with the Commonwealth Government's retirement income standards.
	• Life Insurance Act 1995 • Insurance (Agents & Brokers) Act 1984 • Insurance Contracts Act 1984	Oversight of all life insurance companies and superannuation funds.
	• Insurance Act 1973 • Insurance (Agents & Brokers) Act 1984 • Insurance Contracts Act 1984 • Insurance (Deposits) Act 1984	Oversight of all general insurance companies.
Other Relevant Commonwealth Regulatory Organisations		
Australian Competition and Consumer Commission	• Trade Practices Act 1974 • Prices Surveillance Act 1983	All industries.
Australian Securities Commission	• Corporations Act 1989 • Australian Securities Commission Act 1989	General regulatory oversight over all companies; specific regulation of brokers, dealers, investment advisers, ASX, SFE – policy statements – investigation of potential violations – prosecution.
Australian Stock Exchange	• Corporations Act 1989 • ASX listing rules • ASX business rules	Regulatory oversight over brokers and listed companies – investigation – disciplinary proceedings – administration.
Foreign Investment Review Board	• Foreign Takeovers Act 1975	Review of all foreign investment.

Sources: ISSA; Allen Consulting Group.

1.5 Concluding Comments

The Australian financial system has undergone sweeping changes over the past few decades. Pressures from increasingly demanding customers for financial services, facilitating new technologies, deregulation, new products and competitors and rapid globalisation at the wholesale level—and of course the initiatives taken proactively by institutions in this environment—have changed the face of the sector in less than two decades.

Two competing currents have been features of the Australian financial system. On the one hand, financial intermediaries have provided traditional intermediated services, standing between borrowers and lenders and performing important functions such as overcoming information asymmetries, facilitating payments, pooling funds etc. And funds management, in which life offices remain the leading players, has grown in relative terms.

On the other hand a variety of new institutions have sprung up to exploit certain efficiencies that arise from specialising in particular lines of business, and opportunities created by traditional joint pricing structures for financial services. This disaggregation or 'deconstruction' trend is an ongoing one.

At the same time, major established institutions have diversified across the range of financial specialties, and this 'convergence' trend appears also to be ongoing.

The interplay between all these forces will continue to re–shape the financial system.

In summary, the financial sector plays a central role in our economy. As change occurs in that system and its environment, it is both blurring the distinctions between the two major groups of institutions—although not in the same way between the very different types of claims issued—and creating openings for new (mainly niche) players. Realisation of the full benefits of change, to users individually and to our economy overall, requires development of the regulatory framework to make it more adaptive to change while at the same time ensuring that it continues to protect the integrity of the system.

Chapter 2

The Banking Industry

Key Points

- This chapter provides an introduction to the features of the Australian banking industry. Banks are the major class of financial institutions in Australia, holding directly almost 50 per cent of the total assets held by such institutions, and substantially more through subsidiaries. As such, banks are crucial to the functioning of the economy.

- By specialising in the collection and assessment of credit information about their clients and in monitoring and ensuring the observance of their obligations, banks enable borrowers and lenders to overcome the information asymmetries and search costs which prevent or significantly impede their dealing with each other directly.

- Central to banks' importance to the economy is their role in the payments system. By ensuring a safe and reliable payments and settlement system, banks enable payers and payees to be confident that they can exchange value through financial intermediaries without worrying that the transaction may not be completed due to the failure of an intermediary. The banks play a critical role not just in domestic payments but in international payments, supporting Australia's trade and investment links with the rest of the world economy.

- As well as benefiting the economy generally, banks also benefit their own customers, shareholders and employees, and pay substantial taxes to governments. To meet the needs of their customers, Australia's banks have made significant investments in service channels and in new technologies. They have also succeeded in providing competitive returns for shareholders, and together they are major providers of employment.

- The number of banks operating in Australia has changed over time. At present, there are 51 licensed banks operating in Australia in 44 banking groups, comprising four major banks, ten regional banks, 27 foreign banks and a few government and specialist banks.

- The banks are regulated by the Reserve Bank and the Treasurer under the *Banking Act 1959* and *Reserve Bank Act 1959*. The Reserve Bank is chartered to maintain "the stability of the currency" and pursue "the maintenance of full employment" and "the economic prosperity and welfare" of the people of Australia. The Reserve Bank has adopted the guidelines of the Bank for International Settlements (BIS) for the maintenance by banks of adequate capital reserves. Accordingly, banks are now required to maintain capital of at least 8 per cent of risk-weighted assets. Compliance with BIS standards provides an essential signal which helps Australian banks compete in international markets.

2.1 Introduction

Certain characteristics and roles of banks continue to make them an especially important part of the financial system. Banks provide transaction services through the payments system, provide deposits which are both a secure store of value and are the means of access to that system, and are the major lenders. This section briefly describes the Australian banking industry; how it has changed in recent years and what factors may lead to change in the future.

The number of banks operating in Australia has been quite changeable over time. In 1888, 43 banks had operations in Australia. In subsequent decades there was a general decline in the number of banks—due to merger activity and some withdrawals from the market—so that by 1955 twenty banks remained. That twenty included the Commonwealth Bank (at that time still with its central bank function), eight private trading banks, three foreign banks and five state–government–owned banks.

Up until the 1980s there was very little change in the number of banks in the marketplace. There was a general reluctance towards granting new banking licences—especially to foreign banks. However, after 1985, following the recommendations of the Campbell Committee and Martin Review Group, this policy changed markedly. In that year, 15 new licences were granted to foreign banks (16 if the re–opening of the Bank of China is counted).

The rationale for the entry of foreign banks was basically the expected competitive stimulus it would provide for existing banks—as well as the improvements in access to overseas sources of finance and information. The foreign banks that were admitted to Australia have generally concentrated on wholesale banking business rather than aiming to establish retail networks. In the selection of the banks, preference was given to those which proposed to provide a wide range of banking services often in partnership with Australian financial institutions.

In 1992 it was announced that, subject to Reserve Bank guidelines, foreign banks would be permitted to operate in Australia as branches, as well as subsidiaries. The number of foreign entrants to the Australian market subsequently rose, after invitations were again extended to foreign banks in 1994. There are now 30 foreign banks operating in Australia—17 as branches and 13 as subsidiary companies (if jointly-owned banks are counted as single entities, there are 27 foreign banks operating). Further increasing the number of banks, numerous building societies adopted bank status.

A number of bank consolidations (arising from, for example, the merging of the State Bank of Victoria into the Commonwealth Bank, the acquisition by Westpac of Challenge Bank, and the acquisition of Bank SA by Advance Bank) have partly offset these increases. The upshot of all this movement is that as at

July 1996, there were 51 licensed banks operating in Australia in 44 banking groups.[2]

Table 2.1 shows that 66 per cent of the total assets of Australian banks (n.b. banking assets only) are accounted for by four individual banks: National Australia Bank (19 per cent), Commonwealth Bank (17 per cent), Westpac (15 per cent) and ANZ (14 per cent). The major banks' total domestic assets amounted to over $300 billion in July 1996.

TABLE 2.1

CURRENT MARKET SHARES OF BANKS BY TYPE

Type	**Total assets (%)**	**Total liabilities (%)**	**Deposits (%)**
"Majors"	66.2	66.0	64.6
"Regionals"	19.7	20.2	22.8
Foreign	11.8	11.6	10.4
Other	2.3	2.2	2.3

Note: Deposits shown include deposits repayable in Australia only.
Source: *Reserve Bank Bulletin*, July 1996.

A further 20 per cent of assets are accounted for by smaller regional banks, the majority of which were formerly building societies or state–government–owned banks. Seven former building societies have converted to banks, the first in June 1985.

As was mentioned above, the number of foreign banks in Australia has grown rapidly. Presently, foreign-owned banks (operating either as branches or as subsidiaries) account for approximately 12 per cent of total bank assets. Table 2.1 shows that foreign banks have made some inroads into deposit taking (holding 10 per cent of Australian deposits as at February 1996), though this was partly achieved by shifting business from existing non-bank operations. The remaining assets are held by a number of relatively small government and specialist banks (specialising for example in corporate finance or rural lending).

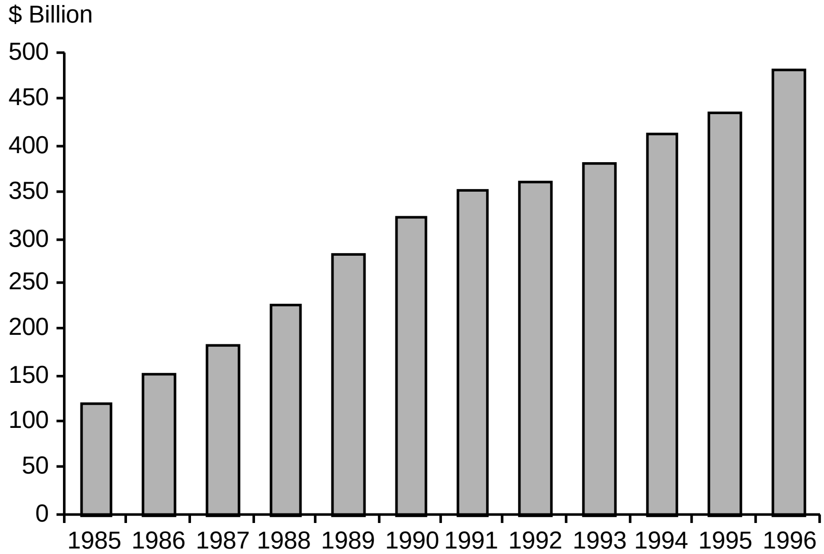
The environment in which banks have operated has changed markedly over time. For most of the period following the Second World War, Australian banks were singularly subject to an onerous system of regulation. As a consequence, banks' share of the assets of financial institutions declined over the 1960s and 1970s at the expense of other financial intermediaries such as finance companies and merchant banks. However this loss of business by banks to other types of institutions was offset to a considerable extent by the banks operating their own finance company and merchant bank subsidiaries—banks as financial services groups have broadly held share.

As was noted above, once these regulations were reformed, banks significantly increased market share. Figure 2.1 shows all these forces combined to produce substantial growth in bank assets, from around $120 billion in 1985 to about $440 billion in 1995.

2 NDB Bank possesses a banking license but at the time of writing was not operating in Australia.

FIGURE 2.1

TOTAL ASSETS FOR ALL AUSTRALIAN BANKS, 1985 TO 1995 (A$ BILLIONS)



Source: *Reserve Bank Bulletin*, July 1996.

2.2 The Role of Banks

As discussed in Chapter One, financial intermediaries play an important role in the economy, in allocating economic resources, providing payments services and reducing risk. Banks exemplify this role. By pooling funds, as well as by transforming the maturities of assets, banks match the divergent needs of borrowers and lenders. This allows participants in the economy to realise ‘gains from trade’ in financial claims by bringing together those that have surplus funds—depositors—with borrowers whose funding requirements exceed their current resources. By specialising in collecting and assessing credit information about their clients and in monitoring and ensuring the observance of their obligations, banks overcome the information asymmetries and search costs which prevent or significantly inhibit borrowers and lenders from dealing with each other directly, and so generally reduce risks.

Banks also provide a ‘safe haven’ for deposits i.e. banks offer investments with lower levels of risk than can be found elsewhere. As discussed in Chapter Seven, this safety, and its integral relationship with confidence in the integrity of the payments system, underlies much of the regulation of banks.

Payments services

Central to banks’ importance to the economy is their role in the payments system, whose *daily* throughput is about $80 billion—over two months’ GDP. Individuals, businesses and governments require a safe and reliable payments and settlement system in order for them to conduct their commercial affairs. That is, they must be confident that they can exchange value through financial intermediaries without worrying that the transaction may be aborted by a failure of an intermediary.

Clearly, the Australian community has enormous interests at stake in the integrity of the payments system. For this reason, thus far only banks, which are closely supervised by the Reserve Bank, have been allowed full access to the payments system.[3] Moreover, payments are settled in 'central bank money' i.e. through debits and credits to banks' exchange settlement accounts at the Reserve Bank, and no institution not supervised by the Reserve Bank holds these accounts.

Cheques are the largest form of non-cash payments in Australia, and, under the Cheques and Payments Orders Act, cheques can only be drawn on banks.[4] Cheques in Australia are cleared through the Australian Paper Clearing System (APCS). APCS is in turn controlled by the Australian Payments Clearing Association, (APCA), a company whose shareholders are the Reserve Bank, the banks and industry bodies representing the building societies and credit unions. APCA is responsible for the day to day operation of the payments system. The Australian Payments System Council (APSC), a body chaired by the Reserve Bank, is charged with monitoring the operation and management of the payments system.

By 1997, for domestic transactions, Australia will have a fully implemented real time gross settlement system (RTGS) for higher value, irrevocable payment transactions. This will replace the current system under which the net positions of banks are settled and exchanged through the exchange settlement accounts. As part of the introduction of RTGS, the Reserve Bank will be paying market rates of interest on banks' Exchange Settlement Account (ESA) balances. This change has reduced the need for an official market for cash and has seen the disappearance of the authorised money market dealers which formerly played such an important role.

In addition to domestic payments services, the banks play a major role in international payments and associated services (e.g. risk management), supporting Australia's involvement in international trade and investment.

Customers, Shareholders, Employees and Other Stakeholders

As well as benefiting the economy generally, banks also benefit specific groups of individuals. These groups include bank customers, bank shareholders and bank employees.

Banks' lending and deposit taking activities are focussed to meet the needs of their customers. Banks have made significant investments in service channels and in new technologies to further improve service delivery. At mid 1995 there were almost 6,700 bank branches in Australia, together with about 5,900

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3 However, limited settlement account facilities have been made available to special service providers such as the Credit Union Services Corporation (Australia) Limited, for example, to settle for direct entry transaction exchange.

4 The previous Commonwealth Government announced in 1995 that building societies and credit unions would be allowed to issue cheques in their own name, but the enabling legislation was not passed prior to the 1996 election, and a decision on this matter has been deferred pending the outcome of the Wallis Inquiry.

agencies; about 6,500 automated teller machines (ATMs) and approximately 93,000 EFTPOS terminals. Other payment channels include telephone banking centres, PC banking and the Internet. About four million cheques are processed each business day (about one billion per year); almost 550 million debit and credit card transactions were processed over the year to May 1996.

The listed banks are owned by a wide distribution of small and large shareholders. Table 2.2 shows over 900,000 individual shareholdings in Australian banks.

TABLE 2.2

BANK SHAREHOLDERS, EMPLOYEES AND BRANCHES, 1995

Bank	No. of ordinary shareholders	Number of employees	Number of branches
National Australia Bank	205,313	45,585	2,025
ANZ	114,829	39,240	1,639
Commonwealth Bank	274,247	35,822	1,601
Westpac	125,969	31,416	1,402
State Bank of NSW	1	4.441	292
St George Bank	52,570	3,757	292
Advance Bank	28,760	2,459	239
Bank of Melbourne	31,226	1,574	122
Metway Bank	22,367	1,506	112
BankWest	67,387	2,872	111
Bank of Queensland	4,772	786	97
Bendigo Bank	8,450	701	74
Adelaide Bank	9,959	779	40

Notes: Numbers of shareholders are at last balance date; employee numbers are full–time equivalents (FTE).
Sources: Annual reports; KPMG 1996 Financial Institutions Performance Survey.

The recent and third Commonwealth Bank share sale has further widened equity ownership in Australian banks.

In addition to being an major avenue for share investment, the banks are also major employers. At the end of 1995 over 214,000 people were employed by banks in Australia (excluding foreign branch employees). The banks have made substantial investments in staff training and workplace improvement.

The banks are important providers of finance to the rural sector, and to small and medium sized enterprises generally. Finally, banks are major contributors to the public purse. In 1995, the banks paid company taxes to the federal government of over $2 billion (excluding foreign bank branches and foreign subsidiaries of major Australian banks), in addition to other taxes and charges at all levels of government.

2.3 Regulation

Prior to deregulation, banks were subject to a plethora of strict restrictions such as restrictions on lending, interest rate ceilings and the flat prohibition of certain products. In addition, banks were required to keep substantial liquid deposits with the Reserve Bank. The Reserve Bank set complex guidelines for banks' lending policies and directed what interest rates could be charged on loans and paid on deposits.

There was some relaxation of regulation in the 1960s, with banks being permitted to offer an expanded range of products such as lease finance and term loans. Over the 1970s and early 1980s, a variety of restrictions such as interest rate ceilings on fixed deposits and maturity limits on certificates of deposit were eased. In 1984 banks were permitted to offer interest on cheque accounts and certain minimum term requirements were removed. The remaining interest rate controls, except for the maximum rate on housing loans, were abolished in 1985. The relaxation of regulations allowed banks to compete more effectively with other financial institutions in responding to customers increasingly demanding better financial products and services. The discussion of this process of deregulation is continued in Chapter Three.

2.4 Conclusion

As the largest group of financial intermediaries, banks play a central role in the economy. They carry out the essential functions of facilitating trade in deficit and surplus financial units, operating the payments system and enabling economic agents to mitigate risks. More generally, the banks, operating in a competitive and responsive environment, serve the range of interests of their customers, shareholders and employees. Accordingly, factors which affect banks in turn impact on the whole community. One such factor has been bank regulation. For many years, banks' operations were handicapped by an unnecessarily onerous system of regulation, involving lending restrictions, interest rate ceilings and tight limits on the products they could offer.

The removal of many of these regulations, if not the precise timing or precise form of deregulation, was inevitable in the face of increasing pressures from customers for better, and better value, services; and increasing competition and product innovation in response, facilitated by advances in technology. Deregulation, producing a more neutral system of regulation across different types of intermediaries, has led to a rapid increase in the level of bank assets, and in banks' share of the assets of financial intermediaries.

It has already been noted that much of this increase was due to the conversion of building societies into banks, and to the re-absorption of substantial non-bank activities of banks into their core bank operations. It is now clear that the loss of business by banks to building societies and other near-banks was primarily driven by an unbalanced system of regulation of intermediaries, and so amounted to a misallocation of economic resources. The fact that the banking structure has prospered under the new, more neutral system, is evidence that this structure and framework have a natural efficiency advantage in financial intermediation as defined in the previous chapter.

The banking industry, like all elements of the financial system, has seen the emergence of a number of trends which are likely to shape financial services in coming decades. Chapter Four discusses the prevailing trends in depth, and Chapter Five explores what they may imply for the future shape of the financial system.

Chapter 3

Deregulation of Financial Services: Benefits and Costs

Key Points

- By the late 1970s, a variety of pressures were making financial deregulation inevitable. Regulations that had been designed to protect consumers and insulate the domestic economy were becoming ineffectual, indeed counter-productive. Australia could not effectively shut out international forces, and one cost of attempting to do so would have been a more and more insular economy. Domestically, new products and competitors were springing up outside the regulations in response to customer demand.
- Major deregulations included the floating of the Australian dollar, the abolition of exchange controls, implementation of market determined rates of interest and the entry of foreign banks.
- Regulation had served to reduce the competitiveness of banks compared to non-banks (although banks themselves were able to compete to some extent via non–bank subsidiaries). When allowed to compete on even ground, the banks regained market share. This also strengthened the channels for effective monetary policy.
- There have been a host of innovations in the post-deregulation period. An enhanced choice of banking products and technological advances, to enable more time and cost effective transactions, have been of great benefit to customers. For example, there is now a choice of over 500 cheque accounts, most paying interest and many of them charging no fees; in 1980 there were only 10 products, none paying interest and all charging fees. Access to services has expanded greatly; opening hours are much longer and there are over 6000 ATMs and 93,000 EFTPOS terminals, all hours telephone services and so on.
- Customers now have the choice of a far larger number of institutions from which to source banking and financial services, due to the migration of non–banks into banking status, the entry of foreign banks and other players and the diversification of existing financial institutions. Competition in the sector has risen considerably and the cost of financial services has consequently fallen. In the 1980s, bank net interest spreads averaged over 4.5 per cent. Since 1990 the annual average spread has not exceeded 4 per cent.
- Controls over interest rates, and quantitative controls on lending, had the effect of limiting the availability of credit to borrowers. When these

and restrictions on the international movement of capital were lifted, the allocation of capital in the market could be determined more effectively by market forces. While difficult to quantify, the benefits of these allocative efficiency gains appear to be significant.

- The end of the rationing of credit, and the advent of market determined rates of interest, has been of benefit to most users, although not necessarily to all of those who were formerly subsidised as borrowers. Adjustment to 'user pays' pricing is necessarily a lengthy process but inevitable in the new competitive environment. Pricing services in relation to their true cost encourages more economically efficient usage patterns and is inherently fairer, but considerably more education and communication is needed in the transition.

3.1 Introduction

Public confidence in the soundness of the financial system is one of the cornerstones of any modern economy. Without this confidence, potential investors would be less likely to invest or lend funds, and the economy would be very restricted in its ability to grow. Regulation of the finance sector is justified in the interest of ensuring that investors and lenders can, without repeated and costly information gathering, be confident that financial intermediaries are prudently run and markets are efficient and fair.

This does not mean that the role of government is to eliminate risk from investment or other financial transactions. Rather, it is to seek to ensure that transactors can, to the extent practicable and efficient, access the basic information they need to make their own assessments about the risks involved; and that in respect of the most frequent and pervasive uses of the financial system—for the multiplicity of payments transactions occurring constantly in the economy—the costs of accessing information needed to transact with confidence are largely eliminated.

Furthermore, regulation should increase investor confidence that fraud in the marketplace will be uncovered and the perpetrators prosecuted. The case for this is particularly easy to see with compulsory superannuation. Members should expect their fund to have a prudent exposure to market risk in the interest of achieving good long–term returns, and not look to government to offset that risk, but they can reasonably expect government at least to regulate to ensure probity in the management of the fund.

Again, especially for a country which is chronically dependent on foreign savings, it is important for the willingness of investors to provide capital that the key exchanges for securities, derivatives etc—together comprising the capital markets—operate with integrity; i.e. fairly, transparently and efficiently.

Governments should seek to create a regulatory environment which encourages an active and efficient market for financial transactions, facilitates investment—domestically and internationally—and maintains financial system integrity and confidence.

Evolution of the institutions and processes of the financial system requires that regulation not be static. Indeed, the Australian experience of regulation up to the 1980s was that the environment had changed so markedly in the preceding decades that it rendered regulation ineffective against some of its basic aims; moreover competition was significantly inhibited in the regulated area while being relatively unhampered outside.

3.2 The Deregulation Process

Australia

Extensive deregulation of the Australian financial markets occurred following the recommendation of the Committee of Inquiry into the Australian Financial System (the Campbell Committee), which ran from 1979 to 1981 and then the Martin Review Group which in 1983 (as its name suggests) essentially reviewed the Campbell Committee's findings for the incoming government. The rationale for deregulation was that controls that had been designed to protect consumers and insulate the domestic economy from external shocks had become counterproductive. Deregulation was implemented at both 'macroeconomic' and 'microeconomic' levels. Major policy initiatives at the macroeconomic level were:

- the floating of the exchange rate;
- the abolition of nearly all foreign exchange controls; and
- implementation of the tender system for the sale of Commonwealth Government securities—allowing the market to determine rates of interest on Commonwealth debt.

The second major thrust of financial deregulation was 'microeconomic' reform—i.e. reform of the regulations affecting the institutions which comprise the financial markets. The deregulatory agenda at this level was aimed at increasing competition among market participants and making it more neutral. Major policy changes were:

- abolition of direct interest rate controls and credit guidelines;
- allowing entry of foreign banks;
- allowing the establishment of new banks; and
- abolition of a number of restrictions on banks entering certain areas of finance.

Fundamentally, deregulation at some time and in some form was inevitable, with new products and competitors (often outside the regulated domain) responding to increasingly demanding customers for financial services. Australia was (as discussed below) not alone in deregulating its financial system in response to such pressures. Equally irresistible were forces for increasing globalisation of financial markets, attempting insulation from which was increasingly futile.

The outcome of Australia's deregulation is a significantly globalised financial marketplace where numerous financial institutions now compete with each other on quality and price. Gone (as also discussed below) are the 'bad old days' when savers were paid low rates to subsidise transactors and borrowers, loans were strictly rationed at the discretion of the bank (subject to the qualitative and quantitative controls imposed by the Reserve Bank); and those rationed out had few and expensive options.

More institutions now offer their customers far more products than at any time in Australia's history. For example, there is now a choice of over 500 cheque accounts, most paying interest and many of them charging no fees; in 1980 there were only 10 products, none paying interest and all charging fees. Access to services has expanded greatly; opening hours are much longer and there are over 6000 ATMs, 93,000 EFTPOS terminals, all hours telephone services and so on. Australia's banks have been at the forefront of this progress, reducing costs, expanding their business into new fields including funds management and insurance, and acquiring significant businesses overseas.

International

Australia, as noted, undertook the deregulation process amidst a worldwide trend toward freer financial markets. Acceleration in the pace of technological change combined with an increasingly integrated international macroeconomic environment necessitated more competitive and dynamic financial institutions. Financial institutions used the changing global environment to maximise returns for their stakeholders, by seeking the best returns on a global basis. This has meant that global capital flows have grown enormously. Internationally, regulation has accordingly changed in emphasis.

Governments, generally speaking, no longer seek to defy financial market forces (although there has been some costly re–learning of this lesson, for example the failed attempt in 1992 and again in 1993 to defend parities within the European Exchange Rate Mechanism). Rather, the focus of regulation has moved from attempting to control market outcomes (e.g. interest or exchange rates) to achieving higher standards of prudential supervision and consumer protection. That is, regulation became more market–oriented, relying more on disclosure and less on controls, aiming in this way to ensure that markets served transactors better.

3.3 Major Deregulatory Changes

A summary chronology of the major financial deregulations is shown in Table 3.1. The most important of the changes are discussed briefly below.

TABLE 3.1
SUMMARY OF THE MAJOR REGULATORY CHANGES

Year	Month	Regulatory Change
1980	December	Interest rate ceilings on all trading bank and savings bank deposits were removed.
1981	August	Minimum term on certificates of deposit was reduced to 30 days.
1982	March	Minimum term on trading bank fixed deposits ($50,000 and over) reduced from 30 to 14 days, and for fixed deposits (less than $50,000) from 3 months to 30 days.
		Minimum term for certificates of deposit reduced to 14 days.
		The requirement of one month's notice of withdrawal on savings bank investment accounts was removed.
	June	The end of quantitative lending guidelines.
1982	August	Savings bank asset requirements reduced to 94 per cent, and prescribed asset ratios relaxed.
1983	December	Australian dollar floated and most foreign exchange controls removed.
1984	August	All remaining controls on bank deposits removed.
		Savings banks permitted to offer cheque facilities.
1985	February	16 foreign banks invited to take up banking licences.
	April	Remaining ceilings on bank interest rates removed, except those on owner–occupied housing loans under $100,000.
	May	The Prime Assets Ratio (PAR) replaced the Liquid Government Securities (LGS)convention.
	September	The first foreign bank began trading.
1986	April	Interest rate ceiling on new housing loans removed.
1987	April	Savings bank reserve asset ratio reduced to 13 per cent.
1988	September	Statutory Reserve Deposit (SRD) ratio reduced to zero.
		PAR reduced from 12 per cent to 10 per cent. PAR to replace existing savings bank regulations.
1989	December	Changes to the Banking Act removed the distinction between trading and savings banks and gave legislative backing to the Reserve Bank's powers in bank supervision.
1990	May	PAR was further reduced to 6 per cent.
1993	June	Increase in the rate of interest paid on Non Callable Deposits (NCDs) to the prevailing market rate (13 week Treasury Note rate). Between 1989 and 1993 NCDs were paid a rate of interest 500 basis points below the market rate.
	December	Further applications from foreign banks were considered, and foreign banks were given the option of operating as branches.
1995	May	Rate of interest paid on NCDs reset at 500 basis points below the market rate—a reversal of the June 1993 regulation.
	October	Revised prudential guidelines for bank involvement in funds management and securitisation activities.

Source: Harper, I, "Bank Deregulation in Australia: Choice and Diversity, Gainers and Losers", in I. Macfarlane (ed),*The Deregulation of Financial Intermediaries*, Reserve Bank Conference Volume, 1991; Jonson P, *Financial Deregulation—The Scorecard*, CEDA 1996.

Floating the Dollar and Lifting Exchange Controls

A number of events during the 1970s, including successive oil price shocks, and rising inflation and interest rates, led to an escalation of trade imbalances and put considerable strain on the existing system of fixed exchange rates. Amidst an environment of wholesale changes to regulation in financial markets, it became increasingly difficult to operate a fixed or heavily managed exchange rate, as Australia had done up to that time. No government could effectively control international capital flows so as to maintain an exchange rate significantly at variance with the market's views.

The floating of the Australian dollar, and the abolition of most exchange rate controls, bowed to this reality and allowed the increasing internationalisation of the Australian financial system. Australian companies were permitted to source capital from overseas more freely, and in a greater change from the past, to pursue investment opportunities abroad essentially without restriction. This has been instrumental to the rise of a number of Australian companies as true multinational corporations successfully competing in the global marketplace—among them leading Australian financial institutions, including the major banks.

Market Determined Official Interest Rates and an End to Credit Rationing

Australia introduced a tender system for Treasury notes in 1979 and Treasury bonds in 1982. Rather than announcing the terms on which securities would be sold (although the preceding 'tap' system was itself an advance on earlier methods), under the tender system the Government would announce the total amount of securities, and their maturity, and let the market determine the prevailing price. This policy change allowed the Reserve Bank's debt management role (on the Government's behalf) to be divorced from the conduct of monetary policy. It also went hand in hand with a general move to market interest rates, and an end to the rationing of credit (quantitative controls over lending).

Interest Rate Ceilings on Deposits

Stringent controls over banks' interest rates were gradually relaxed during the 1980s. Governments had previously prohibited the payment of interest on deposits held for short periods (generally anything less than one month), and placed upper limits on the interest that could be offered on fixed interest deposits. These restrictions only applied to banks, so that under a range of market circumstances the competitive position of the banks compared to non–bank intermediaries (albeit some of them bank subsidiaries) was eroded.

New products and competitors, responding to increasingly discriminating customers, were able to emerge outside the regulations. There was a realisation that to a degree, regulation itself was determining where capital flowed and inhibiting a more general response to customers' needs. It was also the case that interest rate ceilings were acting as a disincentive to save in mainstream financial forms.

Housing Interest Rates

Until 1986 the interest rates that banks could charge on mortgages were restricted by governments. This regulation favoured the many who could access regulated finance over the few who were rationed out. The ceilings effectively placed a cap on interest rates, and were retained for existing mortgages in place in 1986 when rates on new loans were deregulated. Despite the continuing (but fading) distortion in housing lending created by the pre–1986 mortgages, the move to freely variable (un-capped) interest rates has largely removed the disparity in the competitive position between banks and non-banks. It has also provided a more predictable position for the banks (and others) in this market, and therefore facilitated both competition and innovation in the home lending market; this has recently been vigorously apparent.

Statutory Reserve Deposits (SRDs)

The Commonwealth required banks to hold Statutory Reserve Deposits (SRDs) with the Reserve Bank between 1960 and 1988. The SRD was a variable percentage of the banks Australian dollar deposits, and was used as a monetary policy tool. As SRDs made it costly for the banks to raise deposits, they had incentives to fund themselves in a way which avoided the SRDs. The SRD ratio was reduced to zero in 1988, and all banks instead agreed to lodge Non-Callable Deposits (NCDs) with the Reserve Bank. NCDs are equivalent to one per cent of a bank's total $A assets within Australia, less its capital base and favourable overnight settlement balances. These balances are paid a rate of interest which is set at 5 per cent (500 basis points) below the prevailing market rate, costing the banks about $185 million per annum—many times the direct cost to the authorities of their supervision.

Liquid Government Securities (LGS) Convention

The 'Liquid Government Securities' (LGS) convention that operated from 1956 to 1985 required the banks to maintain a ratio of liquid assets and government securities to deposits, above an agreed minimum level (which was 18 per cent when LGS conventions were abolished in 1985). LGS was replaced by the Prime Assets Ratio (PAR) which typified the progressive change in the emphasis of regulation away from direct controls and towards prudential supervision. PAR ensures that banks hold a minimum proportion of their assets in high quality liquid assets on prudential grounds. While present regulation is overly prescriptive (see Chapter Seven) about the range of assets qualifying for inclusion, PAR is less onerous (currently 6 per cent) and is not used as a monetary policy tool as was the LGS convention.

Opening of the Payments System

In the early 1980s banks were the exclusive providers of payments services. In many respects this reflected the legal restriction on the issuance of cheques and the predominance of cheques as a payment instrument. As a result the clearing houses were owned and operated by banks.

Access to the payments system expanded during the 1980s through the implementation of agency arrangements between banks, building societies and credit unions which allowed building societies and credit unions to offer their customers cheque facilities and other payments services.

Access was further expanded with the establishment of the Australian Payments Clearing Association (APCA) in 1992. APCA is now responsible for the operation of the major clearing systems in Australia. Participation in APCA is not based on the status of institutions, but on a set of criteria related solely to the clearing and settlement of payments including:

- having a permanent establishment in Australia;
- being a provider of payments services;
- being able to comply with technical and operational standards;
- paying appropriate fees and expenses;
- not adversely affecting the integrity of exchanges or introducing significant new risk into the system; and
- not impairing the overall efficiency of the system.

APCA is responsible for developing regulations and procedures for inter-bank clearing systems. To date those for paper and bulk electronic clearings have been implemented with consumer electronic and high value to be completed over the next eighteen months. The APCA framework of regulations and procedures covering participation, operation, and failure-to-settle rules are approved by the ACCC before being implemented.

Increased Regulation in Parallel with Deregulation

Deregulation did not totally remove government controls from the financial markets. Regulations which served a prudential purpose were not removed, and the Reserve Bank retained responsibility for prudential supervision of the banks, the Life Insurance Commissioner (from 1987 the Insurance Superannuation Commissioner) for supervision of life offices, and so on.

Indeed there has been increased regulation in a number of areas at the same time, e.g. increased consumer protection regulation generally, increased prudential supervision of banks and a significantly more rigorous prudential supervision regime for superannuation via the *Superannuation Industry (Supervision) Act 1994.*

3.4 The Benefits of Deregulation

The Starting Point: The 'Bad Old Days'

The current regulatory environment allows banks and other providers more freedom to develop products that cater for customers' specific needs than at any time in the past, and competition plus advances in technology enabling providers to respond, has put customers in the driver's seat. It is easy to forget how radical this change has been. This is best illustrated by considering how customers were treated in the pre–deregulation era—the 'bad old days'.

Rationing and 'Capture'

To begin with, due to the rationing of credit, banks would only lend to those personal customers who had an established savings record with their bank. This meant that customers were 'captured' by the institutions, because in order to qualify for a loan they had to accumulate funds for a deposit with only one institution—and generally to demonstrate their loyalty by placing all their business with that institution. This situation was a direct result of regulations that restricted the amount of money banks had available to lend, and the rate of interest that they could charge for those funds. Therefore it was only those customers who maintained large balances over time who could get loans.

Rationing primarily occurred in respect of lending to business. The Reserve Bank imposed both qualitative and quantitative lending controls on banks which both limited the level of lending available to business, and controlled the allocation of lending between different industries. This meant that many businesses were unable to obtain the level of funding through the banking system necessary to grow or invest in new ventures. This particularly affected small businesses who were likely to be assessed as higher risk than large businesses, and thus stood at the end of the queue for the monthly rationing of credit.

Higher Costs of Secondary Finance, 'Rationing Out'

Those customers who managed to overcome these original hurdles would still have to pay a premium for their loan. The cheapest housing loans were rationed among the banks' best customers, so that a bank would rarely lend a customer all of the money needed at the regulated (low) housing loan interest rate. Usually customers then had to take out an additional loan at a higher rate of interest. Those customers who could not demonstrate an impeccable savings record were forced to borrow money from other (non–bank) institutions such as finance companies—usually at considerably higher rates. Or they were 'rationed out'—unable to access at all the loan they needed (and could service).

Low Interest Rates to Depositors

Prior to deregulation, banks were also not allowed to pay interest on cheque accounts. This meant that customers had to juggle funds between a number of accounts to avoid earning negative real returns on their savings (or minimise that). However even normal passbook accounts—without a cheque facility—could be paid only a regulated low maximum rate of interest. For some years this rate was 3.75 per cent, usually well below the inflation rate. When inflation rose to 10 per cent or more, which it regularly did in the 1970s, passbook account holders would 'earn' a significantly negative return on their funds (especially with the nominal interest taxed)—a considerable disincentive to save.

Vastly More Restricted Access than Today

Much freer access by customers to their funds is one of the key advances of the last 15 years. In the 1970s it was necessary to enter a branch of one's own bank to make a withdrawal. This task was particularly onerous because branches opened for business only between 10 a.m. and 3 p.m. They now open for much longer hours and for a range of products, personal service is often provided where the customer decides.

Over 6000 automatic teller machines (ATMs) and 93,000 Electronic Funds Transfer at Point of Sale (EFTPOS) terminals together with telephone banking and the beginnings of on–line services now allow any bank customer to access funds from most locations in Australia and many throughout the world, seven days a week.

The Customer Now the Driver

Deregulation has therefore both allowed and forced the banks and other institutions to offer services that customers had been demanding—what they wanted, how they wanted it provided, and when; and on competitive terms. Competition in the market for loans means that rather than approaching one's own bank after establishing a savings record with it to get a loan, banks and other providers will now send representatives to the customer's home, even after hours.

Clearly deregulation has fundamentally changed the nature of interaction between banks and their customers, the means by which they interact, and the efficiency of the process of intermediation. The consumer is now in a real sense the driver.

Figure 3.1 gives a summary of the major beneficial effects of deregulation to customers.

FIGURE 3.1

EXAMPLES OF INCREASED CHOICE OF PRODUCTS AND INSTITUTIONS

	1980	1995
Banks	19	43
Credit Unions	213	293
Specialist mortgage providers	0	26
Merchant banks	59	83
Funds managers	35	93
Number of different cheque accounts	10	533
Number of different types of mortgages	26	1800
Savings products	600	1700
Credit card holders	3 million	7 million
Bank branches	5,800	6,600
Credit card merchants	120,000	350,000
ATMs	25	6,000

Source: Robert Joss, *"Has Deregulation Worked?",* Australian Banking & Finance Lecture Series 1996

Indicators of Effective Competition

ABA's December 1990 submission to the Parliamentary Inquiry into the Australian Banking Industry (the Martin inquiry) identified eight criteria which could be used to judge the effectiveness of competition in banking:

- profits and margins are subject to competitive pressure;
- costs are declining and productivity is increasing;
- prices represent value for money and reflect costs and product demands;
- access is open and responds to market demands;
- the range and quality of products and the degree of innovation are responsive to customer needs;
- there is no impediment to exit from unprofitable areas and entry to profitable areas. There will, as a result, be rationalisation and changes in market shares, and no particular seller will dominate a market;
- sellers provide adequate information to customers and produce information material as a means of eliciting what customers want; and

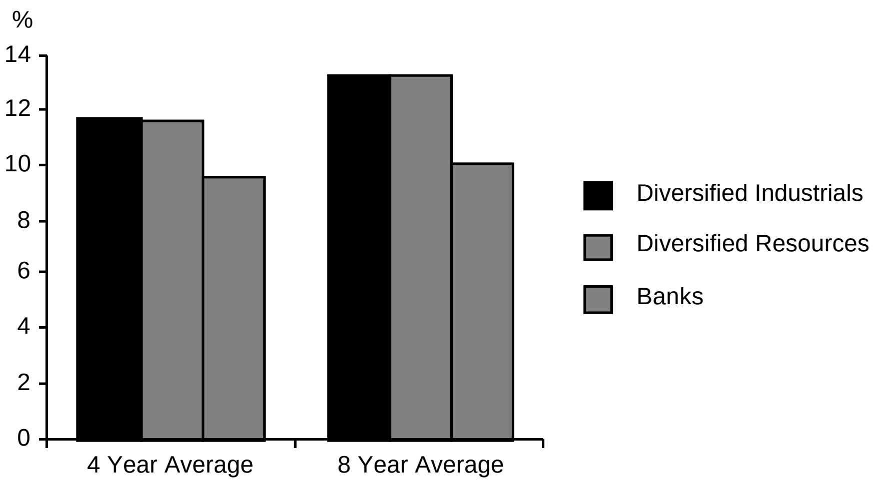
- customers change supplier when not satisfied with the service or price of particular products.

As articulated below, the Australian banking industry satisfies each of these criteria. It has never been more competitive than it is today.

Bank Profitability

The perception that bank profits are excessive is largely driven by the size of the dollar amounts—which are of course substantial. However the absolute size of the balance sheets of most Australian banks means that the dollar value of profits will be large even if returns on shareholders' funds are no more than adequate. In terms of shareholders funds, bank profits indeed do not appear abnormally large compared to those earned in other sectors, even allowing for different industry risk characteristics (see Figure 3.2). A reasonable long–term return to shareholders is essential for the industry to attract capital in competition with alternative fields of investment.

FIGURE 3.2
RETURN ON AVERAGE SHAREHOLDERS' FUNDS

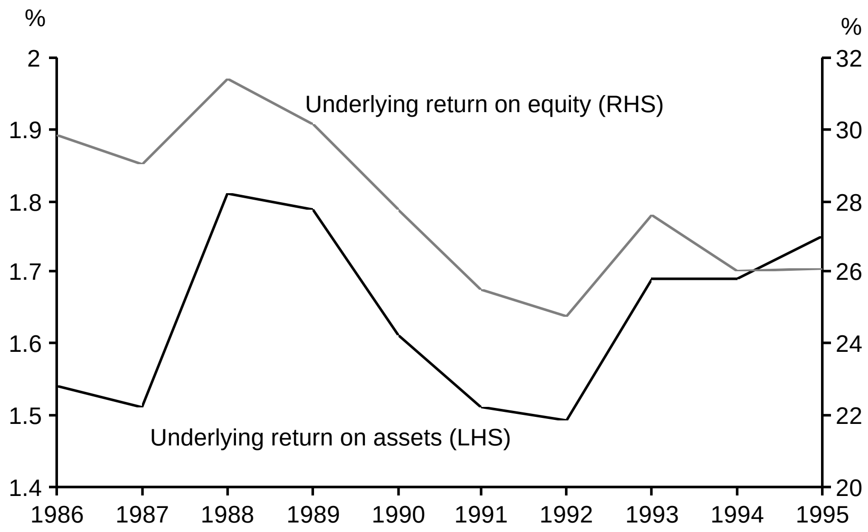


Source: Statex, various issues to July, 1996

Figure 3.3 shows that underlying bank profitability measured in terms of Return on Assets and Return on Equity is below historically high levels. Underlying profitability is a well–accepted indicator of the sustainability of earnings, as the measure removes the impact of the funding of provisions for bad and doubtful debts, abnormal and extraordinary items, and taxation.

FIGURE 3.3

UNDERLYING PROFITABILITY BEFORE TAX



Source: Bank Annual Reports.

Figure 3.3 shows that in underlying terms, return on equity has levelled out (due to improvements in the recent economic environment), after a declining trend over a run of years. This conforms with the explanation that the recent increases in profits and return on shareholders' funds are mainly attributable to substantial decreases in charges for bad and doubtful debts; the increases in underlying return on assets since 1992 result from the reduction in the level of non-performing loans.

It was the conclusion of the Martin Committee[5] that:

> "There is a misconception that banks' profitability has increased since deregulation. In fact it has fallen slightly. Had they not reduced their operating expenses, they would have been even less profitable."[6]

The Martin Committee also stated that

> "when banks rates of return are corrected by the bond rate, the returns earned by Australian banks are consistent with those earned by banks overseas".

Net Interest Rate Margin

In its submission to the Prices Surveillance Authority inquiry into the fees and charges on transactions accounts, the Office of Regulation Review (ORR)

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5 That is, Parliamentary Inquiry chaired by Mr Stephen Martin, MP, as distinct from Mr Vic Martin who chaired the Review Group considering the Campbell recommendations.

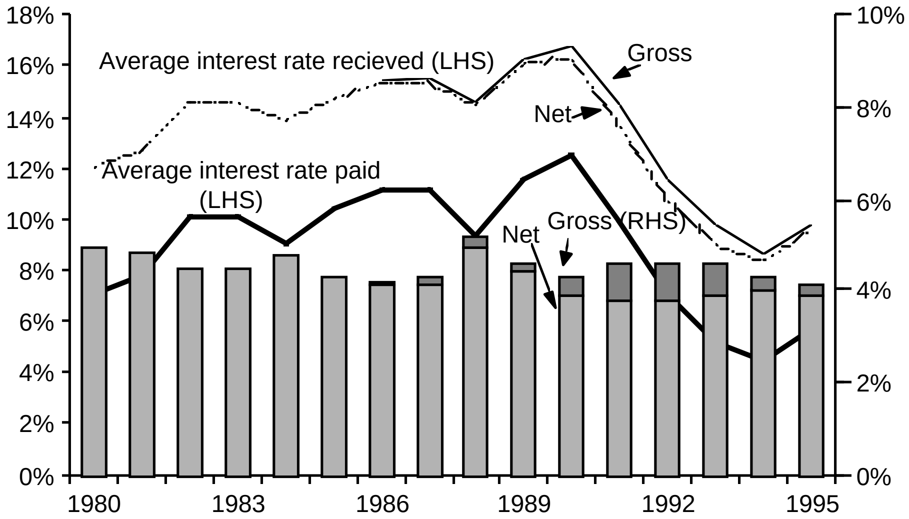
6 *A Pocket Full of Change*, Report of the House of Representatives Standing Committee on Finance and Public Administration, November 1991.

provided an analysis of interest rate margins. ORR cited work conducted by the Reserve Bank which indicates that there has been a decline in the net interest rate margin since deregulation. It is important to note that interest rate margins vary with changes in the level of capital and non-performing loans (reductions in the number of non-performing loans will increase interest income). Therefore, the appropriate measurement is the net interest spread—equivalent to the difference between the average rate of interest earned on a bank's portfolio of interest bearing assets and the average rate of interest paid to its depositors.

As can be seen in Figure 3.4, the net interest spread has trended progressively downward since deregulation.

FIGURE 3.4

INTEREST RATE SPREAD (MAJOR BANKS)



Source: Reserve Bank

Over the 1980s, bank net interest spreads averaged over 4.5 per cent. Since 1990 the average spread has not exceeded an annual average of 4 per cent. The rise in interest spreads in 1988 can be explained by the 1987 sharemarket crash, which encouraged investors to return to the safety of low interest deposits in banks. The reduction in size of the adjustment between the gross and net measures in the chart results from the reduction in the level of non-performing loans.

International comparisons of interest rate spreads are difficult because of structural and institutional differences, however, the Reserve Bank has concluded that total income and profitability of banks are in line with comparable institutions overseas. "While interest margins tend to be higher than in other countries, this is offset by relatively low fees and charges."[7]

7 Reserve Bank Annual Report, 1993-94.

Cost of Financial Services

Competition has compelled all financial institutions to reduce operating costs and the price of services while still earning an acceptable rate of return in the competitive marketplace. Ackland and Harper[8] have shown that bank operating costs have fallen since deregulation. Real deposits per employee have increased, and unit labour costs have fallen. The primary source of operational cost savings has been technological advances which have allowed increased automation of routine procedures previously conducted manually. Figure 3.5 shows a clear fall in banks operating expenses as a proportion of income in the post-deregulation period.

FIGURE 3.5
OPERATING EXPENSES AS A PROPORTION OF GROSS INCOME (MAJOR BANKS)

Source: Bank Annual Reports.

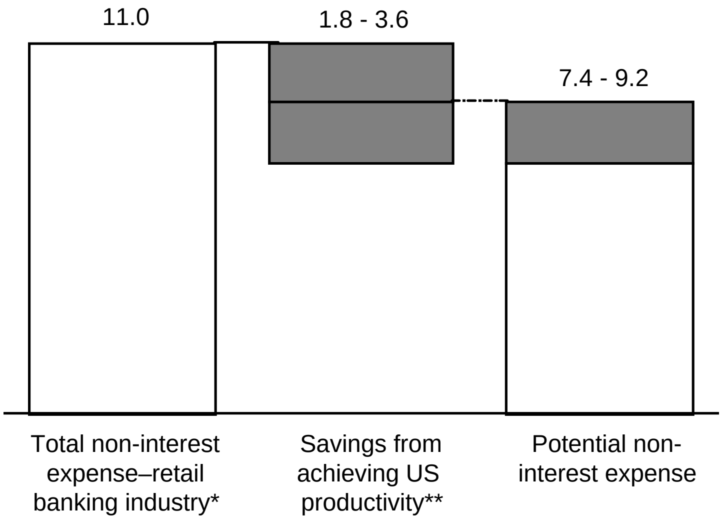
However, despite these cost savings, a recent study by McKinsey and Company has shown that productivity in Australia's retail banking sector lags that in the United States by up to 40 per cent.[9] This implies that the Australian banking sector could save between $1.8 billion and $3.6 billion per annum if it achieved US levels of productivity: see Figure 3.6. According to this analysis, the primary cause of the relatively low level of retail bank productivity in Australia is the large number of branches—in 1993, there were 509 bank branches per million people in Australia, compared with 305 in the United States.

8 Ackland, Robert and Ian Harper, "Financial Deregulation in Australia: Boon or Bane?" in Peter Forsyth (Ed.), *Microeconomic Reform in Australia,* Allen & Unwin 1992.

9 McKinsey & Company Australia and McKinsey Global Institute, *Growth Platforms for a Competitive Australia*, 1995.

FIGURE 3.6

IMPLICATIONS OF ACHIEVING US RETAIL BANKING PRODUCTIVITY
(COST SAVINGS, $ BILLIONS)



Source: McKinsey & Company Australia and the McKinsey Global Institute.
Note: * Assumes that average non-interest expense for a branch is $1.6 million for major banks and $0.8 million for all other institutions. ** Upper bound assumes branch closures spread proportionately across major banks and others. 50% expansion in employees per branch assumed to be required in remaining branches. Lower bound of savings assumes that productivity improvement takes form of employment reductions without savings in premises cost. Employment accounts for around 50 per cent of non-interest expense.

Prices and Demands

In a competitive market, prices reflect costs and changes in market demands. This is the case in Australia. The recent round of drops in housing loan interest rates following the easing of monetary policy is evidence of this: the cost of banks' funds fell as a result of this easing, and they passed on this fall to their customers.

Just prior to that, the fall in mortgage interest rates, initiated by one bank and soon followed by the others, *which occurred even without a fall in the cost of funds,* was a reflection of the highly competitive nature of the housing loan market.

Market Share, Access and Entry

The restrictions placed on banks before the deregulation of the 1980s had reduced their competitiveness vis a vis the non banking sector. There had therefore been considerable substitution away from the banking sector.

In the deregulation era, the market share of the banks has recovered; as outlined in Chapters One and Two, however, to a substantial degree this represents a return of business to bank balance sheets from finance company subsidiaries and the move of building societies to bank status, rather than existing banking groups expanding overall share.

Access to traditional banking markets is open. The recent success of the mortgage originators, whose share of new housing loans has risen from virtually zero to about 8 per cent, is testimony to this. Following a lengthy hiatus, insurance companies are also re–entering the mortgage market.

Similarly, the deposit market—while not as open to entry, for good prudential reasons (as we discuss in Chapter Seven)—is nonetheless very competitive. Evidence for this is the rapid growth in the number of savings products for consumers, as discussed below.

Innovation and Product Diversity

One of the most rapid developments in the post–deregulation era has been accelerating *innovation* in the products and services provided by the financial services sector, and in particular the banks. At the time of deregulation, banks were under considerable pressure from the non-banking sector, primarily due to credit rationing (and also to interest rate ceilings).

The freedom to respond innovatively to consumers came when these credit restrictions ended. Banks were granted both the opportunity and the incentive to expand their business and allow the market to determine rates of interest. To attract new customers, it was necessary for the banks to respond to market pressures, and offer a range of new products and services. Table 3.2 describes many of the major developments in the banking product inventory since 1980.

TABLE 3.2

SUMMARY OF MAJOR PRODUCT INNOVATIONS BY BANKS

Year	Innovation
1980-85	Automatic teller machines become widely available
	Monthly income term deposits
	Card (rather than passbook) savings accounts
	Variable repayment home loans
	Visa card and MasterCard for domestic and international use
	Reduced terms and minimum balances for term deposits
	PIN for credit and debit card access introduced
	Compounding term deposits
	Automatic sweep facilities
	Daily interest cheque account
1985-90	EFTPOS
	MasterCard ATM linkage
	ATM network links
	Packaged statement account
	Specialised agri-business and rural budgeting centres
	Telephone banking
	Cash management accounts
	Housing bonds
	Equity mortgage loans
	Life insurance
	Fixed-rate mortgage lending
	Home banking
	Bankcard debit/credit card
	Enhanced retirement services
	Payroll system
	Business credit cards
1990-96	Mortgage Offset Account
	Credit cards with pricing/features tailored to consumer needs
	(following the deregulation of the consumer credit card market)
	Financial EDI (Electronic Data Interchange)
	Expanded purpose housing loans and redraw facilities on home loans
	Mobile managers used to service remote customers
	Smart Card trials
	Securitised home loans
	‘No frills’ home loan products marketed
	Cash flow lending products marketed to SMEs
	Equity participation in SMEs
	Export Finance Packages marketed
	World-wide ATM access (via Maestro & Cirrus)
	Internet banking
	Mobile EFTPOS (in taxis)

The summary shown in Table 3.2 provides a general indication of the period in which the above innovations became widely available. The actual year in which the products were made available by individual banks varies. It is therefore clear that deregulation has greatly enhanced the choice and diversity of banking products and services on offer to customers. In the post deregulation era these innovations have continued apace, facilitated by considerable developments in technology. As will be discussed in Chapter Four, many Australian banks are, for example, developing on-line banking services using the Internet. Other major developments in the pipeline are mass-market, cost effective usage of electronic bill presentment and payment services, electronic cash and smart card technologies. Intense competition in the housing loan market, for example, has led to the development of innovative loan products which allow extremely flexible payment and withdrawal.

Customers also have far more institutions from which to source their financial services. As noted in Chapter Two, there are currently 51 banks operating in Australia. While many non-banks have obtained banking licences, that sector too has grown, particularly in the area of funds management. The end of capital rationing has meant that financial institutions are less able to ‘capture’ customers. Competition means that banks can no longer reward loyal customers with scarce loans. While relationships still matter, customers will now shop around for the most attractive rates and returns, to a far greater extent than previously.

The banking sector has been (unjustly) criticised for ‘window dressing’ its range of services. The underlying assumption with this criticism is that the expansion in services and products provided by the banks is little more than a marketing exercise—that behind the facade of diversity lie the same old products. Innovations such as EFTPOS and ATMs refute this—showing that there has in fact been a wholesale change in the convenient delivery of transactions services of this kind.

A few more specific examples of increased product variety are as follows. In 1980 there were 26 different types of mortgages and 600 different savings products; currently there are over 1800 different types of mortgage products offering different variable and fixed interest facilities, honeymoon rates, redraw facilities etc, and 1700 savings products. [10]

Considerable expansion in the array of funds management products, and a widening array of risk management (derivative) products also indicate significant financial innovation. The inherent nature of financial products is such that seemingly moderate changes to terms and conditions (including contingent conditions) for repayment can significantly alter price/risk characteristics and so represent significantly different products. Increased diversity is perhaps not as widely recognised as the reality justifies.

Information and Switching of Suppliers

Consumers of finance products now have available to them a wide variety of sources of information to guide their decisions—quite apart from the

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10 Taken from Robert Joss, *Has Deregulation Worked?*, Australian Banking and Finance Lecture Series, 25 June 1996.

information provided by financial institutions. For example, comparisons of mortgage rates and fees are regularly published in newspapers, and specialist magazines provide a wealth of detail on mortgage financing.

For more complex matters, customers can purchase the services of financial advisers.

Customers are also showing much more willingness to shop around for their banking products, to drive hard bargains with their bank managers, and to change suppliers if need be. Indeed, banks have actively encouraged this process by, for example, offering special deals on mortgage interest rates to new customers.

Control over the Financial System

A key motive for the government to engage in deregulation was that monetary policy was becoming more difficult to administer. The declining market share of the banks meant that the key monetary policy transmission mechanism was being eroded.

> "The growth of non-bank financial institutions operating beyond the direct influence of the Reserve Bank, the development of new financing techniques by banks and the increasing integration of domestic and overseas financial markets all contributed to the steady erosion of the effectiveness of monetary policy."[11]

The market determination of exchange and interest rates represented a mechanism by which the government could "extend and even out the influence of monetary policy".[12] Deregulation therefore assisted the Reserve Bank in the implementation of monetary policy.

3.5 Deregulation's Impact on Economic Efficiency

Economic efficiency can be thought to involve four different dimensions—allocative, technical (or operational), dynamic and inter-temporal efficiency. The first three of these criteria were used by the Campbell Committee to assess the efficiency of the Australian financial system.

Deregulation has had a wide–ranging impact on the economy, and has affected all four of these aspects of economic efficiency.

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11 Ian R. Harper, "Why Financial Deregulation", *The Australian Economic Review*, 1st Quarter, 1986, p 430.

12 *Ibid.*

Allocative Efficiency

In an efficiently operating capital market, capital will flow freely towards those areas of the economy which can offer investors the highest possible returns (for a given amount of risk). Regulations that existed in Australia prior to the 1980s hindered these capital flows. Credit was 'rationed', which made it more costly for some customers, and cheaper for others. The managed exchange rate and insulated economy also disrupted the efficient allocation of resources in the economy. Financial deregulation brought the Australian economy closer into the world economy, and thus facilitated an investment climate where capital could flow freely into and out of the country. Thus the removal of many of the impediments to freely flowing capital and the introduction of market determined rates of interest would be expected to have improved allocative efficiency in the economy.

While these allocative efficiency gains are notoriously difficult to quantify, the available evidence suggests that deregulation has been of considerable benefit to allocative efficiency.[13]

It is however true that there remain a number of distortionary regulations and practices in the finance sector, including the ongoing cross subsidisation of many financial services. However, recognising that adjustment was bound to take considerable time on both demand and supply sides (e.g. to identify separate costs very extensively), there has been considerable progress in banks moving toward 'user pays' for many financial services.

Inter-temporal Efficiency

Non-market determination of interest rates payable on deposits meant that the incentives for lenders invariably did not match the underlying economic returns available from investment.

Deregulation of interest rates has removed some of the distortion (other than that induced by tax treatment) from the incentive to save; i.e. consumers face a more realistic trade–off between spending now or saving. In general terms better access to finance has assisted people in planning their spending over their lifetime, and loans are now made on more realistic and equitable criteria than pre-deregulation. Non–price rationing of loans no longer exists.

Dynamic Efficiency

Dynamic efficiency gains refer to advances in technology, innovation and service. As previously discussed deregulation led to rapid growth in financial products and services. The 1980s also saw marked growth in the widespread use of derivatives—essential in modern finance for risk management. More

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13 See for example Carmichael, Jeffrey (1992) "Capital Inflow and Macroeconomic Stability under Australia's Floating Exchange Rate System" EPAC Background Paper no. 17, AGPS Canberra.

sources of finance and more attractive terms have lowered costs for business generally, with consequent impacts on the wider economy.

Operational Efficiency

Overall economic efficiency is enhanced by the degree to which individual enterprises organise their resources to maximise output while minimising costs. Operational efficiency of banks is commonly measured in terms of expense ratios, productivity, number of bank branches relative to population, and interest rate margins.

In the early years of deregulation, banks' emphasis at the operational level tended to be on new product development and the expansion of their business. Consequently, significant improvements in operational efficiency were not particularly obvious in the years immediately after deregulation. In recent years there have been more concerted efforts by the banking sector as a whole to improve their operational efficiency. Technological innovations have allowed the banks to reduce their transactions cost. The implementation of these technologies has been accompanied by the realisation of some economies in branch networks and use of personnel.

3.6 The Claimed Costs of Deregulation

User Pays

Prior to the 1980s, Australian banks rarely used fees to recover the costs of particular bank functions. Instead banks would subsidise certain services—notably transactions services—by funding them through their net interest margins.

Retail customers who made frequent transactions (which were not charged on a per unit basis) were subsidised by other retail customers who made few transactions. In general the system also meant that depositors tended to subsidise borrowers as well as transactors. Less demanding bank customers, in the less competitive banking environment created by regulation—in particular, interest rate ceilings—received a lower return on the capital they lent to the banks, so that the banks could offer lower rates on loans, together with cheap (or even free) transactions services. Indeed, as customers became increasingly demanding but with competition on interest rates still inhibited, institutions were obliged to compete via the (cross–subsidised) services they offered rather than on price.

This system of cross–subsidisation was largely supported by the Australian taxation system. Low fees and charges constituted a benefit which was not taxed whereas if interest rates were higher on deposits (the 'pay-back' for higher fees) this benefit would be subject to a relatively high rate of tax. Many customers who actually contributed to the subsidisation of other bank customers therefore might have preferred to continue doing so on this basis.

Hence the incentives for banks to convert fully to 'user pays' were, and to some extent still are, lacking.

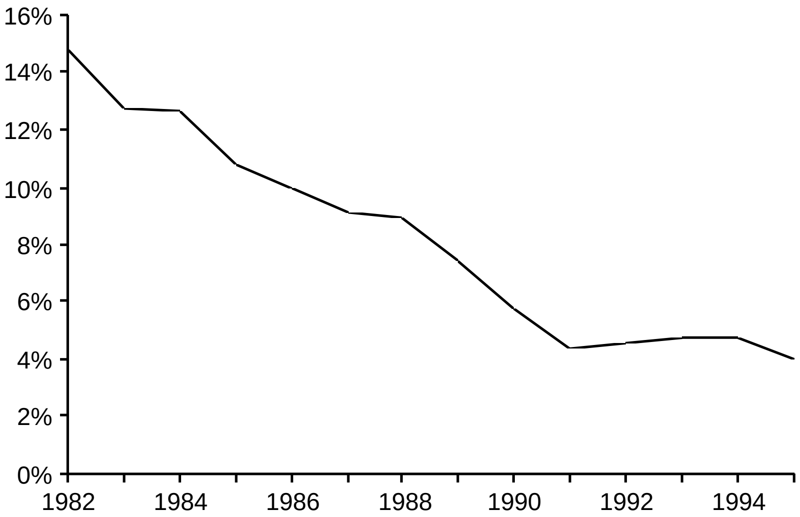
That said, competitive forces have forced a great deal of attention to pricing among the banks. Post deregulation, the larger cases of cross–subsidisation have ceased to be sustainable, as niche competitors (in general, facing low barriers to entry) can quickly emerge to undercut the banks in a service that is being over-priced. Although yet to be fully implemented, it has come to be recognised that 'user pays' pricing represents the most efficient pricing regime for the banks, as it encourages customers to use only the services they require, and at the level with which they require them. Previously, cross–subsidised services gave customers incentive to 'over-use' the 'free' services—such as provision of bank cheques.

Deregulation has therefore seen a movement towards user pays pricing by many banks—including for example transactions charges on deposit accounts, bank cheques, credit cards and custody services. An additional incentive to move towards user pays is that banking is now a more mobile activity. Customers are increasingly likely to switch between banks in the new competitive environment, and banks can no longer rely on credit rationing to 'capture' customers and ensure their allegiance. They therefore do not have a large book of low cost deposits from which to subsidise many of their services. Evidence of this is shown in Figure 3.7 which shows the declining proportion of bank accounts which are not paid interest.

FIGURE 3.7

TOTAL DEPOSITS NOT BEARING INTEREST

(AS A PROPORTION OF TOTAL BANK LIABILITIES)



Source RBA Bulletin, December 1995.

The declining ability to cross–subsidise means that banks must *inevitably* move towards making each service 'pay its own way', even if this is not what customers who use some of the subsidised services would prefer.

User pays represents, to different customers, both a cost and a benefit of deregulation. By definition, cross subsidisation involves a transfer of costs from some customers (and historically, the taxpayer) to others. Inevitably some of those customers who currently receive a significant share of the subsidies will not be as well off under a system of user-pays pricing, even though it is intrinsically fairer and there are others (especially depositors) who are gaining significantly.

Consequently there has been opposition to the progressively fuller implementation of user pays, despite the positive effects for many customers and greater efficiency in the banking industry, which competition will ensure benefits users collectively. Central to these concerns appears to be the view that fees and charges have a negative impact upon disadvantaged groups within society.

It is true that bank fees and charges have the potential to impose a burden on some sections of society. The most costly accounts to run from the banks' perspective are those which maintain low balances and have a large number of transactions—consequently these accounts tend to incur fees. Therefore the case is often made that the user pays system hurts the poor—although, in fact, it is not at all clear that is just the poor, or even mainly the poor, who maintain accounts with low balances and many transactions. Similarly customers who use tellers rather than ATMs are more costly from the banks' perspective, and while a proportion of these customers are elderly and disabled, most are not.

Banks are sensitive to the problems of their disadvantaged customers, and have done much to overcome them. They have voluntarily provided exemptions from fees and charges to many customers who could be regarded as disadvantaged. Some have also introduced a 'basic banking' product with minimal fees following the 1995 Prices Surveillance Authority Inquiry into the fees and charges imposed on retail transaction accounts by banks and other financial institutions. In addition, many banks have promoted methods by which customers can at their own choice avoid paying fees e.g. by maintaining a minimum balance above the fee threshold, or by changing their transaction patterns. Clearly there is a considerable education and communication task remaining, along with further consideration of social aspects.

Most importantly, as the Campbell Report stressed, the best way to help the disadvantaged is through the social welfare system. Distortions to prices implied by the *absence* of user pays—which are in any case not sustainable in the current competitive environment—not only lead to wasteful use of scarce economic resources, which harms the whole community, but are not even a good way of helping those people at whom such actions are presumably targeted. Bank charges are simply part of the cost of living, no different in this respect from the cost of anything else. Community concerns about the effects of bank charges on disadvantaged members of society should be pursued mainly by reviewing the adequacy of social welfare benefits.

ABA submits that operational efficiency gains from user pays have been significant, and that these gains have been passed on to customers i.e. user pays has in fact been an advantage of deregulation in banking. The declines in banks net interest spreads that were shown previously in Figure 3.4 would suggest that these gains have indeed been passed on to customers.

The Office of Regulatory Review found that:

> "As consumers become more used to 'user pays', and as banking technology advances further, fees and charges are likely to be applied more broadly and in a manner which more accurately reflects the cost structure of retail banking. As this will take some pressure off interest margins as a source of profitability, margins could be expected to narrow further."[14]

The Lending Boom

The end of credit rationing in the early 1980s and the advent of market determined rates of interest saw the banks compete aggressively for the market share they lost in the pre-deregulation era. This competition manifested itself in what turned out to be excessive lending. Prolonged asset price rises throughout the 1980s saw rapid expansion in credit—much of which was lent at high rates of interest, and dependent on continued escalation of asset prices. When asset prices began to fall, many of these loans became bad debts, and merchant banks and banks were both left with considerable liabilities.

There is a perception that deregulation allowed this credit 'binge' to occur. It is argued that relaxation of many prudential controls enabled the banks to act in an irresponsible manner. It is certainly true that some banks did not exhibit adequate skills in risk assessment at that time, but it is easy to criticise in hindsight—what is not clear is whether or not greater prudential supervision would have reduced the likelihood of risky lending. Furthermore, and most importantly, the credit boom and bust of the late 1980s and early 1990s was not just a matter of bad lending decisions by banks: these were made in an environment where high inflation interacted with the taxation system to produce a high and growing *demand* for credit by businesses. And, of course, the lending boom was a world–wide phenomenon which occurred in both regulated and deregulated markets.

There is no available evidence which supports the view that the Reserve Bank or another regulator would have made better decisions about credit risk than the banks did.[15] The Australian economy was growing strongly, and deregulation was expected to lead to an increase in the riskiness of banks' portfolios. Prudential regulation, supervisory practices and reporting standards could have been tightened at the same time as lending and interest rate controls were eased—rather than a few years later. However, many of the difficulties of the policy makers could not reasonably have been foreseen, and

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14 Submission to the PSA inquiry by the Office of Regulation Review.

15 And, of course, the two banks which failed in this period, State Bank of Victoria and State Bank of South Australia, were not, as State–owned banks, supervised by the RBA.

short of reinstituting credit rationing—which would see many worthwhile investments go unfunded, regulation would have done little to stop the excessive lending of the 1980s.

Volatility

Financial deregulation has increased the capacity of Australia's financial system to absorb shocks to the Australian economy, but has also increased the exposure to external forces. While it is difficult to demonstrate conclusively that interest rates and asset prices have been destabilised by deregulation, it is plausible that globalisation has increased volatility in financial markets. Integration with other major economies around the world has made us more constantly feel the influence of fluctuations in those economies. This volatility makes domestic macroeconomic management more difficult, and arguably has reduced the effectiveness of fiscal policy.

It is not possible to insulate the Australian economy from overseas developments. It is clear that the benefits of a globalised financial system far outweigh costs such as increased volatility, particularly given the risk management tools now available.

Deregulation has allowed Australian residents to invest and borrow more freely from overseas—essential for maximum wealth creation, including diversification of exposure to both risk and economic opportunity. Equally it has allowed users of capital in Australia to access a richer array of funds sources on favourable terms. While Australia's own saving is recognised to be sub–optimally low, that traces largely to structural settings of Australia's public finances and overall incentives to the community through taxation and spending policies. The benefits of integration with international financial markets stand independently of those factors.

3.7 Re–Regulation or More Deregulation?

The Australian financial system has been substantially transformed in the last 15 years. Large-scale deregulation has proceeded at a pace that has been at the forefront of financial system reform worldwide. Increasingly, the inefficiency of the bureaucratic and regulated environment of the pre-deregulation era could not be sustained amidst an environment of global competition. The current regulatory system has opened the Australian financial system up to the rigours of international competition and made the Australian currency one of the most actively traded in the world.

As previously mentioned, these changes have made the Australian economy more directly exposed to external volatility on a regular basis. This has motivated some economic commentators to call for a return, or at least a partial return, to a more regulated financial environment—i.e. for re–regulation.

Since deregulation, Australian authorities have introduced a number of new regulations, particularly in the consumer protection area (privacy laws, a new

Consumer Credit code and so on). A new *Superannuation Industry (Supervision) Act* and a new *Life Act* have significantly intensified prudential (and other) regulation in relevant non–bank fields. The most significant change in prudential regulation of banks has been the introduction of internationally agreed capital adequacy controls; these require banks to hold an amount of capital commensurate with the risk of their balance sheets. The prudential regulation of banks is discussed at length in Chapter Seven.

3.8 Conclusion

Deregulation has made Australia's banking system highly competitive and responsive to its customers domestically and increasingly competitive internationally. This competition is reflected in the development of numerous new products and services—all of which enhance customer choice. Competition has also ensured a far closer relationship between bank and market rates of interest. Legislated ceilings on interest on deposits have been removed, so savers are now able to obtain higher returns on their money, and borrowers no longer suffer from the rationing of credit. All financial institutions have adapted to the new competitive environment—bank interest spreads are now a full percentage point lower than they were pre-deregulation.

Customers have therefore benefited considerably from the improvements in efficiency created by competition. More fundamentally, deregulation assisted banks to respond to customer pressures and has effectively made the customer the driver. Banks have been steadily reducing their cost ratios and increasing their deposits per employee—with the immediate consequence of lower costs to customers. Banks have also become increasingly competitive in the services that they provide to business—which assists those businesses to be competitive, domestically and internationally.

The best assurance that this will continue to be the case is the strength of competition now apparent across the financial sector, domestically and internationally. Chapter Four, the next chapter, describes the trends in financial services that are now apparent, having emerged out of the environment of the past two decades or so, flowing from deregulation, globalisation and the onset of new technologies for delivering banking services. In Chapter Five following, a vision is sketched for the Australian financial system to play its optimal role in the unfolding environment. That vision is then brought to bear in highlighting the constraints that stand in the way, and which require review by the Inquiry.

Chapter 4

Trends in the Provision of Financial Services

Key Points

- Deregulation, the rising influence of the customer, globalisation (in some market segments) and technological advance are the four key, interacting trends that are changing the structure and environment of the financial services industry—as they have done for more than a decade past. Perhaps the most influential driver is the customer—with banks and other institutions taking initiatives in response and technology playing a key enabling role.

- These trends have led to the emergence of both niche players and 'financial conglomerates' which have taken advantage of the easing of entry barriers and blurring of boundaries between segments of the financial sector. All types of financial institutions are under increasing pressure to respond to increasingly demanding consumers who require mobile, flexible access to financial services at low cost.

- There is an increasing trend to disaggregation (or 'deconstruction') of banking into component activities, with new players entering some such parts (e.g. loan origination or administration) without becoming banks.

- Globalisation has seen enormous growth in the flow of capital between nations. Financial groups need to achieve competitive scale in the delivery of financial services, particularly in the most internationally open areas. However, competitive scale is not necessarily synonymous with large scale, as in some activities technology allows more customised or smaller scale operations to be efficient.

- Improvements in technology have indeed proven critical to financial institutions in achieving and maintaining competitive advantage. Computer and communications technology have helped the industry become less labour–intensive and less reliant on 'bricks and mortar' networks.

- Technology is enabling consumers to access services 'anywhere, anyhow, any time'. It is now possible for retail banks to offer customers phone, automatic teller machine, fax and telebanking facilities—all of which offer alternatives to personal contact, while that also remains an option. But the technology based options enable potentially significant cost savings which improve competitiveness and deliver better services to consumers at lower cost.

- Electronic and on-line banking are already here but have yet to change the face of banking. However they have the potential for their effects to snowball and to revolutionise financial service provision—to re-shape distribution radically, to provide further opportunities for new competitors to enter, and to open up cross-border banking far more widely to retail customers.
- The take-up of on-line banking is at present more constrained by the rate of penetration of personal computers with modems than by the rate of provision of higher bandwidth, but will grow. Other technologies, such as smart cards, are currently being used as alternative forms of data and credit storage. While more expensive than magnetic strip credit cards, declining technology costs and convenience mean that multi–purpose cards have the potential to compete widely with cash for small value purchases in the relatively near future.
- In the US, remote delivery channels for financial services have enabled institutions without extensive branch networks to enter areas of business traditionally restricted to retail banks. The most obvious cases are major funds managers who now offer transaction services via computers and the telephone. Software and telecommunications companies are also in the wings, along with new players with no close past involvement with the sector or the technologies it uses. Some of these developments are emerging in Australia.

4.1 Introduction

Deregulation, the rising influence of the customer, globalisation and rapid advances in technology are all having a fundamental impact on the Australian financial services industry. These trends are changing the structure of the industry, the nature of the business itself, and the means by which it is conducted. Globalisation has necessitated, and deregulation has allowed, the emergence of ‘financial conglomerates’—paradoxically along with niche businesses, small and large. Technological advances are allowing a range of financial business strategies and configurations to be viable in the changing environment, each designed to respond better to particular groups of customers.

Technological change has also meant that the distribution channels for financial services are changing—responding to customers wishing to access services ‘anywhere, anyhow, any time’. These technological developments have not, as yet, created a total technological revolution in Australian banking, or other financial services. (Australia remains somewhat behind the US in this area.) However, use of electronic, phone and on-line banking and other financial services is growing, and this trend is expected to accelerate. The cost and convenience of such transaction channels is both an opportunity and a threat to traditional banking. As time goes by, financial services can be expected to look and operate quite differently from the way they currently do.

Banks—which continue to have an advantage in their extensive physical presence (many points of contact with customers) are feeling increasing competition from e.g. the funds management industry, which can potentially overcome its lack of physical infrastructure by employing new technologies (available, of course, to the banks as well).

While the new technologies are increasing the competitive pressures on banks in some markets, they are also providing opportunities for banks. In the United States, for example, several banks have joined with Microsoft to provide services on its Home Banking Network, and other personal computer–based banking systems, while others have entered into alliance with Intuit, who manufacture and sell the ‘Quicken’ financial software package. While Australian banks are not as far along in terms of these types of alliances, some steps in this direction have already been taken. Similarly, the potential exists for banks to work with telecommunications companies to enhance their delivery of financial products and services to their customers.

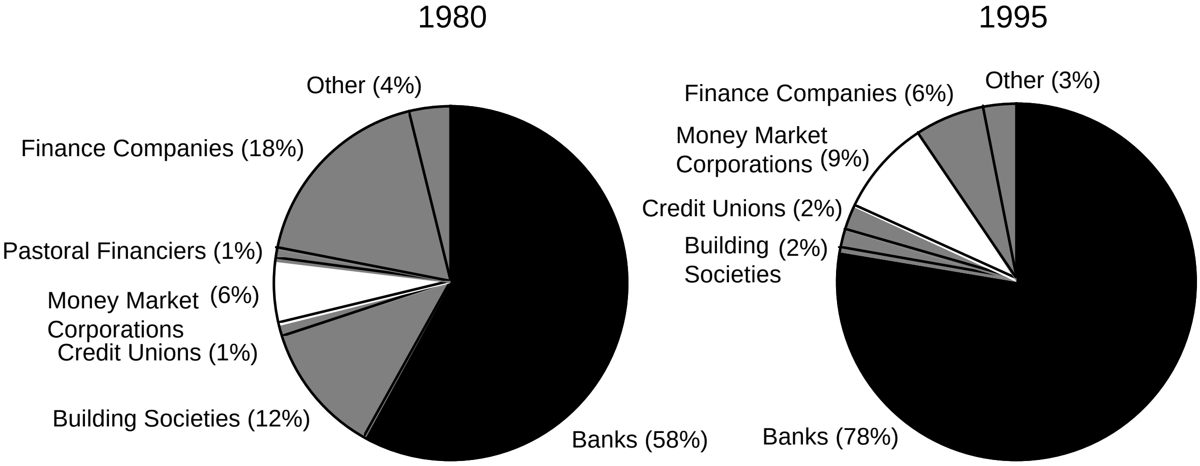
Competition is driving improved service provision and structural change in the supply of financial services, which is in turn steadily raising the expectations of consumers. Customers have been a strong force in all the changes since the 1970s; deregulation opened the way to their stimulating providers to be more responsive and technological change is allowing them to be increasingly demanding. The choice and diversity of institutions and products on offer to consumers is now greater than at any time in the past, and this has led to a constant search for new technologies and products that will sustain provider comparative advantage under this customer–driven and technology–facilitated environment of ongoing change.

This chapter explores the trends in financial services which are creating this environment. The following chapter discusses a vision for the kind of Australian financial system that may emerge in the period ahead, and what constraints lie in the way of that vision.

4.2 Market Share

In the post–deregulation period there has been a reversal of the trend away from bank finance. Immediately after the Second World War banks accounted for as much as 90 per cent of the assets of all financial intermediaries. By 1980, as noted in earlier chapters, this share had fallen to just 58 per cent—largely due to the effects of regulation on the terms of competition between banks and other (less regulated) intermediaries. After deregulation the banks share of assets improved, reaching 78 per cent in 1995 (see Figure 4.1).

FIGURE 4.1
ASSETS OF FINANCIAL INTERMEDIARIES



Source: RBA Bulletin, April 1996.

As already noted, the apparent decline of the banks to 1980 was overstated to the extent that they operated in less regulated segments via subsidiaries, and conversely the rise after deregulation (their ranks being augmented by the new banks). Nevertheless it is clear that free from regulatory barriers, the banking sector is able to offer services very competitively *vis–a–vis* other financial institutions.

In the post-deregulation period, the traditional distinctions between financial services organisations have become less marked. Banks have diversified into areas that were previously the domain of non-bank financial intermediaries, such as superannuation and other funds management institutions, notably insurance companies. Conversely, non-bank financial intermediaries are now performing a range of traditional banking functions—such as offering cheque and credit card facilities, as well as housing and even commercial lending.

The trend remains for building societies to pursue banking licences, as relative to other non-bank deposit taking institutions, bank status generally does confer the ability to raise funds on more favourable terms. A former building society which recently gained a banking licence, Bendigo Bank, gave the following rationales in its first annual report:

- an enhanced capacity for expansion by virtue of superior access to capital markets and the ability to offer a wider range of products to customers, especially corporate customers;
- the ability to issue cheques in its own name;
- the ability to accept deposits from a wider range of clients, including other banks; and
- a lower cost of funds.

In addition, as discussed in Chapter Seven in the regulatory context, there is the public perception of safety that is associated with banks.

The trend for building societies to become banks is just one manifestation of the erosion of distinctions between banks and non–banks, and the consequent development of multi–faceted financial service institutions (with a banking licence) and smaller niche businesses (such as mortgage loan originators) competing in all sections of the financial services sector.

Financial Conglomerates

Financial conglomerates have arisen largely in response to the institutional basis of regulation and the perception of profit opportunities from leveraging existing customer bases using core competencies. In addition, globalisation has forced financial groups to obtain sufficient critical mass to offer services at internationally competitive price and quality, or (at some time) face foreign competitor entry; and these conglomerates are using ‘product bundling’ and branding as a competitive weapon against players (both small and relatively large) adopting niche strategies. The largest ten of these conglomerates account for more than 50 per cent of Australian financial system assets.

Figure 4.2 shows the distribution of financial services provided by a number of the prominent conglomerates operating in Australia.

Niche Firms and Disaggregation (or ‘Deconstruction’) of Banking

The ability of niche firms (often, but not necessarily, small) to be competitive is most fundamentally a result of technology reducing distribution and processing costs, reducing efficient scale of some activities and facilitating customisation—against a background of competition for the business of discriminating customers. In the past, distribution typically represented 60 per cent of a bank’s costs—which represented a significant barrier to entry. New product specialists have emerged to compete in areas of cross–subsidised bank business and to take advantage of cross–industry linkages. Home loan originators and car-maker owned car leasing companies are two obvious examples.

These businesses generally avoid costly branch networks and concentrate on customer service by way of technological solutions. Home lending officers who are linked to their headquarters through mobile laptop computers are one example. The net effect of the growth of these businesses on the banking sector has been to raise competition and increase the quality of service provision to consumers.

In effect, we are seeing the beginnings of a future trend, to be discussed more fully in Chapter Five, to disaggregation of the component activities of banking (‘deconstruction’ as it has been termed). New players who can provide *parts* of the overall process (e.g. home loan origination, or subsequent administration) can enter a particular activity without becoming banks.

FIGURE 4.2

FINANCIAL SERVICES OFFERED BY MAJOR PROVIDERS

(ILLUSTRATION ON A SEPARATE PAGE)

Internationally, new players have emerged from perhaps unexpected quarters. As noted, for example, Intuit, a software company (developer of the 'Quicken' range) is offering financial transactions services in alliance with financial institutions. General Electric Capital Corporation has become a major player in a considerable range of services (e.g. credit cards); and telecommunications companies are actively looking at financial services markets. While such developments are not yet as far advanced in Australia, it is very likely that non–traditional players from such quarters will target niches in financial services in Australia in the period ahead.

4.3 Globalisation

Advances in communications technology, and the progressive deregulation of international financial transactions have assisted financial institutions around the world not only to compete for domestic customers, but to globalise their operations. Combined with the easing of restrictions on foreign investment in many Western economies, these forces have led to a very strong increase in international capital flows, with growth in portfolio investment flows now running well ahead of direct investment flows. Globalisation has precipitated unprecedented growth in the trading of currency, debt and financial instruments of all kinds.

Gross portfolio and direct foreign investment flows combined have increased more than tenfold since the late 1970s. Over the same period world trade has increased by only three times. Similarly, foreign exchange turnover in Australia has grown to over $50 billion each day—making the Australian currency the sixth most traded in the world. This rapid rise in cross–border transactions has made national economies, and their financial institutions, considerably more interdependent and, perforce, competitive. It has also necessitated a greater industry focus on risk management, and consequently the development of derivative securities markets. Some of the consequences of globalisation, in combination with technological advances and deregulation, have been:

- advances in credit management, such as portfolio lending, dynamic credit reviews and dynamic provisioning;
- the use of negative correlations to reduce volatility in portfolios of all sorts;
- sophisticated asset/liability management, including the extensive use of derivatives;
- real time gross settlement and improved counter party risk management; and
- risk weighted capital allocation systems to understand the range of institutional exposures and risk/return trade-offs.

These developments are not functionally related to globalisation *per se*—they could, in principle, have come about in a world without cross–border capital flows. However, globalisation has increased the extent of their adoption by banks, who have become increasingly conscious of competitive forces around the world, and how those forces are affecting they way they do business (though to different degrees in different markets).

Technological advance has both changed the nature of competition and responded to changing customer preferences. In turn, each of these forces has responded to deregulation, and, to varying degrees, driven the policy agenda as market forces have made some regulations obsolete. Technology, deregulation and globalisation together have both reduced many of the barriers to entry in the financial services sector and provided the means for institutions to respond.

4.4 Technology

Increased domestic and global competition in banking is thus making the timely adoption of technological advances critical for the maintenance of competitive advantage by all financial institutions. The essential nature of financial intermediation is that it is information and technology intensive. Superior information technology systems deliver operational efficiency, provide greater functionality and comparative advantage. Historically retail banking was among the more labour intensive occupations. This is being changed dramatically by computer and communications technology.

Current trends in financial services make it clear that banks are set to become more rather than less dependent on technology. The emergence of electronic systems for payment, which include ATMs and EFTPOS, has begun to impact significantly on the share of transactions handled at bank branch level.[16] It would appear that the majority of bank customers in Australia are using these services, but also continue to use branch services. Figure 4.3 shows the rapid growth in the use of ATMs and EFTPOS in Australia.

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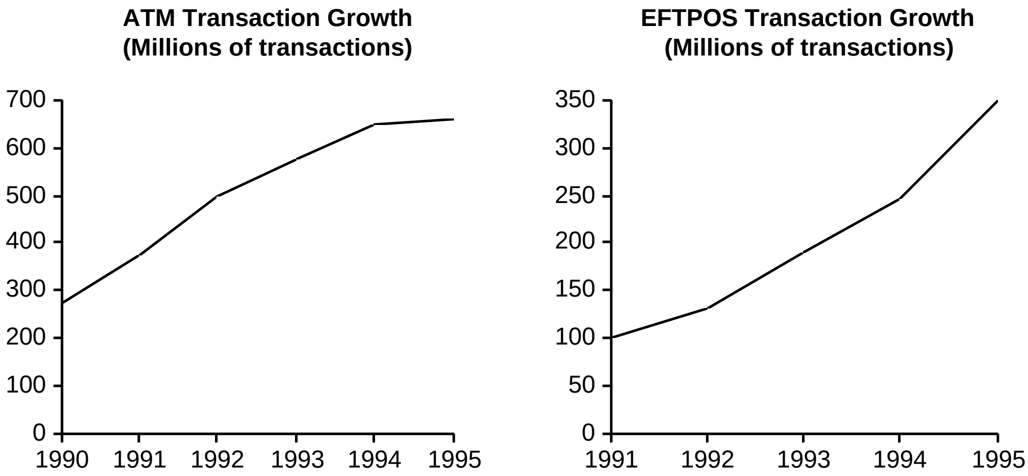
16 According to Ernst and Young's *1996 Technology in Banking Survey*, the proportion of retail transactions performed in bank branches is expected to fall from 35 per cent to 30 per cent between 1994 and 1998. The proportion of electronic transactions performed in branches is expected to fall from 61 per cent to 30 per cent, over the same period.

FIGURE 4.3

GROWTH IN ELECTRONIC DISTRIBUTION



Source: Australian Payments System Council.

Table 4.1 gives further evidence of the move towards electronic transactions.

TABLE 4.1

NON-CASH PAYMENTS (PER CENT OF TOTAL)

	Volume		Value	
	1991	1995	1991	1995
Paper	60	50	59	35
Electronic				
Retail	40	50	2	1
Wholesale	*	*	39	64

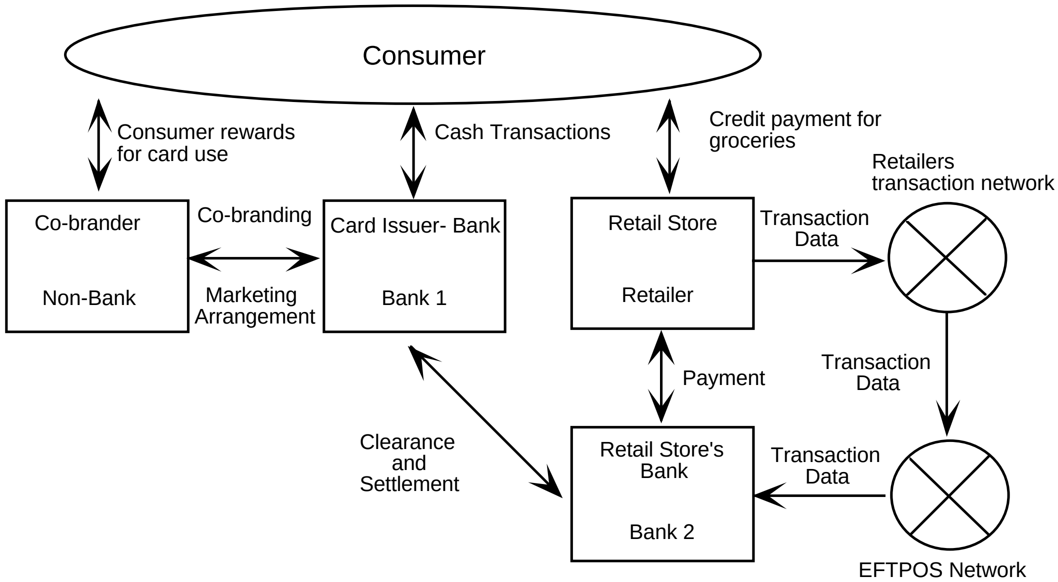
Source: RBA Bulletin, May 1996.
Note: * Below 0.1 per cent.

Customer behaviour is thus changing to make the most of the currently available technology, without yet totally revolutionising the way in which banking business is conducted. In effect the menu of choice of how to receive service is being widened, without the previous choices being dropped. In particular, traditional face–to–face service is clearly preferred by many people for at least some services, and retains a significant place. However the trend towards greater use of technology in financial services is likely to continue.

One effect of the emergence of electronic banking has been to begin to 'interweave' the payments system into a much broader base of business in the economy. Figure 4.4 gives an example of this concept for a credit card transaction. What would once have been a simple cash purchase between a customer and a retailer can now involve a number of bank and non-bank players electronically. While the functions of the banks involved remain fundamentally the same, there is much greater involvement of non-banks in the payment process. For example, when a consumer uses a credit card issued by a non–bank, settlement may involve payment from the non–bank's bank to the merchant's bank. This has added to the 'blurring' of the traditional distinctions between financial services firms—although, for sound prudential reasons, non–banks are not involved in the settlement of value in payments systems.

FIGURE 4.4

A CREDIT CARD TRANSACTION



Electronic Banking for Business

Electronic banking in various forms has been available to the business sector for some years. For example:

- The Direct Entry (CEMTEX) system was developed in the 1980s primarily to address the electronic payment of wages and payrolls for business customers. This system is similarly used for direct debits.
- Most banks have offered to businesses proprietary systems for the processing of electronic payments e.g. payroll, account reconciliation.
- Similarly, banks have offered cash management products, such as those which provide the ability of businesses to access and download their account balance and transaction information, or download data using a computer.
- Other electronic products include remote banking and information systems which facilitate transfer between accounts and access to a wide range of financial information. There are also PC–based systems available to business customers for commerce and international trade, which are used for issuing payment instructions in various forms.

Electronic Banking for Retail Customers

For retail customers, the availability of widespread electronic banking is more recent, and technological innovation has further potential to change dramatically the key interface between these customers and financial service providers. The traditional mechanism of customer contact in retail banking has been a network of branches located throughout the company's market area. It is now possible for banks to reduce the necessity for physical infrastructure, and instead to employ technological solutions which provide customers convenient and cost–effective access to a wide variety of financial services. (However, as noted, this does not mean the *elimination* of bank branches, for which there will undoubtedly be an on–going demand by customers for some services; the trend is to *menu–widening* and a *relative* shift of usage patterns to the newer delivery modes.)

Electronic distribution of financial services can currently (or in the immediate future) be delivered via the following mechanisms:

- Branches (eg kiosk);
- Delivery channels (eg telephone banking, mobile sales force);
- Devices (eg ATM, EFTPOS);
- Payment instruments (eg Credit, Debit and Smart card);
- Message format (eg Electronic Data Interchange).

These forms of service provision have three key advantages: convenience, cost, and the additional customer information provided by the method of interaction—which assists institutions in their marketing of products. The information provided through these media can be automatically downloaded, and customer accounts can be updated in real time. It is, however, bank customers who are the primary beneficiaries of these innovations. Lower costs are passed on to the customer in lower fees, lower interest rates on loans and higher interest rates on deposits, and remote access to banking services reduces the time consumers spend conducting financial transactions.

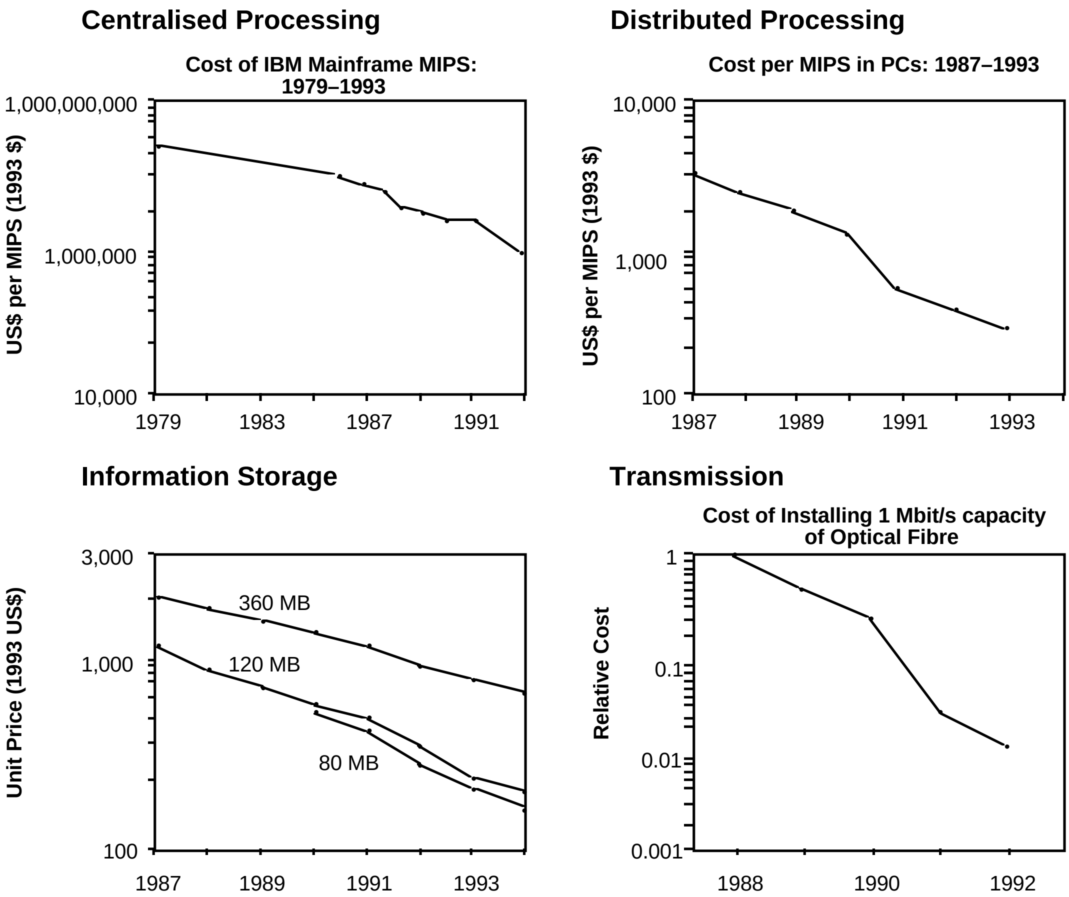
The most significant of the advantages from the banks'—and their customers'—perspective is cost, and hence the level of charges. Branch networks are costly to maintain, require large numbers of staff, and thus provide services in an expensive manner. As noted in Chapter Three, when customers maintain low balances, and particularly if transactions services are not separately priced to cover their costs, the provision of these services becomes uneconomic. Traditional banks have also tended to mass market their services, cross–subsidising those customers who are uneconomic. The traditional branch system has allowed little differentiation among customers of an institution in either service or pricing.

While banks have reacted to the cost of operating branches by investing in new technologies (see below), this does not mean the end of branch banking. As noted above, there will remain a demand for the services provided in bank branches for the foreseeable future. For some customers, personal interaction with their bankers will not only be preferable but necessary, at least for some services, and bank branches will provide the location where that interaction takes place. Moreover, as noted by McKinsey & Company,[17] perceived customer and competitor reactions make it difficult for any individual bank to close its branch in any one micro–market.

This has slowed the pace of branch rationalisation. Nonetheless, banks have reacted to the costs associated with providing large scale branch networks, by providing and promoting the use of ATMs. As ATMs conduct transactions at about one quarter the cost of human tellers, this clearly makes economic sense, to the extent that many customers can have their needs fully met by the ATMs. Provided that the implementation of electronic infrastructure is accompanied by reductions in branch costs, overall costs will fall.

As the panels in Figure 4.5 below indicate, the costs of information processing and storage technology are declining rapidly—indicating a continuing strong trend favouring technology–intensive channels for delivery to the consumer.

FIGURE 4.5
THE FALLING COST OF TECHNOLOGY



Source: *The Future of Retail Banking*, Deloitte Touche Tohmatsu International, 1995.

Declining technology costs have already realised significant cost savings for banks and their customers, and will continue to do so. McKinsey & Company

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17 *op. cit.*, p 106.

has outlined a scenario envisaging three waves of progression in the move towards electronic banking (see Figure 4.6).

FIGURE 4.6
THREE WAVES OF DEVELOPMENT IN MULTIMEDIA SERVICES

Primary consumer benefit driving change ...		
Access / Convenience	**Information / Financial Control**	**Price / Convenience & Value Added Services**
1990-1996: Wave One ATMs and telephones	**1994-2005: Wave Two** PCs and On-Line Services	**2000+ Wave Three** E-Cash and interactive video
Wide consumer acceptance of remote delivery • Telephone • ATMs • Mail Proliferation of electronic payment vehicles and clearing/ settlement networks • Debit • Credit • Electronic bill payment	Large segment of customers routinely accessing information on-line Financial management software/ gateways gain popularity Electronic bill presentment and payment services become standard Gateways and intelligent agents spur wave of "electronic commerce"	Electronic cash and smart cards displace cash and checks for a significant proportion of transactions Real-time, interactive two-way video financial services gain wide acceptance Interconnectivity among various payments/ information networks (credit, debit, E-cash) allows funds to be easily transferred among various accounts

Source: *The McKinsey Quarterly*, Volume 2, 1995.

The time frames of this progression are based on the presumption that:

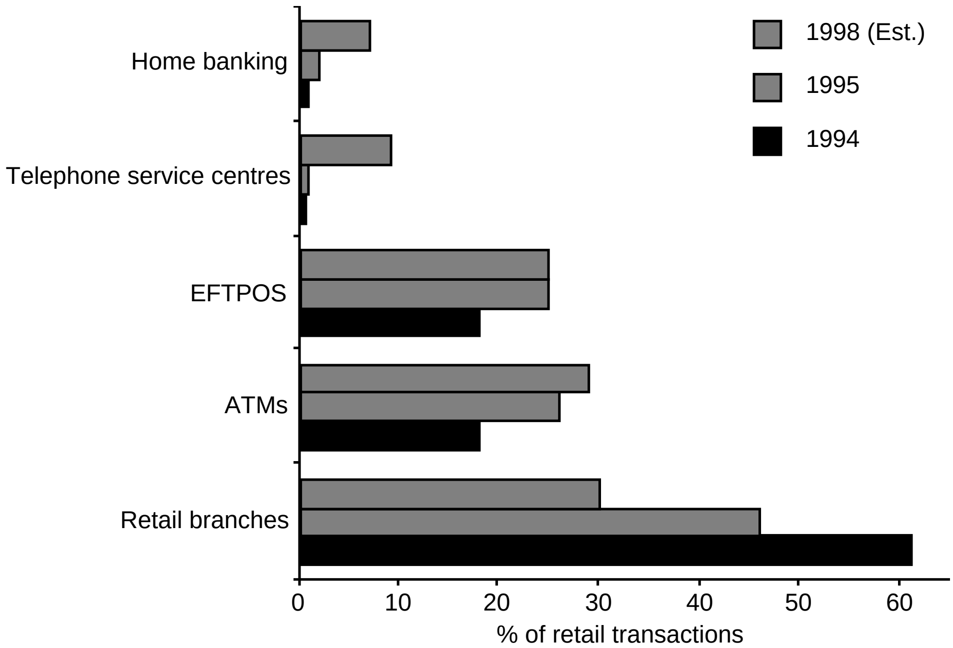
- most of the technology required to drive each wave has already been developed;
- the length of each wave will be dependent on the acceptance of new technologies among consumers and reduction in technology costs; and
- waves and changes in the delivery of financial services are building and reinforcing changes in the delivery of all products and services.

In the US, where much of this analysis is focused, the trend towards electronic banking, and rationalisation of branch infrastructure is most pronounced. Already 57 per cent of all banking transactions take place outside the branch—24 per cent by phone and 31 per cent by ATM. Nearly 20 per cent of US consumers visit a branch less than once a month.

Figure 4.7 shows projections for Australia on the distribution of electronic banking by different channels. Between 1994 and 1998, the percentage of electronic transactions performed in branches is expected to drop sharply, with increasing percentages for ATMs, EFTPOS, Telephone Service Centres, and Home Banking.

FIGURE 4.7

CHANGING DISTRIBUTION OF ELECTRONIC BANKING—AUSTRALIA



Source: KPMG *1996 Technology in Banking Survey.*

The key technologies that are facilitating the trend away from branch banking are phone banking, banking via computer, and potentially smartcards.

Phone banking

Phone banking enables customers to perform a number of common bank transactions over the phone. These transactions include checking account balances, transferring funds between accounts, and paying bills. The range of options available in phone banking services varies between Australian banks. Many banks offer a 'minimum service' which includes obtaining account balances, ordering bank statements and accessing transaction details. Other banks can now offer ordering of cheque books, payment of bills (including credit cards) and checking of term deposit rates.

Telebanking

Telebanking allows bank customers to use their personal computer for conducting some transactions. At present most telebanking services operate through direct linkages to the bank, although CBA's 'telebank' operates through Telstra's public videotext network called Discovery.

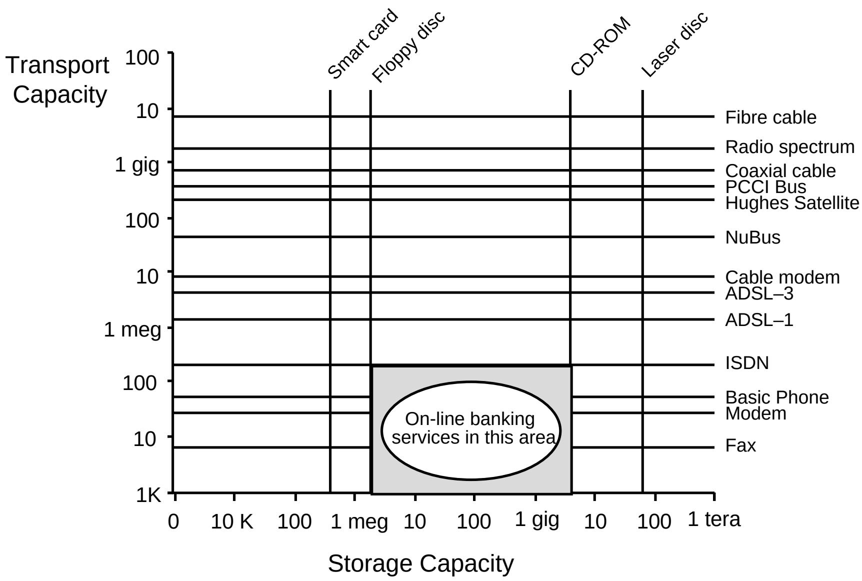
On-line Banking

It is predicted that the next major impact in the financial services industry will come from on-line banking. On-line banking will occur both via the Internet and via private commercial networks. On-line banking will entail a revolution in financial service provision because it will substantially re-shape distribution, provide opportunities for new entrants to extend cross-border banking to the mass market. The first Australian bank to use the Internet to offer transactions services (between accounts at present) is Advance, although all banks see the potential of this medium due to its cost and availability advantages.

When the capabilities of today's technologies are considered, it is clear that the enabling technology for on-line banking is already available. As Figure 4.8 shows, on-line banking can be achieved with a modern personal computer, a modem, and existing telephone services.

FIGURE 4.8

ELECTRONIC TRANSPORT AND STORAGE CAPACITY OF DIFFERENT TECHNOLOGIES
(BITS PER SECOND (LOG SCALE), BITS (LOG SCALE))



While on-line banking services are currently available on a small scale, large scale implementation of on-line banking is popularly thought to require the installation of sophisticated optical fibre networks—to provide the broadband communications ideally required for fully interactive services. This is however more in the nature of convenience technology, rather than enabling technology. Skilful use of the storage capacity in today's personal computers allows them to mimic a fully interactive service very effectively, even over ordinary phone lines. The take-up of on-line banking services is therefore likely to be driven in the present circumstances by the rate of penetration of personal computers with modems, the spread of purchase of access to on-line services (including subscription to the Internet), and the availability of the service from banks or other providers.

This is not to downplay the importance of bandwidth, expansion of which will improve the quality of interaction and thus no doubt encourage take–up. In this regard, Australia is currently a leader in roll–out of optic fibre cable networks. And as indicated in Figure 4.8, technologies such as Asymmetric

Digital Subscriber Line (ADSL) are in any case capable of raising the transmission capacity of ordinary telephone lines by a factor of 50 or more.

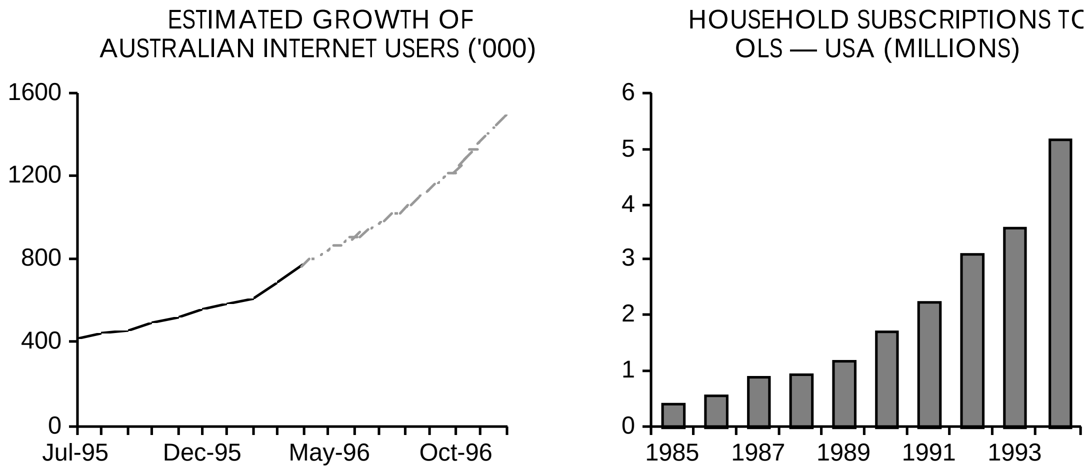
If penetration of personal computers with modem is the presently binding constraint, Australia is also among the leaders on that score. Australia has the second highest penetration of personal computers in the world, after the United States. It is estimated that in early 1995 approximately 40 per cent of Australian households had a personal computer, and this number is growing steadily.[18] The rate of modem adoption in Australia is also accelerating. It is estimated that in 1995 about 20 per cent of Australian households also had a modem, and this figure is also rising very rapidly; penetration of modems may now be over 20 per cent of *all* households. (In the future, PCs may be manufactured with modems and Smart Card readers both in-built.)

The situation in the US is very similar; on recent estimates, already 30 million households had PCs, and over twenty per cent of those owners currently used modems to help manage their financial affairs. The provision of services and software to facilitate the integration of this PC infrastructure with the financial services sector is likely to become a very big business.

Access to on-line services, and not merely the means to achieve it, is also growing rapidly—both in Australia and around the world. As shown in Figure 4.9, if Australian Internet connections grow as predicted, there will be substantial population coverage by 1997.

FIGURE 4.9

GROWTH IN INTERNET AND ON-LINE SERVICES USAGE IN AUSTRALIA AND THE UNITED STATES



Source: Standard & Poors Industry Profile.

It is also the case that Internet and modem ownership among high net worth

18 *The Online Economy*, Cutler & Company Report, October 1995.

individuals is even greater.[19] Therefore if the next few years does see the introduction of on-line banking services to satisfy these individuals, it is likely that cost pressures on traditional branch networks will intensify. Traditional banking channels may end up serving predominantly lower value customers—and branch networks at their existing extent may not be able to sustain the costs of the remaining customer base.

Financial Services Software

Financial services software forms the last part of the enabling environment for on-line banking. More sophisticated financial software for personal computers is now commercially available and widespread. However the provision of on-line services by financial institutions is less well developed. As security and other issues are overcome (as is occurring), this will undoubtedly begin to change rapidly at some point.

Smart Cards

Smart cards are a type of data storage system, which encode information on an embedded microchip rather than on the magnetic strip used by credit cards. The memory capacity of the microchip is approximately 80 times that of a normal credit card, consequently the data storage possibilities are far greater. The extra space on a smart card could be utilised for storing additional information, such as the management of customer loyalty programs.

The memory capacity of a smartcard would allow retailers to store customer loyalty information on the card—with loyalty credits added to the balance on the card as purchases are made. At present the cost of a smart card can be as much as twenty times that of a conventional magnetic strip credit card, and smart cards also require an expensive reader. While information storage and processing costs are declining rapidly, and smart card technology has been predicted (for some time) to be about to revolutionise cash transactions, in reality it would appear that cost effective technology that will totally replace cash is some time away.

That said, in many environments, smart cards can be implemented cost–effectively, and are being trialled in many parts of the world, including Canberra, Adelaide, Queensland and Western Sydney. The most immediate and obvious use for the cards is that they will compete with cash for small value purchases. Phone cards—a special single purpose smart card—are an example of this. Their advantage is that the consumer no longer requires exact change, and the telephone companies simultaneously reduce phone theft and coin collection costs.

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19 Cutler & Company, *op. cit.*, point out not only that there is high penetration among the top 30 per cent of households, but that there is considerable overlap of this segment with small businesses with less than four employees, many of which are operated from homes. Penetration among such businesses is estimated at around 80 per cent.

While total replacement of cash may not be imminent, widespread use of smart cards for small value purchases, both single and multi purpose cards, is likely in the near term.

The development of electronic cash and smart cards, in particular multi purpose cards, creates a number of policy questions:

- Should there be any restriction on who can issue 'electronic cash' and under what circumstances it is to be issued? (This is addressed in Chapter Seven.)
- What is the status of the promise to pay? Should there be restrictions on how the float is used, or unused float retained? Should issuers of electronic cash be required to maintain cash reserves against the 'electronic cash' they have issued?
- Can electronic cash be used to evade laws such as the Financial Transaction Reports Act? Should there be restrictions on the cross border transfer of electronic cash?

4.5 Non-Banks Entering the Banking Business

The advent of remote delivery channels for financial services has sparked the interest of financial service providers worldwide. In the United States mutual fund companies have already taken advantage of the growing use of multimedia, and many would appear to be moving towards the 'virtual financial institution' concept. Fidelity and Schwab, two major US fund managers, already offer 24 hour telephone and PC access, transaction accounts, bill payment services, and cheque facilities, linked to a wide range of investment products. Both have developed a low cost network of 'microbranches' in strategic locations to satisfy consumer needs for personal service.

It is therefore conceivable that in the near future Australian non-bank financial institutions could begin to compete aggressively for some aspects of bank business without a major physical branch network. It is not just fund managers who see the possibilities of the new distribution channels for financial services. An important group of new entrants will be technology based companies—e.g. software companies and telecommunications companies. These companies possess one or both of two key advantages—in–depth knowledge of advanced technologies, and established networks of customers.

The continuing fall in the cost of technology exhibited in Figure 4.5 compounds those advantages, spelling rapidly falling entry barriers. The structure of on-line services is particularly likely to advantage telecommunications companies. These advantages are likely to mean that complex alliances develop—both linking financial service providers with electronic distribution specialists and redefining the on–the–ground distribution and sale of financial services products.

Already in Australia's concentrated retailing market, alliances of this type have begun to occur. The 'Fly Buys' grouping of National Australia Bank, Coles–Myer and Shell and the 'Telstra Card' grouping of ANZ, Telstra and Mobil are leading the process. Overall, the traditional delivery of financial services by self-contained institutions is unlikely to remain the sole means of distribution. It is likely to have been augmented by a series of complex alliances.

Falling entry barriers will also lead to the entry of new players. An example already mentioned is General Electric Capital Corporation, now a major financial services player, which has bought Myer's credit card business. Its parent's traditional business had little to do with financial services.

Of course, as noted earlier, the entrance of non–banks in the banking business, facilitated by technological advances, offers opportunities for banks as well as competitive challenges. Banks throughout the world are entering in alliances with software providers like Microsoft, and with telecommunications companies. All of this should be to the advantage of banks' customers. However, in order to deliver these benefits, banks must not be saddled with the sort of regulation which prevents or disadvantages them from competing with new providers of banking services. Banks should have opportunity to use the new technologies flexibly to increase diversity of options for customers, and efficiency.

4.6 Back Office Concentration

Scale and cost considerations, as well as advances in technology have led banks to disaggregate and concentrate the component process of banking—e.g. to seek to concentrate, and relocate, their back office processing. Over the last decade the job of processing and clearing individual transactions has been progressively removed from individual bank branches, and performed at centralised processing centres.

The reasons for this are clear. Transactions processing is one area of the banks' business where there are clear economies of scale. A natural result of this trend is for multinational banks to develop cross–border or international processing centres. (A good example is American Express, which uses a single regional processing centre, located in Sydney, for South East Asia.) The development of banking services over the Internet will also necessitate cross-border processing. Back office concentration is therefore likely to become 'footloose', with incentives to locate in countries with the most amenable tax regime. Little or no such processing is likely to relocate in countries that have significant transactions taxes such as Financial Institutions Duty and Debits Tax.

4.7 The Future

The pace and extent of these changes is likely to be such that Australia needs to have policies in place which can accommodate and facilitate them, or run the risk of damaging the international competitiveness of the financial services industry. The next chapter explores these issues. Already, technological trends indicate that in the next decade we will see the following major advances:

- On-line services (via the Internet and proprietary networks) will become a major distribution channel, providing Australians with access to a vast, world-wide range of banks and other service providers.
- The twin trend towards ‘universalists’ and ‘product specialists’ appears likely to continue, possibly with financial and non–financial companies increasingly combining and large multi-national product specialists emerging.
- Back office processing will further concentrate with locations chosen on a regional or global basis.
- Current geographic definitions of markets may, over time, become less relevant with the development of a global marketplace.

4.8 Conclusion

Few industries can be experiencing the rate of change that the financial services sector is undergoing, currently and prospectively. The deregulated, highly competitive and internationally open environment is decisively shifting the drive for change to customers—with the availability of increasingly powerful technology at rapidly falling cost making it a reality for them to access the services they want in the form and at the time and place they want them. Face–to–face human contact at branch or office will be just one mode of financial service provision.

This combination of forces is clearly very challenging to Australia’s financial institutions, not least the banks. They will need to remain at the leading edge of change and flexibly adapt their strategies in response to that change. This may involve the contracting out of some parts of what is now an integrated banking service to specialist providers, or it might involve the integration of what is now not a banking service into a ‘financial service package’.

The essential point is that while it is easy to speculate about what the future might look like, it is very difficult to try to make many specific predictions about how the financial marketplace will evolve, as this will involve a combination of new technologies, customer preferences and business strategies—none of which is easy to forecast.

The regulatory implication of this uncertainty is that it is pointless to be prescriptive now about the future. The financial system, including its regulatory apparatus, must be sufficiently flexible to allow banks (indeed all institutions offering financial services) to adapt to the new commercial environments which will arise. The following chapter discusses a vision for the evolution of Australia’s financial system in the unfolding environment, and discusses the constraints that stand in the way. Later chapters discuss regulatory issues.

Chapter 5

A Vision for the Financial System and Current Constraints

Key Points

- The market for financial services is now more competitive locally and globally than at any time in the past, and the one certainty for the period ahead is that the environment will be one of continuing change and increasing competitiveness. The challenge for Australian financial institutions will be to remain proactive, and to stay at the forefront of continuing change. Consideration of the nature of change, and how institutions can respond, leads to a vision of how the Australian financial system can be successful in the unfolding environment, and a focus on what constraints presently stand in the way.

- Clearly, the way in which financial institutions utilise the emerging technologies and adapt their business configurations flexibly to focus on meeting their customers' needs as the environment evolves will be critical to success. Not all changes will be the predictable outworking of present trends; some will be unforeseen and the key to success will be the ability to adapt.

- Financial service providers are in the best position to identify their own key competencies and develop their own business strategies. Because one of the trends which seems likely to strengthen is the disaggregation of banking into component activities, these key competencies are likely to be best viewed in generic terms—for example, competencies in information processing or relationship management—rather than in 'banking' as such. Banks will nevertheless continue to be for many people the first point of contact with the payments system.

- Current constraints impeding banks (and other financial institutions) include some of the present prescriptive regulations, particularly those (e.g. some of the Reserve Bank's Prudential Statements) which restrict the configuration of businesses through which financial services are provided. Market forces should be allowed the major role in determining those issues, particularly in an environment of competition and continuing change, subject to preserving safety and stability.

- Given the rising need for flexibility, there should be an increased reliance on objectives–based regulation rather than rules–based regulation. That is, regulation should be designed and conducted to accept a variety of means from market participants, so long as they meet the ultimate objectives of the regulation.
- The existing taxation environment in Australia also significantly restricts the ability of financial institutions to deliver products and services competitively; Australia's heavy reliance on transactions taxes drives away internationally mobile business. Australia's system of taxation of financial products also presents significant disincentives to saving and contributes significantly to an uneven 'playing field' among savings products and providers.
- The regulatory and tax environment for financial services will impact directly on the economic efficiency of the domestic economy itself, but equally importantly, on the international competitiveness of the economy. Thus the framework of regulation for the financial services industry needs to be both competitive and dynamic—to ensure that Australia, in an ever–changing environment, fosters and maintains a comparative advantage in markets like banking, funds management and capital and encourages saving.

5.1 Sources of Pressure for Further Change

As outlined in Chapter Four, financial services activities are information intensive, as customers are increasingly 'switched on' to the power of technology to meet their needs more conveniently and more cheaply. This sector is therefore one of those most likely to be affected by changes in technology in:

- information processing, storage etc; and
- telecommunications.

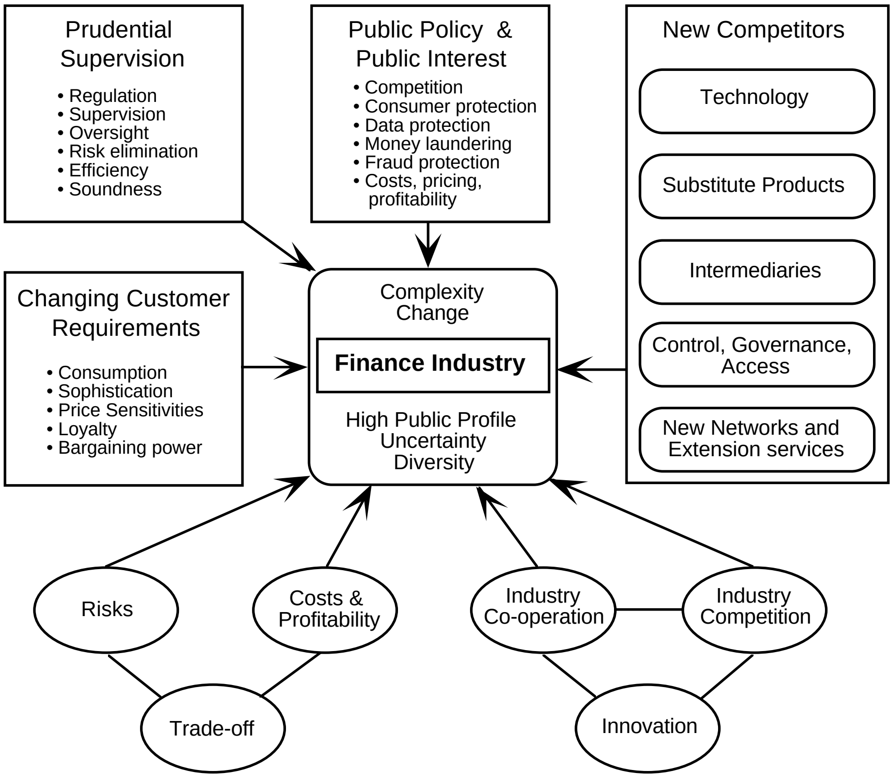
Also, for partly related reasons, financial services has been one of the sectors most involved in the globalisation of economic activity. This has been occurring, and is likely to run considerably further, not merely in areas where improving technology for 'distance delivery' of products or services (e.g. via the Internet) is increasingly becoming available, but widely across the sector—often using already existing technology more intensively.

More generally it is occurring because market entry barriers to many financial services segments are falling, particularly as the cost of technology falls (see Chapter Four) and this is set to continue. Even where market segments are likely to remain essentially domestic (e.g. home mortgage loan or car purchase loan origination), business *ideas* will be rapidly mobile internationally, and will affect competitive conditions in local markets. But the area of *direct* international competition will certainly increase also (e.g. for some transactions services, retail investment products, securities trading etc).

Figure 5.1 encapsulates the overall complex of pressures and changes—including pressures from regulators and from legislators responding to public interest pressures—facing banks in the unfolding environment.

FIGURE 5.1

PRESSURES FOR FURTHER CHANGE



The Disaggregation or 'Deconstruction' of Banking

The pressures and changes in train will, as suggested in Chapter Four, almost certainly continue to open up the financial services industry, including banking, to 'unbundling' or disaggregation—i.e. separation of formerly integrated processes into component activities. The established 'full service' players, particularly the established banks, are already facing selective competition in some activities—especially where traditional joint pricing practices make an activity attractive to new entrants (as in mortgage loan origination). This trend is one which is likely to run much further. Banks will increasingly face more generalised pressures to outsource particular components of service production and delivery where a specialist contractor, or perhaps a joint service organisation,[20] may be able to provide these more efficiently (or at least pressure to ensure that in–house production is efficient).

What this means is that the services bought by customers will not necessarily be manufactured by the financial institution from whom they buy them. Figure 5.2 illustrates how a product which may appear to a customer as an integrated whole is actually a bundle of disaggregated elements. In a possible future way

20 The Credit Union Services Corporation (Australia) Ltd is an example.

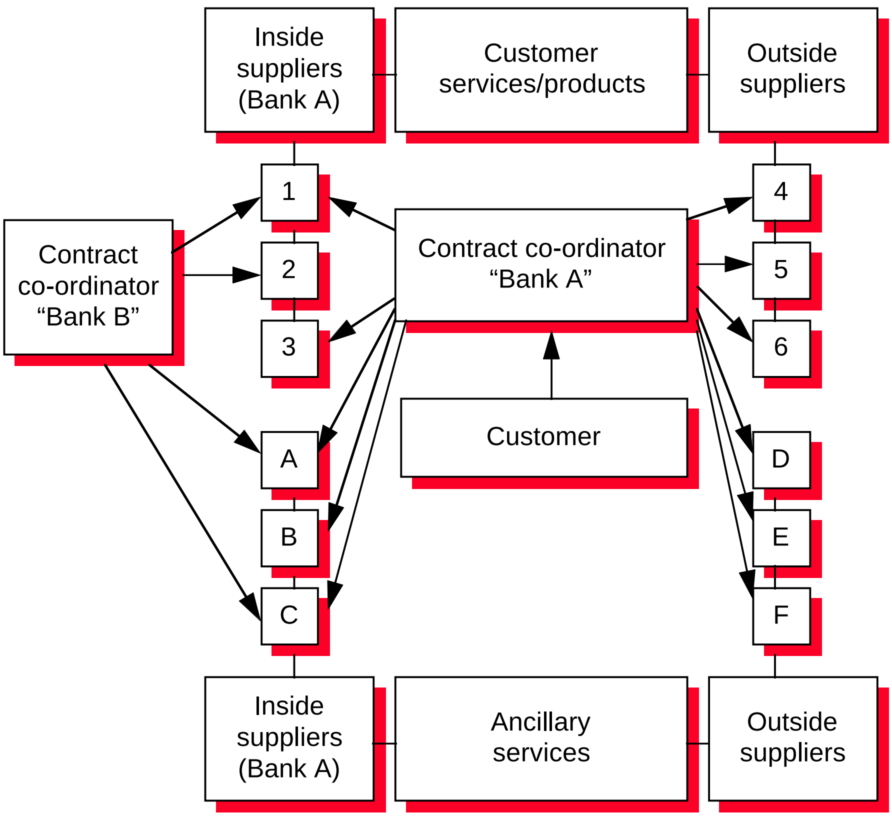
of doing business, some of these elements may be sourced from units within the bank itself, while others are sourced from external service providers. The role of the bank is to determine which components are sourced internally and which elements are 'sub-contracted'.

The boxes marked 1, 2 and 3 are particular products. The consumer of these products has the relationship with the bank in effect acting as the 'contract co-ordinator'. The arrows indicate supply contracts between the bank and other organisations. The boxes A, B and C represent the different components of the products and services offered by bank A. Bank A internally sources the components A, B and C, while E, F and G come from outside. In turn, Bank B sources A and C from Bank A.

Thus each bank may 'unbundle' its activities, specialising in those areas in which it has an advantage, and out-sourcing those which are better produced by someone else. In a recent paper, banking expert Professor David T. Llewellyn describes these possible developments as the 'deconstruction' of banking processes.

FIGURE 5.2

THE 'DECONSTRUCTION' OF BANKING PROCESSES



Source : David T Llewellyn, "Banking in the 21st Century: The Transformation of an Industry", paper presented to the Reserve Bank of Australia Conference, July 1996.

For example, once a credit has been assessed and a loan initiated, the subsequent loan administration might be contracted out to a specialist with the scale to do this more efficiently than a former integrated provider could do in–house. So far, such outsourcing has not been extensive in Australia, but the trend is set towards increased outsourcing—albeit with the bank or other financial institution remaining responsible to the customer for the service and relationship.

For financial services institutions to retain substantial processing and similar operations in–house, these will require minimum efficient scale. For some activities, this may not be enormously large, but it will be for some—particularly those high volume processes which are intensive in centralised information technology (and thus require major overhead investments in this technology). Technology, whose cost is falling, will however make efficient scale smaller for some functions and will certainly support increasing flexibility in tailoring delivery to whatever mode suits the particular customer for the particular product or service at the particular time—as well as supporting increased customisation of the products themselves.

Thus one element of a vision for Australia's financial system a decade ahead of now is the achievement of efficient scale in all component operations, and with technology also used to achieve much greater *flexibility in delivery* to the customer: 'anywhere, anyhow, any time'.

5.2 Benefits to Customers and Challenges to Regulators

Customers will increasingly obtain access to better, more flexible and cheaper products. They will have access to better information and advice and have better ability to manage the risks they face.

Clearly the regulatory framework must allow the market itself the greatest possible role, consistent with broad public policy objectives, in influencing providers of financial services to choose the business configurations which maximise their opportunity in profitably serving customers—by best meeting their needs. Accordingly, there will be greater pressure than in the past to focus regulation as closely as possible on those areas where regulation is justified in the public interest, and not to extend it beyond that domain to the point of imposing unwarranted constraints on providers' ability to respond to market opportunity.

As the following chapters discuss, ensuring the integrity of the payments system will remain one of those areas, as will ensuring the integrity of other key financial market mechanisms, notably the securities exchanges. The former is integral to the efficient conduct of commerce and everyday financial affairs; the latter to the key process of marshalling investors' funds towards productive investments.

In the unfolding environment however, such regulation will need to be undertaken within an overall framework which keeps prescriptive regulation about the configuration of business groups providing financial services, including bank–based groups, to a minimum.

5.3 The Need for Flexibility in Financial Services Groups

The future regulatory system must be one which allows financial services groups and indeed other players in financial services markets the fullest flexibility to identify their own key competencies and to develop their own business strategies to meet customer needs. For banks, and indeed for other kinds of financial services businesses, the key competencies on which to found successful business strategies responding to the environment which will unfold over the next 10–15 years will, no doubt, not be ones which are narrowly institutionally conceived (e.g. 'banking expertise' or 'insurance expertise') but which are more fundamentally generic, focusing on the essence of each activity e.g.:

- delivery capacity;
- expertise in information acquisition and processing;
- expertise in risk analysis (or analysis of some particular generic classes of risk);
- expertise in relationship management;
- monitoring the behaviour of counter–parties and enforcing obligations;
- broking / trading; and / or
- innovative service delivery.

Figure 5.3 encapsulates a vision of how such core competencies will form the fundamental basis for the evolving response of a proactive and successful financial services organisation to the pressures and opportunities which the unfolding environment will present.

Banking and Other Activities within Broader Financial Services Groups

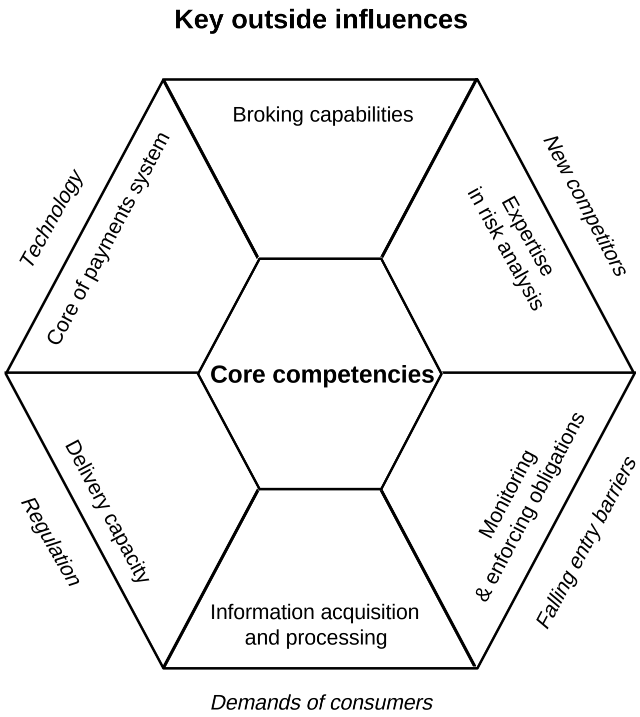
In such a world, banking businesses, typically within wider financial services groups, will confer continuing benefits to their customers (over and above those generated by whatever other generic competencies they possess), by being within the core of the payment system. The advantage, for example, of being the first point of access to the financial system for many users of transactions services (and holders of transactions balances) will no doubt remain worthwhile, ensuring banks are well placed to hold the primary relationship with a customer—although increasingly other players will develop similar benefits.

Providers of investment and administration services to members of superannuation schemes, for example, may increasingly have similar advantages as balances in these schemes build, and as individual choice of fund and investment (and the necessary infrastructure, ready access to information, advice and execution to support it) become more widely used.

Regulation should avoid constraining, or affecting the terms of competition among, providers responding to these evolving needs.

FIGURE 5.3

CORE COMPETENCIES IN FINANCIAL SERVICES GROUPS' COMPETITIVE RESPONSE



Source: Allen Consulting Group, drawing on D. T. Llewellyn, "Banking in the 21st Century: The Transformation of an Industry", paper presented to Reserve Bank of Australia Conference, July 1996.

In the financial system that we should see evolve in Australia, institutions will succeed, and deliver greatest benefits to customers by making their own unique identification of:

- the needs of the customer group they can best serve;
- the products and services which best meet those needs;
- the optimal distribution channels for providing each group of customers with the relevant group of products and services;
- their own mix of in house provision and outsourced provision; and
- therefore their own combination of business units or activities—not all necessarily 'financial'.

The regulatory framework must facilitate, not restrict, these responses, for example by recognising that alliances between financial institutions and other businesses could well enhance competition and efficiency in the financial services sector. Regulation must not prescribe business structures.

5.4 What Can we Expect the Financial System in Australia to Look Like in this Vision?

Based on trends already apparent, we can expect that some of the continuing trends will be:

- increasing direct access to capital markets by corporates, extending this option from the largest corporates (as now) down to middle sized corporates; and generally, more securitisation of loans;
- narrowly defined banking assets and liabilities continuing to fall gradually in share within the overall financial system;
- funds under management in savings vehicles which are invested largely in marketable securities rising in share (in Australia, notably in superannuation funds);
- players not traditionally established in Australia increasingly coming into a variety of component (particularly processing) activities; e.g. into much of the overall payments process (but *not* the settlement system where value is ultimately exchanged), and indeed into component activities within other parts of the financial sector such as life insurance;
- more use of cash substitutes, on–line networks for transactions, and other innovations utilising information and communications technology;
- the structure of the sector becoming less homogenous and more complex:
  - with more niche players, some of them ‘boutiques’ and some of larger scale—some of them at the customer interface and some of them ‘manufacturers’ of component products or ‘contractors’ carrying out specific component activities;
  - but also with a rising role for diversified financial services groups including universal financial conglomerates (no doubt fewer in number than the present range of large financial institutions), retail product and service based groups, and so on.

It is important to note that these trends will be driven not just by the supply side of the market, but equally by the demand side. In other words, the providers of financial services will be responding to the needs of their customers and potential customers.

As stressed earlier, we can be much more certain that there will be change than of its precise shape. Some trends now established, or beginning, seem set to run on, but the further ahead the horizon, the more important will be the ability to handle changes that are not so readily foreseen from those trends.

5.5 Implications

Some foreseeable implications for regulation of this vision of financial services business groups, and contractors to them, adapting their configurations flexibly are readily apparent. For example, it makes it more important that the framework of regulation should provide for the *need* for particular regulation to be reviewed, and the intensity or form of regulation to be changed accordingly, on an expeditious basis as circumstances evolve.

An example of what might warrant a review is the advent of real time gross settlement (RTGS), discussed in the following chapters. As the time which elapses for (at least most domestic and later, international) transactions to be settled diminishes, and therefore the risks of default by counterparties within that narrowing time window diminishes, regulation in the name of ensuring the integrity of the payments system may be able to become somewhat less intense. At least, in the interest of having a framework which is adaptive to evolving circumstances, there should be provision for prompt review whenever there is a material change in the environment; and regular rounds of review in any event.

That is, the regulatory framework should be sunsetted in respect of each of its significant provisions and structures; and it should have in-built not only regular (periodic) review but explicit provision for reviews triggered by material change in the environment.

5.6 Current Constraints

Regulation

Quite clearly given that the unfolding environment is one in which a range of configurations within groups providing financial services will be best in meeting particular consumer needs, the framework of regulation must above all avoid being prescriptive, restrictive, inflexible and excessively rules–based.

A number of the Reserve Bank's present *Prudential Statements*, discussed in more detail in Chapter Seven, conflict with this—for example, in Statement PS G1 (para 9) prescribing that the aggregate assets of a bank's non–bank (financial) intermediary associates not exceed 50 per cent of the bank's assets; and limiting equity investments in non–financial businesses to 5 per cent of Tier 1 capital (with individual investments general to be less than 0.25 per cent of Tier 1 capital).

Such prescription risks becoming less relevant for a future financial system in which providers of financial services may need to be able to deploy any combination of financial and non–financial (e.g. communications or retailing) activities which best responds to their customers' needs.[21]

Rather, in such a vision of the unfolding financial system, the aim should be to avoid or at least minimise prescription and instead to rely on market disciplines to the maximum extent, for example on internal risk management

21 There are mixed views on the desirability of mixed conglomerates.

systems which institutions are stimulated by market pressures (e.g. the activity of ratings agencies) to establish and operate effectively for themselves.

Objectives–Based Regulation

What is desirable is more *objectives–based* regulation and less rules–based regulation. In other words, the regulatory framework must be based around broad principles and objectives of regulation, but be prepared to accept a variety of means from market participants to meet those objectives.

A comprehensive discussion of the regulation of financial services in general, and banks in particular, is provided in Chapters Six and Seven, respectively.

Taxation

It is commonly accepted that the Australian taxation system is in need of fundamental reform, and nowhere is this better illustrated than in current taxation of financial services—for example, the application of Financial Institutions Duty (FID) and Debits Tax (DT). (FID is a State government charge on inflows into financial institutions, while DT is a tax on withdrawals from accounts with a cheque facility.)

Good taxation systems should satisfy four criteria. They should be efficient (i.e. not distort economic activity), equitable, simple to administer, and raise necessary revenue. However, other than raising revenue, FID and DT fail to meet any of these *desiderata*. By taxing financial *transactions*, they impede and constrain the efficient operation of the financial system and commerce itself.

These taxes are distortionary because they discourage the switching of funds to alternative investments offering superior returns, and they encourage the inefficient ‘packaging’ of financial products to avoid transactions taxes. FID and DT are also inequitable, as their burden falls disproportionately on low income earners. For example, DT is inequitable in the sense that it is linked specifically to withdrawals from cheque accounts. This enables those individuals who do not have a cheque account to avoid paying DT while individuals in similar economic circumstances who do have cheque accounts may be charged DT on every withdrawal that they make.

FID is a disincentive to the adoption of the more efficient forms of payments (compared to cheques) because of the inability under the FID legislation to bulk electronic credits together and gain the advantage of the maximum FID rate.

FID’s revenue base is also unstable, as price sensitive funds migrate to jurisdictions with a concessionally (or no) FID regime, such as Queensland—a trend likely to accelerate with the advent of computer–based banking. Indeed, these transactions taxes are likely to disadvantage Australia as a financial service centre by inhibiting the movement of funds to Australia from overseas.

FID and DT are difficult to administer, and likely to become increasingly so as electronic transactions, which make it difficult to determine where a transaction occurs, replace paper–based transactions. Finally, FID and DT create resentment among bank customers, who confuse them with bank fees.

A recent study by Coopers & Lybrand of FID and DT came to the following conclusions:[22]

- As the market for financial services becomes better integrated and international in scope, financial transactions in Australia will become increasingly anti–competitive and inefficient. Australia is the only nation to directly tax financial transactions. Transactional business will be driven off–shore to avoid FID and DT.
- FID and DT already undermine the efficiency of the payments system. They penalise the use of efficient electronic technology, and limit Australia’s ability to compete in the international market for financial services.
- New banking technologies are already undermining the revenue stability of FID and DT, with neither able to cope with the diversity of electronic transactions, smart cards or Internet banking.
- FID and DT both apply regressively to business according to size. They each constitute a greater percentage of turnover for small business than for large business.
- 75 per cent of businesses have implemented group structures to minimise FID and DT. 65 per cent of businesses with annual turnovers in excess of $750 million maintain off–shore foreign currency accounts. 43 per cent of this group cite FID as a major or decisive factor in this decision.
- 62 per cent of Australian banks consider that financial transactions taxes have a major or decisive influence on Australia’s regional competitiveness. 40 per cent of Australian banks, including three major banks, consider that FID and DT are major or decisive impediments to retaining Australian resident business. 77 per cent of all banks consider that FID and DT are major or decisive impediments to attracting non–resident business.
- 50 per cent of Australian banks consider that FID and DT regularly impede or prevent individuals from switching between investments to secure more competitive returns. 76 per cent of banks receive complaints about double FID on interstate transfers of funds.
- 80 per cent of banks consider that FID and DT impede the development of new products. 38 per cent of banks consider that FID and DT are likely to be major factors limiting the adoption of electronic banking technologies by businesses.

The Impact of the Taxation System on Saving and Financial Competition

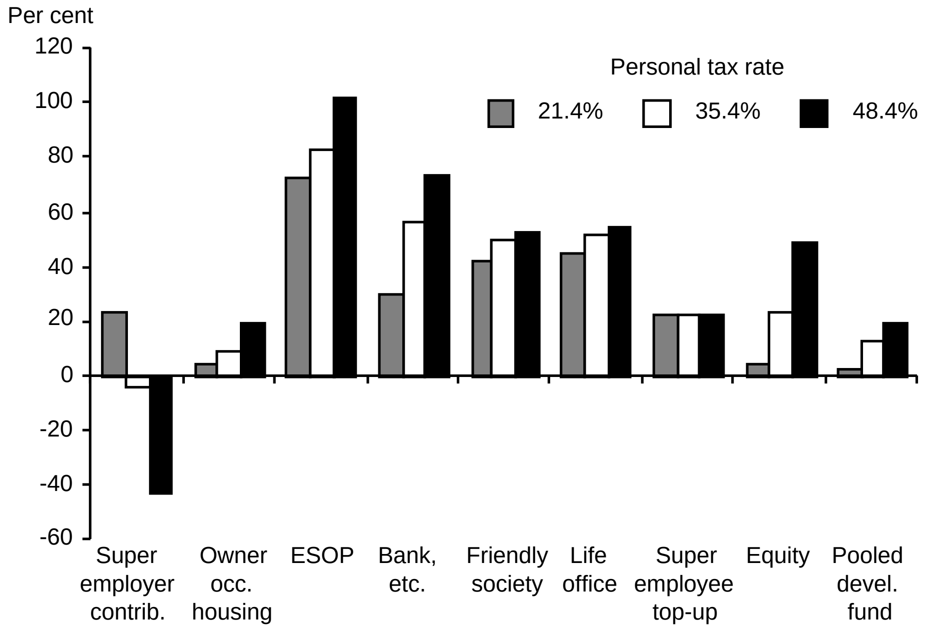
[22] Coopers & Lybrand, *Financial Institutions Duty and Debits Tax: Constraints on Australia’s Future in a Global Financial Market*, March 1996.

The system of taxation of financial savings products is inextricably bound up with the issues for the Inquiry, and demands attention—notwithstanding that the Inquiry is not to make recommendations in this area.

Not only do the high rates of taxation on most forms of financial saving inhibit the level of household saving in Australia, but the ‘system’ of taxing savings products has created severe distortions by taxing some products at much higher rates than others, as illustrated in Figure 5.4. Deposits are particularly highly taxed, for two reasons: taxation is levied on the *nominal* value of interest payments i.e. without taking into account the effect of inflation on capital; and, unlike e.g. superannuation, there are no tax concessions at all for this form of saving, not even deferral of any of the tax until returns have accumulated and the funds return to the use and disposal of the saver.

FIGURE 5.4

IMPACT OF DIFFERENT PERSONAL TAX RATES ON EFFECTIVE TAX RATES



Source: Chart 4.2 of Pender and Ross, *Taxation*, *Regulation and Private Saving in Australia*, EPAC Background Paper No. 36, January 1994, AGPS, Canberra. [23]

Recommendation 5.1

The ABA recommends that Financial Institutions Duty (FID) and Debits Tax be abolished as part of a reform of the taxation of financial savings products generally, designed to produce a regime which is more neutral and conducive to saving; and preferably in the context of wider taxation reform.

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23 Assumptions: Inflation 3 per cent. Shares held for 4 years, geared rental property and Employee Share Ownership Plan (ESOP) 5 years, superannuation, friendly society and life office products 10 years. For the ESOP, newly issued shares with no deduction to the employer.

Electronic Banking

There are a number of legal requirements which either prevent or significantly restrict the ability of financial institutions to deliver financial products and services electronically.

Requirements for Signatures

There are a range of Federal, State and Territory requirements for contracts or related documents to be signed either by the financial institution or customer.

For example, the Consumer Credit Code, scheduled to take effect on 1 November 1996, requires a credit contract to be in writing and signed by the credit provider, and either signed by the debtor or accepted by the debtor by certain types of conduct. Although the Code allows the regulations to sanction other ways of making a credit contract, no such regulations have been made. In any case there are concerns about whether the regulation making power is sufficiently broad to allow electronic contract formation.

Current State legislation derived from the Statute of Frauds has similar requirements in relation to certain types of contracts, including guarantees, and contracts which cannot be performed within a year of being made.

In addition, there are a number of other documents which financial institutions must obtain, and which must be signed by the customer. For example, the *Privacy Act 1988* requires certain consents in relation to obtaining, use and disclosure of credit–related information to be in writing and signed. The *Financial Transaction Reports Act* imposes identity verification procedures in relation to accounts, which include the need to obtain a signed verification statement from the holder of an 'account' and from signatories to the account. In addition, supporting documents must be supplied.

These sorts of requirements mean that contracts cannot be formed through an electronic distribution mechanism without the exchange of written documents which have been physically signed by one or both of the parties. The requirements generally apply even where there is an existing relationship between the parties, and cannot generally be avoided or replaced by some substitute for a signature or agreement between the financial institution and the customer. In the future, laws must be developed to account for technological innovation.

One possible use would be enabling legislation permitting the use of a digital signature wherever a signature is required by law. There is actual or proposed legislation enabling the use of digital signatures in a number of states in the United States.

Recommendation 5.2

That existing laws be reviewed and amended to permit digital signatures in appropriate circumstances.

Electronic Provision of Notices

There are a number of laws, including legislation and industry codes of conduct, which require financial institutions to provide various notices and documents to customers. The types of notices and documentation also vary widely.

For example, there are requirements in the Consumer Credit Code and in relation to life insurance to provide certain precontractual disclosures in relation to credit contracts and life insurance contracts respectively.

These notices may be required to be in a particular format, with matters like font sizes, highlighting and layout prescribed. For example, the precontractual contract required under the Consumer Credit Code must contain a ‘financial table’ which sets out certain prescribed financial information in tabular form, and there are minimum print size requirements.

Another example is the requirement under the Electronic Funds Transfer (EFT) Code of Conduct and the Consumer Credit Code to provide periodic statements of account, which must contain certain types of information. The EFT Code also imposes an obligation on the financial institution to ensure that receipts are issued by a terminal when an EFT card is used.

Provision is often made for the notice or document to be provided to the customer personally, to the last known business or residential address. The Consumer Credit Code also permits notice to be sent by telex, fax or other similar facility to the last known business or residential address.

Again these are requirements which may mean that services cannot be provided through a purely electronic distribution medium should the customer wish to utilise this medium. Again, they are not requirements which the parties can generally agree to replace by some other means of delivery.

The most important issue for financial institutions is whether a notice provided by an electronic means can comply with the notice requirements at all. Not only must it be clear that the notice may be in electronic form, but the provisions which permit delivery to be made in certain ways should include delivery to an e–mail address or, where appropriate, by making the information available for the consumer to access electronically. Obviously it is important that this is clearly the case for electronic product delivery to be practicable.

The second issue is, where formatting requirements apply, the extent to which the financial institution should be liable where the form in which the document appears is affected by the communications service provider or the device used by the consumer to capture and read the notice. Again, it is important that financial institutions are not unduly burdened with liability arising from hardware and software they do not control, particularly where it belongs to the consumer.

The need for these matters to be addressed has been recognised by the Board of Governors of the Federal Reserve System in the United States. It has issued for comment a proposed rule[24] which would permit disclosures required under the Electronic Funds Transfer Act (15 USC 1693) to be satisfied where, with the consumer's agreement, the information was sent electronically to or otherwise made available for downloading to the consumer's computer. Consumer protection measures, such as an ability for the consumer to request a retransmittal of information or provision of a paper copy, are also under consideration.

Recommendation 5.3

That existing laws be amended to permit the electronic delivery of notices and documents with the agreement of the customer concerned.

Evidentiary Issues

The current position is that for financial services to be provided through a purely electronic medium, a financial institution must be able to tender in court a reproduction of a document provided electronically.

The Commonwealth *Evidence Act (1995)* defines a document as any record of information and specifically includes anything from which writings can be reproduced, and has broad provisions relating to admissibility of documents. The contents of an electronic document can be proved by tendering a document produced by a device which can retrieve the information stored in it, for example a computer printout. Of course, the court has a discretion as to the weight to be given to the document, and this may depend on the evidence of the financial institution as to its system for recording, storing and using electronic documents.

New South Wales has adopted the Commonwealth model.

Most other states have provisions which would include reproductions of electronic material as documents, and establishes some procedure to admit them. For example, Victoria, Queensland, Western Australia and the Northern Territory include as documents discs, tapes or other devices in which data other than visual images are embodied and from which the data can be reproduced. Victoria has a procedure for admitting computer generated documents if a certificate as to the process by which the document was generated is provided by a person occupying a responsible position in relation to the relevant procedures.

However, there is a distinct lack of uniformity in position. Some states have no specific legislation dealing with the admission of electronic evidence.

24 Federal Register, Vol 61, No 86, May 2 1996, Proposed Rules.

Recommendation 5.4

That national uniform legislation covering evidentiary issues related to electronic delivery of financial services be enacted.

Use, Storage and Transmission of Customer Data

Under current laws customers' rights to privacy are currently regulated by a range of different laws, including Commonwealth and State legislation, and provisions in industry Codes of Conduct.

Banks are subject to a specific common law duty of confidentiality in relation to their customers; in addition, all types of institutions are bound by an equitable duty of confidentiality in relation to certain types of information.

The Commonwealth *Privacy Act 1988* regulates the use, storage and disclosure of certain credit related information by credit reporting agencies and credit providers. Victorian, Queensland and South Australian legislation also regulates credit and some other prescribed information, and the ACT *Fair Trading Act 1992* was recently amended to regulate disclosures in relation to stored value cash cards. There are also provisions relating to privacy in the EFT Code.

Privacy concerns will be highlighted by the trend towards electronic delivery of financial services and the associated use of personal data. A number of issues will emerge.

One example is the outsourcing to service providers of various functions, including communications, data processing, and customer service functions (e.g. answering telephone inquiries). Outsourcing will be critical to the efficient delivery of those financial services for which financial institutions are unable to achieve scale economies on their own.

Another example is the extent to which financial institutions will be able to use information obtained about a customer for profiling, research and planning, and to make contact with the customer for marketing purposes. At present, generally speaking, an institution could use information it obtained from the customer directly for these purposes, but the *Privacy Act* and the ACT legislation may restrict the use of certain types of information, or information derived from certain sources. For example, information obtained by a credit provider from a credit reporting agency may only be used for certain specified purposes, such as assessing applications for credit. In some cases, the *Privacy Act* does not permit the customer to make an informed decision to permit additional uses of the information.

ABA agrees that there are sound policy grounds for justifying strict limitations on collection and use of certain types of information (for example, information as to race or political and religious beliefs). However, the use of financial and other personal information by financial institutions should not be unduly restrained. In general, and in particular where the customer has consented, information should be able to be used for the commercial purposes of the institution, such as profiling, research and planning, and communicating with the customer.

A particular instance of a use of customer information is credit scoring, where an applicant for credit is awarded points depending on how the applicant 'rates' in relation to a number of criteria. The applicant's total credit score is a factor in determining whether and to what extent the applicant is eligible to be provided with credit. At present there are limitations in federal and state equal opportunity legislation on the types of information which may be used in the process. There is the possibility of restrictions being introduced on the automation of decision making processes like credit scoring. Restrictions such as these affect the efficiency of financial institutions in providing financial services to consumers.

Another issue which will increase in prominence will be the types of security requirements which apply to data storage and transmission, including cross border transmission of data. While the ABA recognises the need for security, it is also concerned to ensure that security requirements are practical and cost effective.

Ongoing legislative reform in this area seems likely. The Commonwealth Government has a policy to review current privacy laws, New South Wales has introduced a bill which would provide the development of binding codes of conduct, and there are proposals for new legislation in Victoria.

In addition, a Direct Marketing Code of Conduct is being developed by the Australian Direct Marketing Association in conjunction with the ACCC, and a number of organisations are developing Codes of Conduct for stored value cards which contain provisions in relation to privacy.

Recommendation 5.5

It is critical that a coherent national approach to privacy regulation emerges from the current consultative processes. This may require cooperation between the Federal and State governments. It is also important that a reasonable balance be struck between consumer protection, consumer choice, and the legitimate needs of financial institutions to use information in a manner which promotes effective and efficient delivery of financial services to Australian consumers. The financial services industry should be consulted at all stages as policy evolves, and changes in policy should be continuously tested for their effectiveness.

Other Consumer Protection Issues Specifically Relevant to Electronic Service Delivery

There is currently a range of legislation which provides for consumer protection in a general sense. The only instrument which specifically relates to the electronic delivery aspects of financial services is the Electronic Fund Transfer (EFT) Code.

The EFT Code is a self–regulatory document. It was developed under the oversight of the Australian Payments System Council (APSC) by a working group formed in 1985 and comprising representatives of the ACCC, Federal Attorney General, Consumer Affairs and chaired by Treasury. It is reviewed periodically and cannot be amended other than through consultation with participants and agreement of Treasury, ACCC and APSC. Participating institutions adopt it by including a warranty in their terms and conditions that they will comply with the EFT Code.

At present the EFT Code only applies to transactions initiated through an electronic terminal by the combined use of an EFT plastic card and personal identification number (PIN). It would not apply to transactions initiated by the consumer from a telephone or home computer (either by direct dial into the institution or through the Internet) as these do not involve the use of an EFT card. The EFT Code is unlikely to regulate stored value card transactions.

Recommendation 5.6

ABA considers that the Electronic Funds Transfer (EFT) Code has been extremely successful. It has achieved wide ranging acceptance at all levels within the EFT industry. If it becomes necessary to provide specific consumer protection provisions in relation to the developing technologies such as telephone or on–line banking, the EFT Code has the capacity to be extended in scope to deal with this need.

ABA considers that this approach has the following advantages:

- it would provide for a more coherent and consistent response, rather than the trend towards a plethora of technology—or product–specific legislation and Codes; and
- it has and could continue to provide a more flexible and responsive method of providing for consumer protection than a legislative response would provide without inhibiting electronic delivery of financial services.

However, if this were to occur, it would be important that in expanding the scope of the EFT Code, careful consideration is given to the appropriateness and practicability of applying some of its provisions to different technology.

For example, the EFT Code requires receipts to be issued unless the cardholder specifically elects otherwise. Requiring receipts would not be cost effective where the technology permits the consumer to use a telephone to effect transactions, or where a stored value card could be used to effect low value transactions (e.g. at vending machines).

If it is considered that a receipt is necessary for telephone banking, it may be possible to require provision of a reference number, so that the consumer can at least identify a particular transaction. If any protection is needed for low value stored card systems, it should be possible for consumer rights to be protected by providing facilities to check balances on cards.

Another example is the effective requirement in the EFT Code that the card issuing institutions effectively take responsibility for compliance with the Code by all parties to the EFT system. This may not be appropriate in all circumstances with all new technologies. For example, the card issuer is responsible for certain types of system and equipment malfunction, but the relevant equipment may be properly and solely within the control of the customer. Similarly, the communications facility in place between the customer and the institution may be at least partially outside the influence of the financial institution (for example, the customer's telephone line, and/or the customer's Internet service provider).

The EFT Code also sets out rules for allocation of loss caused by unauthorised use of cards. While these rules may be appropriate where the card is used as an access device in relation to an account with a financial institution, there is a real issue as to whether it is possible, appropriate or cost effective to apply them to all technologies. For example, they may be inappropriate in relation to a stored value card system which is a substitute for cash. Some systems may issue anonymous cards, some cards may not have PIN protection, and some systems may not keep a central record of transactions. Even if the system was protected, PIN protected and kept full records, it may be prohibitively expensive to require card issuers to issue refunds in all circumstances.

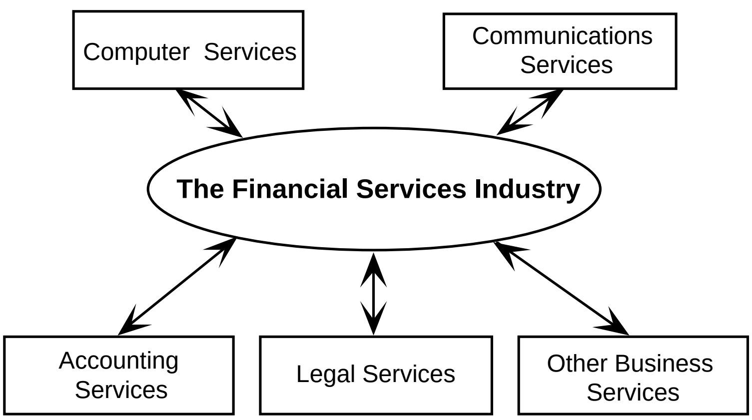
5.7 What Are The Economic Stakes?

In part the economic stakes at issue in the choice of regulatory framework are to do with greater efficiency in the domestic economy itself—more efficient allocation of savings to capital investment; more efficient allocation of risk to those better able to offset or manage it; and generally lower resource costs in the provision of financial products and services such as transactions services.

The stakes extend importantly, however, to Australia's international competitiveness. The financial services sector is at the very heart of the modern service economy which is, in all advanced countries, becoming a progressively larger part of the economic system as a whole. Financial services activities are themselves information, technology and skill intensive and they act as hubs around which other business and professional services (legal, accounting, consulting etc) tend to cluster. (See Figure 5.5.)

FIGURE 5.5

THE FINANCIAL SERVICES INDUSTRY'S RELATIONSHIP WITH OTHER INDUSTRIES



To the extent, therefore, that Australia is competitive in financial service provision, it will tend to be successful in a broader range of advanced service sector activities. In short, this is an area where Australia can create or foster growing comparative advantage.

5.8 Forward–looking Objectives for Regulation

This recognition of financial services activity *as an industry*, and one in which Australia can potentially develop further comparative advantage, focuses discussion of the desirable attributes of the future regulatory system on objectives such as the following:

- fostering a vigorous and innovative *banking* and related set of activities (including over the counter trading in securities, derivatives, foreign exchange and the like);
- similarly, fostering a conducive environment for *funds management* activity, which is one of the financial sector activities in which direct competition occurs between international centres, and which tends to gravitate to centres where the capital markets and banking systems are most advanced; and
- ensuring that regulation fosters the development of deeper and more liquid *capital markets*, since their presence is an essential ingredient in Australia’s competitiveness in those and a wide range of related financial activities.

Success in fostering the environment for financial services in these ways will also be reflected in more vigorous development of human resources, skills and innovative activity—all of which will develop less if we are less competitive in the environment we set. ‘Virtuous cycle’ effects should flow from getting this environment right.

5.9 Conclusion

In redesigning our regulatory system going into the twenty–first century, one of the major considerations should be a recognition that financial services is, perhaps above all industries other than telecommunications and media themselves, increasingly internationally competitive and mobile.

Australia has the attributes to be competitive and successful in financial services, but in this area more than most others, this depends importantly on setting the right environment—including the right regulatory environment. This argues for regulation which is flexible, adaptive, minimally prescriptive about the configuration of financial services businesses, and which utilises and facilitates the operation of the market itself to the maximum extent.

Chapter 6

The Role and Objectives of Regulation in Financial Services

Key Points

- Regulation provides the legal framework within which commercial exchange takes place. While some regulation is necessary in many markets, free and competitive markets generally provide the most efficient allocation of physical resources. Regulation always itself imposes costs, so the existence of some market failure does not on its own justify regulation.

- In financial services, the case for regulatory intervention now rests largely on the existence of a market failure, viz asymmetric information between the purchasers and suppliers of financial services.

- The main elements of the regulatory response are capital adequacy, risk management and disclosure. A well-designed regulatory structure for the financial system should:

  – maintain the stability and safety of the system;

  – minimise the costs of regulation and maximise the consumer benefits consistent with the efficient allocation of scarce resources;

  – be compatible with international regulation;

  – be consistent with equality of competitive opportunity in respect of institutions, products and services; and

  – adapt to market change.

- The present financial services regulatory structure involves five primary regulatory agencies: the Reserve Bank, the Australian Financial Institutions Commission (coordinating State–based regulators), the Insurance and Superannuation Commission, the Australian Securities Commission and the Australian Competition and Consumer Commission. In addition, State authorities regulate miscellaneous types of institutions. Consumer protection includes State-based consumer credit legislation. The banks are subject to various legislation such as provisions of the *Financial Transaction*

Reports Act and the *Privacy Act*, as well as various voluntary codes of conduct.

- Despite the costs and inefficiencies of Australia's system of financial services regulation, the existing system has worked reasonably well to date. Nevertheless, the accumulation of changes in the market environment since the Campbell Committee review, including ongoing globalisation and technological change, require an in–depth review of current regulation. The aim should be to make the regulatory system as adaptive as possible to further change, much of which may be unforeseen, and not simply the outworking of present trends.

- Vigorous competition in financial services can deliver great benefits to consumers, business, the financial services industry and the economy as a whole. The same merger and acquisition provisions as are applied by the Australian Competition and Consumer Commission generally across the economy should be applied equally to the financial services industry, noting that what are the relevant financial markets—in terms of products, institutions and geography—will evolve over time. The Treasurer should have the power to allow, or disallow, a merger between banks or between a bank and another financial institution. This power should be used only for prudential reasons, on the advice of the relevant regulatory authorities, and not to pursue competition policy objectives where no significant prudential issue is at stake. The previous government's informal 'six pillars' policy would become redundant.

6.1 General Principles

Modern market economies depend critically on the process of commercial exchange. A regime of commercial regulation provides the legal and ethical framework within which such exchange takes place. While a degree of regulation is universally accepted as necessary, there is widespread recognition that free and competitive markets generally provide the most efficient allocation of physical resources.

Consequently, the regulatory issues facing purchasers of goods and services are usually limited to those of legal ownership and accurate representation of the quality and nature of the commodities sold. The case for regulatory intervention beyond this level rests on the existence of market failure—situations which are the exception rather than the rule.

While the same general argument of efficiency through competition was advanced to support world–wide deregulation of financial markets in the 1970s and 1980s, there was equally widespread recognition that financial markets are sufficiently different from conventional goods and services markets to warrant some limits on the extent of deregulation. Inadequate competition is no longer the issue it was for the Campbell Committee but there are features inherent in financial products and services which require a regulatory response even in a competitive environment.

Unlike contemporaneous trade in physical goods and services, financial transactions involve the passage of time. By their nature, financial transactions involve promises to make payments at specified times, in specified amounts and/or in specified circumstances. Such promises, or their keeping, inevitably involve uncertainty and yet play a fundamental role in the efficient functioning of commerce, facilitating the settlement of trade and channelling resources across time and space.

The more sophisticated the economy, the greater its dependence on financial promises and the greater its vulnerability to failure of the financial system to deliver against its promises. The importance of finance and the potential for market failure to lead to systemic instability introduces an over–arching externality that has been the focus of financial sector regulation for most of the twentieth century. This externality is essentially one of *asymmetric information*. The purchasers of financial services, who have been made promises by suppliers of financial services, have essentially no way of precisely judging the financial health of those suppliers, which will determine their ability to uphold these promises in the future. Under some circumstances, this lack of information can potentially have destructive effects on the financial system, in ways described below. Moreover, because financial services are often complex, some consumers may not always fully understand what it is they are purchasing. This is another potential failure of the market.

The role of regulation is not to supplant, or significantly alter, competitive financial markets but to ensure that the potential benefits to society arising from those markets are actually delivered. However, it must be recognised that no regulator, no matter how well–intentioned, is omniscient, and that the benefits of regulations intended to offset market failures, or potential market failures, always themselves impose costs and these costs can exceed the benefits. To guard against this very real possibility, regulators should impose only the minimum regulations necessary to achieve their goals, and if possible err on the side of imposing too few regulations rather than too many.

6.2 The Role of Regulation in Financial Services

Systemic Stability

Following the Campbell Inquiry, the Australian financial system was deregulated in the 1980s to improve its efficiency. However, this process did not lead to no regulation of the financial system, notably because there remains a need to preserve the system's stability.[25] This requirement is particular to the financial services industry, as one financially unhealthy institution can impact negatively on the financial health of competitor institutions, and indeed

25 As noted in earlier chapters, there has also been increased consumer regulation and more rigorous prudential supervision of the superannuation industry in the post-Campbell era.

endanger the viability of the entire financial system. It is difficult to think of another industry where that is the case.

A stable financial system requires that financial institutions are able to enter and exit the industry without disruption to the smooth functioning of the system as a whole. In terms of regulation, this has translated into the three pillars of financial supervision: capital adequacy, risk management and disclosure.

Capital provides the last recourse against losses. If financial supervisors are to manage industry exits without disruption and potential contagion, it is critical that there be a financial buffer to absorb losses.

Risk management does not prevent failure, though it should reduce its incidence. Since supervision is not aimed at prescribing precisely how a financial institution should behave, responsibility for risk management resides primarily with the management and owners of financial institutions, although in some areas supervisors prescribe minimum standards.

Supervisory effectiveness requires that problems within particular institutions be resolved before they threaten systemic stability. Timely and accurate data are central to providing early warning of distress. Most supervisory regimes impose relatively rigorous disclosure requirements on institutions, particularly between the institution and the supervisor.

The incidence of these three pillars of supervision across different institutional groups has been determined largely by the extent to which their members provide particular financial services. The blurring of distinctions among different institutional groups has hampered the ability of regulators to maintain an efficient balance among the supervisory imposts on different groups.

In balancing efficiency and stability, supervisors have been conscious of the need to avoid pursuing stability to the point of removing the spectrum of risk and thus the ability of consumers to choose between risk and return. They have been equally careful in most countries to avoid creating the impression that supervision effectively *guarantees* the liabilities of any particular group of financial institutions. The unfortunate US experience of explicit deposit insurance, especially in the case of the savings and loans associations, has been instructive.

Consumer Protection

The case for consumer protection arises primarily from the informational imbalances that exist between financial institutions and retail customers of financial services. This imbalance extends beyond depository institutions to areas of financial advice and management services, where unsophisticated consumers can fall prey to conflicts of interest within service providers and, more generally, to unethical business practices.

The primary response to these problems is disclosure. Requirements to provide information and to meet adequate standards of disclosure are usually imposed by institutional supervisors as well as through explicit consumer protection legislation. Information assists consumers to understand the nature of the contracts they are party to and to make better informed choices between price and risk in the services being considered. Disclosure requirements also expose providers of financial services to public scrutiny and competitive pressure from the professional market.

However, where disclosure requirements are overly complex, onerous in their penalties and administered by multiple regulatory agencies, there is potential for these requirements to become ineffective, and even counter-productive if they serve to confuse consumers.

Codes of conduct in service provision play a supporting role to disclosure requirements. These usually impose minimum standards in terms of business practice and competency, seeking to ensure that customers are treated fairly.

Apart from through disclosure, consumers of some financial services are protected by prudential oversight. In most areas of banking and insurance, for example, consumers are protected to a high degree by the ability of supervisors to act quickly in the event of financial distress and to resolve problems before the capital buffer is fully eroded.

In many countries, prudential supervision has been seen—to an extent—as a substitute for disclosure. In Australia, for example, banks and supervised non–bank deposit–takers are exempt from the prospectus provisions of the Corporations Law. That exemption is obviously necessary to make access to the payments system via deposit accounts workable on a day–to–day basis, and it depends on the existence of prudential supervision. Nonetheless, the essential distinction between prudential supervision and disclosure regulation is clear and important: the former is devoted to systemic stability, and the latter to protecting and informing individual consumers.

6.3 Attributes of a Good Regulatory Structure

While the objectives of financial regulation are fairly well established, there is no universal agreement on how these objectives are best achieved. There will sometimes be a tension between these objectives and the legitimate commercial objectives and strategies of those institutions which are the subject of regulation. Often regulation, while perhaps well–intentioned, is badly designed, imposes unnecessary costs, and is counterproductive.

A well–designed regulatory structure is one that:

- *Maintains the stability and safety of the system, both in substance and in public perception.*

Investors and the public as a whole must have confidence in the system and its stability. Participants must be able to enter and exit without disruption, but they must have appropriate incentives to manage risk and bear the consequences of any mismanagement of their own.

- *Minimises the costs of regulation and maximises the consumer benefits consistent with efficient allocation of resources.*

  The greatest benefit to consumers arises from effective competition, and regulation should be directed to clear market failures, and be subject to cost benefit tests and audit mechanisms. That is, while market failure is a problem, the proposed regulatory solutions, which will have their own (often overlooked) costs, should be a definite improvement. Moreover, these solutions should be the subject of regular review to ensure that they are continually effective, efficient and necessary. The problem they have been designed to eliminate might become less of an issue, for example, due to technological developments. Or in other ways, the balance of benefit and cost may move in favour of scrapping the regulation.

- *Is consistent with equality of competitive opportunity in respect of institutions, products and services.*

  The regulatory environment should not favour particular products or institutions. This means that the regulatory and taxation systems applying to different financial intermediaries should be consistent to the fullest extent possible, and any non–neutralities should be imposed for good public policy reasons, and their basis fully explained.

- *Is compatible with international regulation.*

  Regulation which is more intensive that that which exists in comparable countries can impede the international competitiveness of domestic institutions. This is a particularly important issue with technological developments leading to global rather than national markets for many financial services. At the same time, regulation which does not meet accepted minimum international standards serves as a bad signal for the institutions subject to lax regulatory regimes. In short, in an increasingly integrated global financial system, regulation itself must be competitive in quality and efficiency.

- *Adapts to market change.*

  Regulatory arrangements should not presume the nature of market outcomes and should not require large changes as markets evolve. That is, the regulations themselves should be sufficiently flexible to accommodate changes in market structure, products and modes of delivery. This can be achieved by making regulations as far as possible outcome–oriented and flexible about how their objectives are achieved rather than being prescriptive or process–oriented.

Regulation Impact Statements

The Office of Regulation Review has recently published a set of guidelines for Commonwealth departments and guidelines to assist them in the preparation of regulation impact statements (RIS).[26]

A RIS is intended to ensure a systematic and comprehensive analysis of the effects of a regulatory proposal, and covers four broad areas:

- the objectives being sought;
- various alternative methods or options for achieving the objectives;
- an assessment of the impact on customers, business, government and the community of viable options for achieving the objectives; and
- a strategy to implement and review the preferred option.

A RIS should be prepared when:

- a regulation is being changed;
- a new regulation may be introduced; or
- an existing regulation or set of requirements is being reviewed.

Regulatory Impact Statements do not provide a guarantee against the introduction of unnecessary or onerous regulation, but they do provide a measure of discipline and accountability for regulators.

Recommendation 6.1

Regulation Impact Statements, following the guidelines set by the Office of Regulation Review, should be issued in the future whenever changes to the regulation of financial institutions are contemplated by any regulatory agency.

6.4 The Australian Experience of Financial Regulation

Prudential Supervision

In Australia, as in most countries, the supervision of financial services has been conducted on an institutional basis. In large part, this reflects historical evolution from a system in which there was a close parallel between institutions and functions. The current structure involves four primary regulatory agencies: the Reserve Bank, the Australian Financial Institutions Commission (AFIC), the Insurance and Superannuation Commission (ISC) and the Australian Securities Commission (ASC). These bodies are supported

[26] Office of Regulation Review, *A Guide to Regulation Impact Statements*, September 1995.

by specific institutional legislation as well as legislation aimed at particular financial services and community groups.

The *Banking Act 1959* and *Reserve Bank Act 1959* require the Reserve Bank to encourage the implementation of sound banking practices by all authorised banks and to use its powers to protect the interests of depositors (more on this in Chapter Seven.) The Reserve Bank's approach to supervision is largely informal and consultative and operates within a framework of financial standards that is consistent with the international standards agreed by the Basle Committee on Banking Supervision.[27] The Reserve Bank also supervises authorised dealers in the short–term money market and oversees foreign exchange market. [28]

The AFIC is a national supervisor—or rather, a national coordinator of State based regulation—under the Financial Institutions (FI) Scheme, introduced in the early 1990s to provide a co-ordinated supervisory framework for State–based financial institutions. At present, participation in the Scheme is limited to building societies and credit unions, although friendly societies and trustee companies are expected to join the scheme in the near future. Day–to–day supervision of these financial institutions is carried out in accordance with the provisions of the *Financial Institutions Act 1992* by State supervisory authorities.

As with banking supervision, the main responsibility in non-bank supervision is placed on financial management and responsibility by the institutions themselves. Financial standards imposed by non–banks are largely consistent with the international standards agreed by the Basle Committee on Banking Supervision. Several provisions reflect the particular nature of the industries involved and, overall, the disclosure requirements imposed on non-banks are more rigorous than those facing banks.

The ISC was established in 1987 as the financial supervisor of the insurance and superannuation industries. The main elements of the ISC's approach to supervision are disclosure and risk–management standards. The ISC's supervision of the insurance industry focuses on licensing restrictions, solvency requirements and other provisions of the *Life Insurance Act 1995*. Owing to the size and structure of the superannuation industry, the ISC focuses attention mainly on those funds making offers to the public and on compliance with the *Superannuation Industry (Supervision) Act 1993.*

Unlike the other three agencies, the ASC has very little direct financial supervisory responsibility. Formed in 1991 from the National Companies and Securities Commission, the ASC is responsible for the administration of the *Corporations Law 1991* throughout Australia. The ASC's responsibilities include the regulation of fund raising and the operation of securities markets, licensing

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27 However, in some respects it is too heavy–handed, and unnecessarily restrains the legitimate commercial activities of banks. See Chapter Seven.

28 The system of authorised dealers of government securities was discontinued in August 1996.

of securities dealers and processing company information. The primary focus of the ASC's activities is on disclosure and law enforcement.

Co–ordination of regulation among the four peak agencies is carried out through the Council of Financial Supervisors, formed in 1992 following the recommendation by the 1991 Parliamentary Inquiry into the Australian Banking Industry (the Martin Committee). The Council has encouraged harmonisation of regulation where the interests of regulatory agencies overlap, without necessarily promoting the application of identical standards to all financial institutions and products.

Not all financial institutions are supervised; nor are all financial services regulated. Banks, building societies and credit unions each face detailed supervisory arrangements. Insurance and superannuation providers face a slightly less rigorous regime. Other providers of financial services, including merchants banks, finance companies and a range of security originators, advisers and markets are subject only to the general legal oversight of the ASC. Some financial services, including derivative products such as interest rate swaps, forward rate agreements and over–the–counter commodity options, are not specifically covered by legislation. Competition and anti–trust policy in all industries is governed by yet another agency, the Australian Competition and Consumer Commission (ACCC).

Consumer Protection

While members of the Council of Financial Supervisors have responsibility for prudential supervision, this is not the only legislative influence on the system. Most financial institutions are subject to State–based consumer credit legislation and to legislation directed at particular services (including the *Cheques and Payments Orders Act* and various State Acts dealing with taxes on financial transactions and activities such as securitisation and authorised trustee status). Banks are also subject to various legislation, such as provisions of the *Privacy Act* and the Credit Reporting Code of Conduct. In addition to legislative requirements, banks are governed by the provisions of 'voluntary' codes of conduct, including the Code of Banking Practice, the EFT Code of Conduct, the Farm Code and the Code of Operation for Direct Debit Social Security Payments.

Importantly, whereas prudential supervision has been distinctly institution–based, other legislation operates on a mixture of institutional, transactor–based and functional bases. This results in cross–over and duplication of responsibility among the supervisors and potential conflicts between supervisors and other agencies.

This conflict is most obvious in the area of consumer protection. Consumer credit legislation identifies consumers as a group of transactors requiring specific protection in respect of particular transactions, namely borrowings. The legislation establishes minimum codes of disclosure and behaviour to be observed by all credit providers when dealing with consumers; it also establishes a regime of sanctions for violation of these codes. The legislation explicitly excludes credit provided for commercial purposes.

Consumer issues are also covered by specific institutions and by the banking, non–bank financial institution (NBFI) and insurance and superannuation legislation. These cover specific disclosure issues as well as depositor protection through risk management and capital adequacy. The main supervisory focus on consumer protection in the banking and FI structures is on consumers as depositors. In contrast, the consumer credit legislation is concerned with consumers as borrowers. Conflicts between these responsibilities have arisen periodically with one group being advantaged at the expense of the other.

More general disclosure requirements relevant to consumer protection are contained in the Corporations Law. In general, these apply to non–banks, other than those covered by the FI Code, where interface provisions shift the responsibility for disclosure to the relevant supervisor.

A more detailed discussion of consumer protection issues is contained in Chapter Eight.

Overlaps and Inconsistencies

As has become clear from the Review of Collective Investments by the Law Reform Commission and the Companies and Securities Advisory Committee (1993), there are substantial differences in the approaches to disclosure adopted by the ASC and the ISC. In particular, the ISC has been more prescriptive than the ASC in its disclosure requirements, with respect to both public offerings and fees, charges and commissions. More recently, concern has been expressed by the CASAC over the potential for duplication and inconsistency in the emerging regulation of over–the–counter (OTC) derivative products. CASAC proposed that the ASC exempt OTC products issued by institutions subject to “equivalent standards” imposed by other agencies.

A Deputy Governor of the Reserve Bank, Graeme Thompson, has pointed to overlaps and potential inconsistency between the Reserve Bank’s and the ASC’s treatment of a parent bank’s liability for the debts of its subsidiary. The Reserve Bank requires that a bank “unambiguously inform” holders of securities issued by its non–bank subsidiary that the capital of the bank in no way secures obligations incurred by the subsidiary. Such a requirement is potentially inconsistent with the inference of liability contained in the Corporations Law (administered by the ASC) linking the debts of a subsidiary to the assets of its parent company. In any case, a bank and its insurance subsidiary, say, must satisfy requirements laid down by the ASC when both entities are already supervised by designated institutional regulatory agencies.

Differences in approach have also been recognised within the one supervisory framework. For example, when AFIC writes the financial standards for building societies and credit unions, their implementation is left to State supervisory authorities. Each of these has its own Board of Directors and its own policies and procedures for implementing the standards.

These differences in approach, between and within regulatory structures, are exacerbated by the assignment of regulatory responsibilities to a wide range of ministerial portfolios. Banking, insurance and corporate regulation fall within the purview of the Commonwealth Treasurer. At the State level, non-bank regulation is assigned to the Treasurer in some states, to the Attorney–General in others and to specialised portfolios in yet others. Associated legislation, including consumer protection legislation and trade practices, is assigned to a combination of portfolios in both Commonwealth and State legislatures.

These overlaps and differences of approach have resulted in a system that is inflexible in some respects and costly in others. The institutional basis of the structure has meant that regulatory responses have been largely reactive rather than pro–active. For example, while co-ordination of State–based legislation and supervision of non-banks had been under consideration for some time, it took the collapse of the Pyramid Building Society in 1990 to galvanise the States into action. Similarly, it took the large losses incurred by two State banks to highlight the lax arrangements between them and the Reserve Bank.

The direct cost of supervision varies considerably amongst supervisors. The Reserve Bank, for instance, imposes a well below market (although market related) interest rate on non–callable deposits held by banks; the reduction below market rates is 500 basis points. The reduced rate was once regarded as an implicit charge for its supervisory services, but as the Reserve Bank Governor has recently acknowledged, is in fact largely a revenue–raising measure, ($185 million in 1995). Non-banks face a range of charges varying from State to State both in their level and the basis of calculation; in some cases, the charge is based on assets while in others it reflects the expenditure of resources by the supervisor on particular institutions. Indirect costs of supervision also vary amongst supervisory agencies, with some agencies being heavily interventionist and conservative while others exercise a lighter touch.

It is no surprise that with lines of responsibility overlapping between legislators and supervisors, and differences in application even where the overlap has been resolved, competitive imbalances are a constant source of concern. Identifying, and where necessary, correcting gaps, overlaps and inconsistencies in the current regulatory regime is a stated priority of the Council of Financial Supervisors.

These inefficiencies notwithstanding, the existing regulatory framework, has, on balance, worked reasonably well to date. To a degree, the system has responded to changing needs including extensions of the framework to include new products and a broader range of institutions. It has survived a major stock market crash and the demise of two State banks. The formation of the Council of Financial Supervisors and on-going legislative reforms bear testimony to a degree of adaptability to prevailing conditions, and a recognition of the need for more effective coordination.

Whether the structure is sufficiently robust to cope with emerging trends in communications and the technology of service delivery is a different question altogether. The financial services landscape appears set to continue to change considerably, with the formation of alliances between financial institutions and communications providers and global access via the Internet just two of the areas where change is likely to continue. It is difficult to imagine how existing regulatory institutions and approaches will adapt to meet these challenges. A thorough review of current thinking on financial regulation will be required.

6.5 Competition Policy

ABA is strongly of the view that the vigorous competition in the financial services industry can deliver great benefits to consumers, businesses, the industry itself, and ultimately the nation. Accordingly, it strongly supports policies which make the industry efficient and competitive, both within Australia and overseas.

The 1993 Hilmer Report explained at length why the welfare of the community is enhanced when industries are competitive, and why the same principles of competition policy should be applied to all industries with equal force.[29] The rules governing competitive behaviour by Australian businesses are found in the Trade Practices Act, and the provisions of this Act should apply to financial services—no more and no less—as they do to other industries.

One of the most important applications of the Trade Practices Act is the consideration of mergers and acquisitions by the ACCC. Under the Act, these may be disallowed if they lead to a substantial lessening of competition in the industry concerned. However, if the proposed merger or acquisition can be shown to have significant public benefits, it could be allowed even if the degree of competition is substantially reduced. The specific nature of such benefits may be different in the financial sector (e.g. avoidance of the outright collapse of an institution significant enough to disturb the financial system as a whole), but they should be subject to assessment on the same principles as are applied to assessing public benefits anywhere else in the economy.

ABA agrees with these principles, and believes that they should be applied to the financial services industry.

Recommendation 6.2

As for other industries, proposals for mergers and acquisitions should be subject to scrutiny by the Australian Competition and Consumer Commission (ACCC).

Existing Special Provisions for Banks

Treasurer's Veto and Power to Approve

There currently exists a special provision under the *Banking Act* which provides the Treasurer with the power to disallow any proposed merger

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29 *National Competition Policy*, Report by the Independent Committee of Inquiry ('Hilmer Report'), August 1993.

between a bank and another financial institution (including another bank), even if this merger has been approved by the regulatory authorities.

Under the *Banking Act* the Treasurer also has the power to authorise a takeover of a bank on prudential grounds i.e. to bypass the usual competition policy processes. A good example of this was the takeover of the failed Bank of Adelaide by ANZ in 1979. When such a merger has to take place, it is desirable that it be done quickly, to avoid a run on the distressed institution. This is a useful provision of the financial regulatory apparatus, and should be retained, but as noted above, it should be brought into conformity with general competition policy. That is, the principles for assessing that sufficient public benefit exists to bypass normal procedures should be the same principles which apply to assessing public benefit for such purposes elsewhere.

ABA believes that there is a need for a power, to be exercised on the advice of the relevant regulatory authorities, for the responsible Minister (the Treasurer) to allow or disallow the merger of near–insolvent institutions to avoid systemic risk and maintain confidence. However, such a power and expedited process should not be used to implement competition policy where no significant *prudential* issue is at stake.

Recommendation 6.3

The Treasurer should have the power to allow, or disallow, a merger between banks and between a bank and another financial institution. This power should be used only for prudential reasons, on the advice of the relevant regulatory authorities, and not to pursue competition policy objectives where no significant prudential issue is at stake.

The ‘Six Pillars’ Policy

Under the previous Government, there existed an informal ‘six pillars’ policy which prevented mergers between any of the four major banks and two major insurance companies. Such a special provision does not exist for any other Australian industry and it would be redundant in the policy and regulatory environment just described.

Recommendation 6.4

The ‘six pillars’ policy should be discarded, and all mergers should be evaluated on their economic merits under the same competition policy principles as are applied across the economy, with an expedited process of consideration via exercise of the Treasurer’s powers available where there are significant prudential concerns.

Principles and Practice of Competition Policy in the Financial Sector

Questions of competition policy should be resolved by applying the facts of the case in hand to the relevant provisions of the Trade Practices Act. Decisions by the ACCC on whether mergers and takeovers should be permitted inevitably involve a degree of subjective judgment on how they would affect competition, and the industry generally. In making judgments about proposed mergers and acquisitions in the finance sector, the ACCC should recognise that the nature of the relevant markets is an evolving matter. For example, globalisation (in some market segments) and deregulation, together with rapid advances in technology, have made the Australian financial services industry much more competitive and efficient.

The following principles should apply:

- The objective of competition policy is to promote competitive and efficient markets i.e. avoid monopoly power (allocative efficiency) while promoting low cost production (productive efficiency) and innovation (dynamic efficiency).

- The key issues in applying national competition policy principles to the financial sector are to:

    – define the relevant current boundaries of financial markets, both geographically, and in terms of products;

    – identify the barriers to entry to the markets; and

    – estimate economic benefits and costs.

Emerging changes in the market environment, such as deregulation, globalisation and new technologies, are affecting all of the above. These changes, as described in Chapter Four, imply that the market for financial services is becoming broader in two senses:

– the blurring of the product–line distinctions between institutions implies that, to an increasing extent, there is a single market for financial services, rather than separate markets for investment, risk–management and transactions services. Certainly there are in every part of the country multiple providers of all categories of services (e.g. deposit services).

– the old geographic boundaries which previously defined markets are arguably becoming less sharp over time.

Chapter 7
The Prudential Supervision of Banks

Key Points

- Banks have three particular attributes that make a degree of regulatory oversight necessary. They are at the heart of the payments system; banks' creditors do not always have a clear understanding of each bank's financial position, so that adverse events or news can lead to crises of confidence and runs on banks; and banks are very important in providing credit to small and medium-sized businesses and individuals.

- While some regulation of the banking system is desirable to avoid systemic risk, not all regulations, including a number of the Reserve Bank's Prudential Statements, are desirable. Regulation of banks has become more intense than is necessary, interfering with the legitimate commercial activities of banks and not taking into account the new operating environment faced by banks.

- The system of depositor protection in Australia helps prevent runs on banks and ensures a 'safe' form of investment for risk-averse small savers. ABA believes that the arguments in favour of an explicit depositor protection objective in legislation outweigh the arguments against it.

- ABA further recommends that depositor insurance schemes—of the kind seen in the US—should not be introduced, because they unduly encourage 'moral hazard' behaviour. Nor should a New Zealand–style disclosure regime, which many depositors may not find easy to understand and act upon on a day–to–day basis.

- The Reserve Bank is charged with the maintenance of the integrity of the payments system. This objective is vital given the essential role of the payments system in national and international commerce. The requirements for a safe and efficient payments system outlined by the Campbell Committee are still valid and are endorsed by ABA with one proviso: that access to the payments system by qualified new entrants—that is, entrants who can meet the required standards—be granted on fair, commercial terms.

- Participation in the settlement system, including access to RTGS, should be limited to financial institutions subject to the same level of prudential supervision currently applying to banks. This is because only such institutions are *sure* to be able to raise a large amount of liquidity in a very short (same–day) timeframe. For reasons of public confidence, those institutions which comply should be called “banks” so they can be readily identified in the community.

- The regulation of banks’ participation in financial conglomerates should be modified to allow institutions greater freedom to configure themselves in ways which best meet customer needs, and to recognise banks’ internal risk management systems.

- Banks are presently required to lodge an amount equal to one per cent of their non-capital liabilities with the Reserve Bank (non–callable deposits), an amount for which they are paid a non-commercial rate of interest. This requirement is highly costly to banks and is acknowledged by Government to be nothing other than a revenue raising measure ($185 million in 1995). Lacking any prudential function, this requirement should be abolished.

- The *Banks (Shareholdings) Act* sets limits on the proportion of shares in a bank that can be held by one person or entity. These ownership requirements should apply at the level of holding companies owning banks.

- Only supervised deposit taking institutions should be permitted to issue multi–purpose stored value cards. There should be no restrictions, however, on the issue of specific–purpose pre–paid cards such as telephone cards.

7.1 General Principles

Banks have three particular attributes which make a degree of regulatory oversight of their operations necessary. Each of these attributes means that a failure by one bank can have systemic effects. First, they are at the heart of the payments system. The inability of one bank to honour its payments obligations could have flow–on effects to other banks which, although basically solvent, then become unable to meet their obligations.

Second, because most banks’ assets are loans which are not marked–to–market, they can be difficult to value.[30] This means that banks’ creditors, who are mainly depositors, do not always have a clear understanding of each bank’s financial position. This means that adverse events or news can lead to crises of confidence and runs on banks. This in turn could lead to liquidity crises, as banks would typically have a maturity mismatch between their liabilities and assets. In June 1996, banks in Australia had $381 billion in $A liabilities, of which $68 billion were current deposits i.e. payable on demand.[31] At that time, they held less than $30 billion in liquid assets. Moreover, a run on

30 About 70 per cent of Australian banks’ assets are in the form of loans.

31 Source: Reserve Bank *Bulletin*

a single bank which is in financial trouble can lead to runs on financially healthy banks, as the inability of depositors to accurately monitor the value of banks' assets can lead to general crises of confidence.

Third, banks are essential in providing credit to small and medium–sized businesses and individuals. Banks have skills in assessing credit risks, and individual banks possess particular information about their debtors (e.g. small businesses) which other possible providers of credit cannot easily or quickly obtain—although changes are in train which may allow other credit providers to compete effectively in some parts of the market.[32] A collapse of the system of bank credit can have substantial effects on the economy, as there are only limited substitutes for bank credit.[33]

One expert commentator has described the potential systemic damage from bank failure in the following terms:

> "Governments throughout the world regulate banks because the combination of loans financed by demand deposits has, historically, been a volatile mix, leading to costly banking panics. If the banking system becomes insolvent, potentially large costs are borne because the payments system is disrupted, borrowers become illiquid, and information about borrowers is possibly lost. Banking system insolvency is caused by a banking panic, an event in which bank depositors *en masse* demand cash in exchange for their deposits. Banks cannot honour these demands because markets for bank loans are not sufficiently developed. Markets for loans do not exist because of the expense of producing information about the riskiness of borrowers and the incentive problems of inducing banks to monitor borrowers if the bank has nothing at stake (having sold the loan)."[34]

These considerations are not immutable (advances are being made in securitisation), but they continue to have force. They have led to the Australian regime of prudential supervision in which depositors' money is protected (where the precise meaning of 'protected' has been kept deliberately vague), but not guaranteed, and where there are in place a number of regulations governing banks' activities, based largely on the Basle agreements.

Thus, the regulation of banks is motivated by the undeniable fact that, because accurate information about banks' financial position is difficult to obtain, the banking system is subject to a significant externality: one failed bank (which is

32 For example, technological developments, such as credit–scoring computer packages, are eroding the position that banks have had in information–intensive credit assessment—at least for the more straightforward cases.

33 It is widely thought, for example, that the collapse of bank credit contributed greatly to the severity of the Great Depression.

34 Gorton, G (1994), "Bank Regulation When 'Banks' and 'Banking' are not the Same", *Oxford Review of Economic Policy*, 10(4), Winter.

sufficiently large) could potentially cause failures of otherwise financially healthy banks.

However, the fact that *some* regulation of the banking system is desirable to avoid systemic risk does not mean that the particular regulations in place in Australia are all desirable. In this chapter it is argued that regulation of banking has become more intense than necessary; it interferes in the legitimate commercial activities of banks; and it does not take into account the new operating environments in which banks find themselves, driven by changing technologies, globalisation and consumer preferences.

7.2 The Particular Status and Regulation of Banks

Banks in Australia enjoy certain privileges not available to other businesses, and consequently are subject to certain regulations not imposed on other businesses. The chief privileges enjoyed by banks and not by other financial and non–financial institutions are:

- the right to accept deposits from the public, i.e. to raise debt obligations, in some cases repayable on demand, without issuing a formal prospectus.[35]
- the right to hold an Exchange Settlement Account (ESA) with the Reserve Bank and hence to have cheques drawn in the bank's name (i.e. to participate directly in the cheque clearing and settlement systems);[36]
- special status in the eyes of the Reserve Bank whose statutory responsibility is to exercise its powers and responsibilities to protect the depositors of the several banks; and
- the right to describe itself as a 'bank' and its business as 'banking business'.

These privileges, however, bring with them regulations which govern the ownership and activities of banks. A bank cannot:

- be a co-operative or mutual;
- have more than 15 per cent of its equity owned by any one party (bank or non-bank) without approval from the Commonwealth Treasurer;
- hold significant equity in any company (bank or non-bank) without approval;
- operate with a risk–weighted capital ratio of less than 8 per cent;

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35 Credit unions and building societies can also accept deposits.

36 As noted earlier, it was the intention of the previous Government to allow building societies and credit unions to issue cheques in their own name, but a decision has been postponed pending the recommendations of the current Inquiry. Individual building societies and credit unions do not have ESA accounts, but their special service providers each have such an account.

- operate with a ‘prime assets’ ratio of less than 6 per cent;
- operate without 1 per cent of total liabilities (less shareholders’ funds) held as a non–callable deposit with the Reserve Bank;
- have an imbalance between its domestic assets and domestic liabilities;
- exceed maximum exposure limits on lending without approval;
- accept superannuation contributions on its balance sheet; or
- act in a trustee capacity.

The stated purpose of these regulations is to protect deposits, guard against systemic risk, and guard against ‘contagion’ from non-banking businesses owned by banks. In a speech given in April 1995, Reserve Bank Deputy Governor Graeme Thompson said:

> “Our ... aims are to reduce the likelihood [of a bank failure], to protect the interests of depositors in the event of serious problems and, if a bank did fail, to seek to limit flow–on damage elsewhere in the financial system”.[37]

The regulations governing bank activity are discussed in turn in the remainder of this chapter, together with an extensive discussion of the Reserve Bank Prudential Regulations, and where they can sensibly be liberalised.

7.3 Who Should Accept Deposits?

Deposits are liabilities of financial institutions whose nominal value is guaranteed by them. Deposits are issued by financial institutions without a prospectus, and so involve a large element of trust by consumers in the issuing institutions.

As discussed above, runs on banks which threaten the viability of the financial system can occur when depositors lose confidence in the financial soundness of the issuing institution, and since the assets of these institutions are difficult for depositors to value, this confidence can potentially be fragile. Thus, the question of who should be allowed to issue deposits is crucial.

ABA is not of the view that only banks as presently defined should be allowed to accept deposits without a prospectus. However, it is reasonable to argue that, for reasons of systemic stability, only those institutions subject to stringent prudential requirements—i.e. those which apply to banks—should be able to accept deposits. As discussed elsewhere, the ABA believes that building societies and credit unions which currently accept deposits should be regulated by the Reserve Bank.

Recommendation 7.1

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[37] Thompson, G.J., “Supervisory Developments: The Reserve Bank’s Perspective”, *Reserve Bank of Australia Bulletin*, April 1995.

Any financial institution subject to the same prudential requirements as banks should be able to accept deposits.

7.4 Depositor Protection

The Formal Arrangements

Under Division 2 of the *Banking Act*:

- It is the duty of the Reserve Bank to exercise its powers and functions for the protection of depositors of banks. Depositors have first right of call on the assets of a failed bank.
- The Reserve Bank may require a bank to supply information on its financial stability.
- Where a bank considers it is unlikely to be able to meet its obligations, or is about to suspend payment, it is obliged to inform the Reserve Bank, which may appoint an agent to investigate the affairs of the bank and assume control of and carry on business of the bank. In the latter case, the Reserve Bank can retain control until such time as the deposits within the bank have been repaid or the Reserve Bank is satisfied a suitable provision has been made for the repayment, and believes it is no longer necessary to remain in control of the bank.
- Also, in the event that a bank is unable to meet its obligations, or suspends payment, the assets of that bank shall be available to meet that bank's deposit liabilities in Australia, and meeting those liabilities shall take priority over all other liabilities of the bank. (A similar requirement does *not* exist currently under the AFIC legislation for building societies and credit unions.)

The Reserve Bank has repeatedly emphasised that the arrangements under Division 2 do not provide guaranteed protection to depositors with banks and do not eliminate the need for banks themselves to monitor risk. The Reserve Bank Governor has commented, for example, that:

- The Reserve Bank does *not* guarantee the on–going operation of banks. The prime objective is to protect banks' depositors. In extreme situations, the Reserve Bank can assume control of a bank in trouble.
- Division 2 does *not* guarantee the full return of deposits.
- Non-depositor liabilities are *not* covered. The Reserve Bank is *not* concerned with protecting shareholders' funds or the liabilities of financial subsidiaries not defined as banks.
- The Reserve Bank is *not* charged with protecting banks from losing money or acting recklessly in the belief that the authorities will bail them out.
- The relevant provisions of the *Banking Act* apply only after failure.

- In the ultimate, any bank on the verge of failure should exit the industry in an orderly and timely manner which avoids losses to depositors and instability in the rest of the banking system. A good example of this process working well was the takeover by ANZ of the failed Bank of Adelaide in 1979.

Assessment of Depositor Protection

In assessing the system of depositor protection in Australia, it must first be noted that the purpose of such a system is to safeguard the interests of customers, and not the interests of either the owners or managers of banks. Thus a proper assessment of this system must be in terms of how it meets that objective. All processes, including prudential regulations, are only a means to that end, and should not be seen as ends in themselves. As we argue below, the processes aimed at the objective of protecting consumer interests must seek a balance between correcting for the informational handicaps faced by depositors and creating a system which encourages excessive risk–taking by both banks and depositors and which may not be in the interests of depositors, or the consumers of financial services more generally.

The Australian system of depositor protection, but not guarantee, is a compromise which recognises the trade–off between the extent of deposit protection provided and the incentives for institutions to be competitive, efficient and manage risk. Although the *Banking Act* does not formally guarantee deposits, arguably, the public perception is that it does. Historically, Australians have had a high degree of public confidence in the banking system, reflecting two main influences—the extensive period of regulation, and the absence of a bank failure which has actually cost depositors any of their money.

Australia’s depositor protection arrangements are not without shortcomings:

- Although deposits are explicitly *not* guaranteed, this fact is apparently not widely known or understood. The fact that deposits are protected, and that depositors are first in line to make claims on a failed bank’s assets, may encourage the (false) perception that they are guaranteed, and the public may not appreciate the important difference between the two concepts.

- This false perception may lead some depositors to take less responsibility than they should in their choice of institution. It may also lead the management of some banks to judge that, in the event of a bank failure which endangers depositors, the political reality will be that governments will be put under pressure to use public funds to make up any shortfall between the realised value of that bank’s assets and the value of deposits on its books. What is more, some members of the public (seeing similar branding etc) may think that the perceived ‘bank guarantee’ extends to non–deposit products of a banking group. Given this scenario, bank management may then act less prudently under the assumption that, if their actions lead to the bank becoming insolvent, depositors will get their money back one way or the other. Some customers may exhibit similarly less prudent behaviour—e.g. invest to a greater extent in riskier market–linked products offered through a non–bank arm of a banking group in the belief that they are protected from losses.

- The Reserve Bank sees the avoidance of such 'moral hazard' behaviour as an important part of its supervisory role. However, the public may not appreciate that while the Reserve Bank is fulfilling its supervisory duties by protecting deposits, it would be neglecting its duty if it guaranteed deposits, or guaranteed any individual bank against failure, because such guarantees would encourage moral hazard. The Reserve Bank is thus always treading a fine line between doing too little and doing too much.

On the other hand, there are a number of arguments which can be put in favour of having depositor protection an *explicit* objective of the regulatory system:

- It helps prevents runs on banks. Depositors face the problem of asymmetric information—they know much less about the value of banks' assets than the banks themselves. Moreover, these assets tend to be illiquid. This means that confidence in the solvency of banks is essential, and explicit depositor protection helps to maintain that confidence.

- It ensures a 'safe' (and convenient) form of investment for risk–averse small savers. It is unclear whether the market, left to its own devices, would provide such an investment.

How to balance the asymmetric information problem faced by depositors—which is the rationale for their protection by regulators—while avoiding the moral hazard problems, is a matter of fine judgment. ABA believes that the 'moral hazard' is a manageable issue, and that this is best achieved by retaining in the *Banking Act* the explicit objective (for the Reserve Bank) of protecting depositors, while discouraging the impression of a guarantee. The provisions for depositor protection add to public confidence, and so are worth keeping.

More Disclosure

An alternative to depositor protection is the system adopted in New Zealand. In that country, the information problem faced by depositors is approached by banks being forced to disclose certain information to the public.

To be specific, from January 1, 1996 all registered banks operating in New Zealand have been required by law to publish a quarterly disclosure statement, which contains the following information:

- a brief *Key Information Summary*, which is designed to provide a brief overview of a bank's financial condition, such as its credit rating, capital adequacy, impaired assets, exposure concentration, connected lending, guarantees, profitability, total assets and asset growth.

- a larger *General Disclosure Statement*, which contains a wide range of detailed information, and is aimed at those who wish to obtain comprehensive information on a bank; and
- a *Supplemental Disclosure Statement*, which contains detailed information on guarantees and a bank's conditions of registration. These conditions are the means by which the Reserve Bank of New Zealand applies prudential requirements to banks, such as minimum capital requirements.

While this approach may have some merit in mitigating both the moral hazard problem and any misconceptions held by depositors, the New Zealand model is not necessarily superior to the Australian model:

- Providing the necessary information on a continuous basis may have costs which outweigh benefits—particularly in terms of what the information implies for customers in their day–to–day dealings.
- The Reserve Bank of New Zealand (RBNZ) has tried to invoke an expectation of *caveat emptor* in the general public by explicitly stating that bank deposits are not guaranteed by either it or the New Zealand government, and that it does not guarantee that a bank will not get into trouble or fail. However, since it is still actively engaged on a day–to–basis in the prudential supervision of banks, the RBNZ cannot credibly claim that it does not have superior information to the general public about the financial health of particular banks. Thus, despite claims to the contrary, in terms of practical public policy, it is not at all obvious that the RBNZ would be able to stand by and let a bank fail without first attempting some corrective action. Moreover, the RBNZ is still obliged to take control of a bank which becomes insolvent.
- New Zealand has particular attributes which tend to affect the suitability of its disclosure regime:
  - its banks are predominantly foreign–owned (mainly Australian–owned), and so are subject to the prudential supervision of their home–country regulators; and
  - New Zealand has a history of not providing explicit depositor protection.

Deposit Insurance

Another alternative is a system of formal deposit insurance, such as exists in the United States. While deposit insurance can have the superficial attractiveness of making explicit any guarantee given to depositors, ABA is strongly against its introduction in Australia. The United States experience shows clearly the moral hazard problems arising with publicly provided deposit insurance, where the risks are not priced i.e. depositors (and institutions) face a spectrum of returns without facing the underlying spectrum of risks. Depositors in the US were able to obtain guarantee on virtually any amount of money by opening numerous accounts, each of which fell below US$ 100,000 threshold. Not surprisingly, this encouraged reckless behaviour by some institutions, especially those in near–financial trouble, for whom the temptation of ‘one last throw of the dice’ became overwhelming.

It is also not at all clear that a privately provided system of deposit insurance would work either, because of the tremendous informational difficulties involved in correctly pricing the insurance. There would also be the temptation for governments to impose a ‘community rating’ on this insurance i.e. common premiums for all institutions. This would have the effect of driving the good risks out of the market, leaving an increasingly risky and unstable banking sector.

The issue of how regulators should safeguard the interests of depositors is a matter of judgment, which must balance the informational handicaps faced by depositors against the moral hazard problems engendered by a regime which gives depositors too much comfort.

Recommendation 7.2

The explicit provisions for depositor protection should be retained in the *Banking Act*. Depositor insurance schemes should not be introduced and neither should New Zealand–style disclosure regimes.

7.5 Payment System Risk

The Reserve Bank’s Role

The Reserve Bank is charged under the *Banking Act* with the responsibility of maintaining the integrity of the payments system. Central banks throughout the world have been charged with similar responsibilities by their governments.

The justification for this role relates to the systemic risk that the failure of one payment system participant to settle its obligations may directly lead to the failure of other participants with the ultimate result being the total collapse of the financial system. The objective is therefore not to prevent the failure of one participant but to isolate the failure of a participant in a manner which prevents contagion to other participants unless those other participants have inappropriately high levels of credit exposure to the failed institution.

Settlement Risks

There are two fundamental risks in financial transactions which need to be evaluated in assessing settlement risk:

- *credit risk*—the risk that participants in the transaction will not be paid for an outstanding claim, typically when one party becomes insolvent. This involves the loss of principal.

- *liquidity risk*—the risk that the counter–party that owes funds will not be able to make its payment obligation on time, thus adversely affecting the liquidity position of the recipient when the funds are due.

Credit and liquidity risk can arise because of settlement lags, non-synchronous settlement, or default by the issuer of the settlement medium. Credit risk is eliminated where payments systems are based on Delivery versus Payment (DvP) or Payment versus Payment (PvP); i.e. when both sides of the transaction occur at the same time. However, liquidity risk remains under both DvP and PvP, as lack of funds or securities by one party will lead to a delay in completing the transaction, which may lead to liquidity difficulties for a recipient who is relying upon the receipt of funds or delivery of securities to complete further transactions. Real Time Gross Settlement (RTGS), due for implementation in Australia in 1997, should substantially reduce both liquidity and credit risk; however, for reasons explained below, RTGS will not eliminate them.

Payment Systems

Payments systems are typically categorised in terms of low value (retail) and high value (wholesale) systems. While the vast majority of transactions occur within the low value systems, most of the value (and therefore risk) occurs in the high value systems, accounting for over 80 per cent of the total value of payments made in the economy.[38] The value of gross payments exchanged between direct clearers is estimated at $78 billion per day which compares with the capital base of all Australian banks of $52 billion.

The majority of Australia's wholesale payments are now conducted through electronic settlement systems (BITS, RITS, Austraclear, CHESS) with a diminishing (though still very significant) proportion being processed through the cheque system. (Absolute cheque volumes are not falling.) Each of these wholesale payment systems is briefly discussed below:

- *BITS:* The Bank Interchange and Transfer System (BITS) is a domestic interbank electronic funds transfer system designed to handle irrevocable large–value transactions. BITS is used extensively for the settlement of foreign exchange transactions. Transaction value is around $20 billion per day. Irrevocable payments are achieved by agreement between member banks, with settlement occurring on a bilateral net basis at the end of the day. This results in interbank credit risk and liquidity risk should a participating bank fail during the day. Accordingly, there appears to be a risk of contagion. There are no system–wide arrangements to limit BITS obligations or ensure that members will settle in a timely manner if one member is unable to meet its obligations. With a membership of only five, a single bank's gross transactions could exceed $4 billion.

- *RITS*: The Reserve Bank Information and Transfer System (RITS) electronic transfer and settlement system for Commonwealth Government Securities,

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38 Australian Payments System Council, *Annual Report*, 1994–95.

with daily turnover averaging about $15 billion. The system is based on DvP, eliminating credit risk. Client members are sponsored by banks who can establish limits within the system for clients' cash accounts. Banks accept credit risk in this regard comparable with other lending, i.e. credit extension is a commercial decision which can be monitored. Settlements occur in real–time and are irrevocable minimising receiver risk. Banks' net positions at the end of each trading day are settled via exchange settlement accounts. Both credit and liquidity risk exist between banks in this regard. Loss sharing arrangements exist should a bank fail to settle at the end of the day.

- *Austraclear*: A central depository and clearing house for money market securities. Turnover is approximately $25 billion per day. Securities and funds transfers are settled on a multilateral net basis at the end of each day. All transactions are conditional pending confirmation by banks of members' end–of–day net cash position, with provision to wind back transactions until an acceptable position is reached. Once cash positions are confirmed, inter-bank obligations become irrevocable. All inter-bank obligations are netted on a multilateral basis for settlement through exchange settlement accounts. The conditional nature of transactions leads to a result akin to DvP. Liquidity risk does arise between participants. However the conditional transactions and roll back arrangements (which have never been invoked) will automatically cancel transactions until a liquid position is obtained. Principal is not at risk. There are currently no rules to cover the failure of a bank to settle its position.

- *Cheque Clearing System*: Daily value of gross payments is estimated at $27 billion. Cheque payments are conditional and as such credit and liquidity risks are assumed by recipients of cheques. Whilst inter-bank settlement occurs between banks on a net basis through exchange settlement accounts, inter-bank credit exposures are gross; i.e. should a bank fail during the business day, then all cheques drawn on that bank would be returned whilst other banks would still be required to complete settlement for cheques drawn on them. There is a significant level of liquidity risk in the current system and there is a risk of contagion; a major bank's gross obligations could easily exceed $5 billion (around 20 per cent of total daily value).

- *Foreign Exchange Transactions*: These are settled through correspondent banking arrangements using the BITS system for the AUD leg or other instruments e.g. warrants. Settlement is not simultaneous due to time zones and domestic end–of–day settlement systems (i.e. no PvP) thereby exposing domestic banks, both in terms of liquidity and credit risk. This specific type of exposure is referred to as Herstatt risk[39] and has been of

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39 Named after the Herstatt Bank which was closed on June 26 1974 by German banking regulators, after it had taken in all of its foreign exchange receipts in Europe but before it had made its US dollar payments. Foreign exchange counter-parties to the bank incurred substantial losses, and in the days following

concern to central banks world wide for many years. Foreign exchange turnover against Australian dollars is around $24 billion per day with approximately $15 billion through swaps (where settlement between counter-parties is most likely to be on a net basis).

- *Exchange Settlement Accounts*: Interbank positions in respect of BITS, RITS, Austraclear, cheques and other retail clearance systems are multilaterally netted by the Reserve Bank and applied to exchange settlement accounts on the following day. Banks are able to view their outstanding obligation to the system with their overnight ESA balance at 7.00 a.m. Banks have until 8.45 a.m. to transact to ensure their ESA will be in credit at 9.00 a.m. The RBA does not offer automatic borrowing entitlements, but will rediscount short–term Commonwealth securities.

- *Futures and Options*: The Sydney Futures Exchange operates as a central counter-party to futures deals thereby guaranteeing performance. The SFE is protected by a range of collateral and margins requirements. Funds settlement occurs across the banking system.

- *CHESS*: An electronic register of listed securities combined with a settlement system. The electronic registry allows the dematerialisation of share scrip which will, over time, allow full DvP of all stock exchange transactions. Credit risk will therefore be eliminated, but liquidity risk will remain within the system as settlement will occur three days after the transaction occurs. Liquidity requirements will however be reduced as settlement will occur on a multilateral net basis. Banks are not direct participants in CHESS (though their subsidiaries will participate) and so will be exposed only to net settlements. Problems within the CHESS system are unlikely to extend into the wider financial system, though problems in the wider financial system could flow through to CHESS.

The Major Remaining Risks

Although technological developments (electronic payment, multilateral netting) have served to reduce payment system risks, some major risks remain. These are:

- Cheque clearance (especially high value cheques);

- BITS (until it is phased out in 1997); and

- Foreign exchange transactions.

Bank failures in any of these areas could lead to systemic problems. Actions are under development to address the remaining risks. Payments under BITS and high value cheques will migrate to the Real Time Gross Settlement (RTGS) system due to commence by the end of 1997; BITS will then be phased out. At the international level, a multi-currency RTGS system with payment–versus–

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the closure, the markets experienced severe systemic problems as payments in the major currency payments systems ground to a halt.

payment for foreign exchange transactions is expected to be implemented within three years between the G30 Central Banks, of which Australia is not currently a part.

Real Time Gross Settlement

At present, payments between banks are made prior to the start of each working day (after overnight cheque clearing and intra-day electronic exchange of other transactions e.g. ATM, EFTPOS, direct entry) on a multilateral netted basis, with net amounts debited or credited to each bank's exchange settlement account (ESA) at the Reserve Bank. As discussed, this implies substantial risk should a bank fail during the day.

To mitigate this risk, a RTGS system for domestic payments is currently under development to settle high value irrevocable payments. Under RTGS, payments will be made sequentially through the day via ESAs i.e. actual transfers of funds across ESAs will have to take place before these payments can be passed to the recipient bank and bilateral or multilateral netting arrangements will not be relevant for liquidity purposes. Irrevocable settlement will occur between banks subject to the paying banks being 'in funds'. Where there are insufficient funds, payments will be queued pending the availability of funds. Stand-by arrangements will exist to obtain intra–day liquidity from the Reserve Bank.

Credit risk will thus be removed from the high value settlement system, but liquidity risk will remain and issues related to queue management and liquid reserves will arise. However, the raising of funds for liquidity purposes may give rise to credit risk outside the system, depending on how the funds are raised. Nonetheless, RTGS should serve to reduce systemic risk. There will remain an economic effect in terms of the unavailability of customers' funds to meet commitments, with flow–on effects to others i.e., liquidity throughout the economy will be affected.

RTGS will not completely eliminate credit risk in the payments system as it will apply only to domestic settlements i.e. it will exclude settlements between Australian and overseas banks, which can be substantial. Over time, it might be possible to attenuate this risk through international clearing house arrangements, such as exist in Europe through the European Clearing House Organisation (ECHO), and between American and Canadian banks through the North American Clearing System.

Herstatt Risk

As stated above, Herstatt risk arises in relation to the settlement of foreign exchange transactions across different time zones. Individual banks can be exposed for several billion dollars as settlement takes place across two working days with very little opportunity to manage the risk, except to delay sending funds as late as possible and ensuring funds are received as early as possible. Whilst banks' exposure tends to be diversified across a number of counter-parties, the failure of a single counter-party could give rise to significant loss.

Domestic RTGS can isolate the failure of a single bank, but the full consequences of Herstatt risk could lead to the failure of several banks, either globally or domestically.

Close Out Netting

An important legal issue which has not been clarified by case law in Australia is the legal efficacy of bilateral close out netting or trading exchange participatory arrangements. Through bilateral close out netting provisions under financial markets transactions, a party to a financial contract may terminate the contract on the insolvency of the counterparty and set off amounts payable and receivable by it under the contract so that only a single net amount is payable by one party to the other. Under market netting arrangements the trading exchange or clearing house is able, on the default or insolvency of a participating member, to set off obligations under contracts entered into between that member and other exchange members for the purposes of settlement.

There is a need to clarify the law governing netting so as to place netting beyond legal doubt and to ensure that Australian institutions are able to compete effectively internationally. In overseas countries where legal doubt over netting has existed, a significant number of those countries have taken steps to remove the legal doubt through appropriate legislation. Confirming the legal efficacy of netting in Australia would also remove any doubt that a bank's obligation under Section 16 of the Banking Act to hold assets in Australia of a value not less than its Australian deposit liabilities calculated according to the bank's assets on a net basis.

If a court did not uphold netting arrangements in respect of financial transactions, the liquidator of a failed party would have power to isolate and disclaim unprofitable contracts whilst at the same time enforce profitable contracts against the solvent counterparty leaving the latter to rank with other creditors for sums due to it by the failed party. Such an event could have disastrous financial consequences for the solvent party and for the stability of the financial system.

A sub–committee of Companies and Securities Advisory Committee is reviewing these issues and is to report to CASAC with recommendations.

7.6 Access to the Payments System

Given the essential role of the payments system in national and international commerce, and the possibility of systemic breakdown if just a single substantial institution is unable to meet its obligations, it is vital that the integrity of the payments system be maintained.

The Campbell Committee believed a payments system would be "best promoted if:

- there is a core unit in which there is undoubted confidence in the capacity of all participating intermediaries. This requires:
  - high effective standards of financial management;
  - effective prudential regulation; and
  - a legal and institutional framework which offers adequate protection to users, including in respect of such matters as fraud, misuse and violation of privacy.
- there is adequate opportunity for:
  - new intermediaries to enter the payments system as cheque–issuing institutions either as primary participants or by having their obligations cleared through the agency of a member–clearing institution;
  - non–cheque–issuing institutions to offer, in conjunction with a cheque–issuing institution, a range of cheque facilities to their customers; and
  - all institutions (including banks) to participate in offering payments systems services, using instruments other than cheques, subject to their acceptability to payees (who would need to have confidence in both the drawee institution and the drawer)."[40]

These principles are still valid (notwithstanding the diminishing role of cheques in payments systems) and they are endorsed by the ABA with one proviso. Payments systems are often developed commercially by individual institutions or small groups of institutions as part of the competitive process leading to improved customer service and the reduction of costs. Such institutions are entitled to a competitive return on this investment, especially if access to a developed system is to be granted to competing institutions. Thus, while access should be granted to any institution which fully meets the required technical and prudential criteria, it should be on fair commercial terms. Such a requirement is consistent with the guidelines on access to essential infrastructure laid down in the Hilmer Report and the *Competition Policy Reform Act 1995*.

The payments system cannot function unless there is a high degree of confidence that payments will in fact be credited (and debited) according to the intentions of the payers and payees. To maintain this confidence, a hierarchy of access needs to be maintained, as follows:

- at the highest level, direct access to the settlement system;[41] followed by

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40 Campbell Committee, Final Report, p 417.

41 Clearing is the process by which the participants sort, route and exchange payment instructions from their customers, verify the integrity of the instructions and the accuracy of the sums involved and correct those sums for dishonours, errors and other adjustments and, finally, determine the net

- direct access to clearing systems, but not the settlement system; followed by
- indirect access to both clearing and settlement systems.

Within this hierarchy, institutions offering payments services should be free to choose the level at which they participate (subject to satisfying the standards for that level of participation) and regulators should not unnecessarily force a higher level of participation on institutions. For example, RBA proposals for the RTGS system require all banks to directly settle. This is in contrast to the UK where only 15 banks settle directly.

Direct Access to Clearing and Settlement System

Direct settlement is where the final transfer of value from all payments takes place, and carries the highest level of risk. Accordingly, the demand for integrity is paramount with this function, and integrity in this case overrides questions of efficiency and equity. Clearly, those institutions with the responsibility for direct settlement of payments must be institutions supervised at the most stringent level.

Recommendation 7.3

For reasons of public confidence, direct access to both clearing and settlement systems, including access to the Real Time Gross Settlement System (RTGS), should be limited to banks, and other financial institutions subject to the same prudential supervision as banks. New entrants who can meet prudential (capital and liquidity) requirements should pay an access fee on fair commercial terms.

The reasons for this are only financial institutions subject to the highest level of capital and liquidity requirements can raise a large amount of liquidity in a very short amount of time, if necessary, which is a key factor in the ability to process unexpected third–party debits. This can be done either through the interbank money market or through stand–by facilities with the Reserve Bank (e.g. the rediscount window for government securities).

This should not be taken to mean just the existing banks in the settlement system. Rather, any institution which wishes to participate in the settlement system should be subject to the prudential supervision of the prudential supervisor. An access fee to the existing participants, who have invested in and developed the payments technology, should also be paid, on fair commercial terms. For reasons of public confidence those institutions which comply should be called ‘banks’ so they can be readily identified in the community.

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amounts owing to or owed by each participant. The settling of obligations between the participants is achieved, in the case of banks, by payments through Exchange Settlement Accounts (“ESA’s”) held with the Reserve Bank.

Direct Access to Clearing Systems but only Indirect Access to the Settlement System

This would be available to institutions which, while not meeting the criteria for access to the settlement system, would still have direct access to some clearing systems, e.g. electronic funds transfer. Access at this level would require a high level of technical and administrative standards, and also the level of prudential standards required by banks, as failure by an institution at this level could have significant effects on the payments system as a whole. Institutions aiming to participate at this level will need to work out appropriate sponsorship and settlement arrangements from a direct settler.

Recommendation 7.4

Direct access to clearing systems such as EFT (with only indirect access to settlement facilities) should be available on fair commercial terms to those financial institutions meeting the technical and administrative criteria, and the level of prudential standards required of banks.

Indirect Access to Clearing and Settlement Systems

Participation at this level should be open—on reasonable commercial terms—to any financial institution which is a provider of payments services and which either does not meet, or wish to meet, the prudential and technical criteria for higher level access or, for whatever reason, does not wish to participate at a higher level. Indirect access would thus be available on an agency basis, with direct settlers contracted to make payments on behalf of the indirect settlers.

Recommendation 7.5

All financial institutions which meet minimum prudential and technical criteria under APCA rules should have indirect access on fair commercial terms to the payments system.

7.7 Contagion

Banks these days offer more than just the traditional banking services of deposits, loans and payments. Recognising the integrated nature of consumers' financial services requirements, they also offer insurance, funds management, financial advice, and so on. The Reserve Bank has not sought to stop these developments but has insisted that these services be sold only by legally separate subsidiaries of banks, which do *not* have the backing of the parent bank. The motivation for this regulation has been a desire to protect depositors of the bank from the consequences of any losses from the non-bank affiliate.

That is, the Reserve Bank has insisted that 'firewalls' be set up to prevent 'contagion' from the non-bank to the bank. The Reserve Bank's fear of contagion is not entirely without foundation: virtually all of the bank failures in Australia in the past twenty years or so have been caused by losses made by non-bank subsidiaries, e.g. Financial Corporation of Australia and the Bank of

Adelaide, Tricontinental and the State Bank of Victoria, Beneficial Finance and the State Bank of South Australia. In all of these cases, however, no depositors lost any of their money because of the recovery action taken (i.e. takeover of the Bank of Adelaide by ANZ, and recapitalisation of both the State Bank of Victoria and the State Bank of South Australia).

Even with the best ‘firewalls’ which manage to ‘ring fence’ the banking part of a conglomerate, there is a danger of psychological contagion, based on the market’s perception that different parts of a conglomerate are linked under a common brand and overall management. Bank depositors could react adversely to problems in another part of a financial conglomerate simply because of the commonality of name.

However, even large contagion problems do not always lead to systemic problems. In the recent Barings case, the bank in the group failed as a result of losses incurred by a futures trading subsidiary. However, the problem was sorted out by the market (with oversight from the Bank of England) with no systemic consequences.

In any case, the potential problems associated with contagion have led the Reserve Bank to institute a number of regulations, to try to isolate the banking part of financial conglomerates from its affiliates. This is understandable, given the Reserve Bank’s obligations to protect bank depositors. However what is lacking from the current regulatory approach is a recognition that non-banking financial business may *enhance* the safety of traditional banking business, depending on how the risks of each type of business are correlated i.e. the group can give comfort to its individual businesses above and beyond their individual capital buffers, through diversification.

Moreover, financial conglomerates are increasingly seeking to manage and assess their risks on an integrated basis, and have implemented sophisticated internal management systems for just this purpose. These aspects of the Reserve Bank’s regulatory policy are taken up in the next section.

7.8 The RBA Prudential Statements

Deregulation of the financial system in the 1980s was intended, *inter alia*, to free banks from the constricting effects that the pre-Campbell regulations (interest rate controls, qualitative lending guidelines, the SRD ratio and LGS convention etc) had placed on their operations. A measure of prudential supervision in the wake of this deregulation was both inevitable and necessary to guard against systemic and contagion risk, and protect depositors as specified in the *Banking Act*. However, it is ABA’s view that this process of prudential supervision has in many instances gone too far, and has become an unnecessary impediment to the ability of banks to meet customer needs, both now and in the future.

In ABA’s view, many of the Reserve Bank’s Prudential Statements are inconsistent with the spirit of an efficient, competitive and dynamic banking sector envisioned by the Campbell Report. There are two problems with these

Statements. First, they presume a “one size fits all” approach which does not give sufficient recognition to the sophisticated risk management systems that banks have in place, and which largely obviate the need for such prescriptive regulation.

The Prudential Statements lose sight of the fact that banks’ internal systems can achieve the *objective* of prudential supervision in a less costly, more flexible manner than the current policy approach. The Reserve Bank should therefore focus its prudential supervision more to an assessment of banks’ risk management systems—provided those systems satisfactorily address the issues of systemic risk—and less to the issuance of *ex-cathedra* statements.

Second, they restrict the ability of banks to configure themselves in ways which can best meet the needs of customers. This is important given the changes discussed in Chapters Four and Five. Financial and mixed conglomerates raise important prudential issues.

Broadening the activities in which a financial services group may be involved has the potential to exacerbate the risks that are generally associated with financial conglomerates. The risks associated with conglomerates, include:

- contagion risks;
- concentration of power;
- conflicts of interest;
- corporate structure and transparency; and
- dispersion of management control.

These are already the focus of prudential supervisory arrangements; evidenced, for example, in the growing emphasis on consolidated supervision of financial groups and the increasing interaction and information sharing by financial regulators.

Certain mixed conglomerates may be inherently riskier than financial conglomerates; for example, by providing greater scope for contagion arising from inter–group exposure and the added managerial burden of overseeing a more diverse range of activities.

Conversely, a mixed conglomerate may diminish the level of risk associated with the provision of financial services, for example, by increasing the financial capacity of the provider, by reducing their reliance on single products or industries and by enabling them to better exploit their information bases and core competencies.

The nature of mixed conglomerates therefore creates particular challenges for regulators—how should the aggregation of risk to the group level of mixed conglomerates be assessed; what capital and liquidity arrangements should be put in place, etc.

The extent to which both financial and mixed conglomerates develop in the future will reflect the ability of particular organisations to satisfy demand;

operating, of course, in a regulatory environment that maintains the stability and integrity of the overall financial system.

The Prudential Statements should therefore be substantially amended or withdrawn. To be specific:

PS A1: Prudential Supervision of Banks

This statement was the first to be issued, in January 1985. The guiding principle of this statement, to be found in paragraph 3, is that "the prime responsibility for the prudent management of a bank's business lies with the bank itself". These sentiments are however inconsistent with the prudential regime in total, which is in parts extremely inflexible and prescriptive.

In the eleven years or so since the issue of that statement, the internal management systems of banks, especially for managing risk, have improved considerably, especially following the large losses experienced by some banks in the early 1990s. Yet, while these improvements have been occurring, ever more controls on banks' operations have been put in place in the form of prudential statements, contrary to the original *modus operandi* of prudential supervision. (This increased sophistication has in fact been recognised by the Reserve Bank itself in its generally light–handed treatment of the market risk associated with banks' off-balance sheet activities.)

PS C1: Capital Adequacy of Banks

Capital adequacy is at the heart of prudential supervision, and ABA does not dispute that banks should hold sufficient capital to absorb losses as might arise from time to time, as well as providing a source of permanent funds. (Of course, such capital buffers should not and will not guarantee the solvency of a bank in the event of extraordinary losses.)

ABA also agrees that it is beneficial for Australian banks to be seen to consistent with the Basle capital adequacy guidelines, and has no disagreement that the total weighted ratio of capital to assets of 8 per cent. This said, however, ABA believes that the risk weights promulgated in PS C1 do not necessarily bear any relation to actual risks. Examples include: the 20 per cent weight on claims on all OECD central governments, where clearly the risks are very different for, say, the United States and Mexico; and the 100 per cent weight on claims on some non-OECD governments.

Banks nowadays have very sophisticated, market–based, risk management systems, which they use to allocate capital for internal management purposes.

Recommendation 7.6

The Reserve Bank should adopt a more flexible approach and allow banks to use internal risk management systems to allocate capital according to *actual* credit risk, as assessed by those systems, for prudential supervision purposes, in a way which is consistent with the objectives of the Basle framework.

PS C2: Funds Management and Securitisation

This statement, issued in October 1995, gave banks new freedoms in participating in securitisation and tightened the arrangements in relation to funds management. The statement is motivated by Reserve Bank concerns that existing legal arrangements would be insufficient to prevent banks from recourse.

ABA is of the view that the extensive regulations in PS C2 are complex and unnecessary. Existing risk management systems and the law are sufficient to deal with questions of recourse that may be faced by a bank. These arrangements should be adequate for prudential purposes provided the Reserve Bank is satisfied as to their efficacy, and given the continued existence of the traditional capital, liquidity and other requirements for banks, and Reserve Bank oversight of bank holding companies.

The disclosure aspects of PS C2, although prescriptive, are in principle a sound and efficient means of informing investors.

Recommendation 7.7

Prudential Statement C2 should be amended to cover disclosure issues only.

PS D1: Supervision of the Adequacy of Liquidity of Banks

PS D1 obliges banks to hold a certain proportion of its balance sheet in specified primes assets (the Prime Assets Requirement, PAR) is a means of ensuring adequate liquidity. PAR is the successor the old LGS convention, which, unlike PAR, served as a monetary policy instrument.

ABA supports the retention of PAR as a prudential requirement, but believes that a wider range of high quality liquid assets e.g. US Treasury Bills, should qualify for inclusion as ‘prime assets’.

Recommendation 7.8

A wider range of high quality liquid assets should qualify for inclusion in the Prime Assets Ratio.

PS F1: Off–Balance Sheet Business of Banks

Recommendation 7.9

Given the new risk weights attached to banks’ off–balance sheet activities (in Prudential Statement C1), Prudential Statement F1 is now redundant and should be withdrawn.

PS G1: Banks’ Association With Non–Banks

The requirements in this Statement, together with Reserve Bank policies which require a licensed bank to be the holding company of any financial services group incorporating a bank, restrict the ability of Australian institutions to configure themselves flexibly to meet customer needs.[42]

While each case will be different, a bank association with a non-bank may diminish risk (for example, by increasing their financial capacity, by reducing their reliance on single products or industries, by increasing reliance on less risky industries and by enabling them to better exploit their information bases and core competencies). It may, however, exacerbate risk (for example, by providing greater scope for contagion arising from inter-group exposure and from the psychological attachment of customers to members of a group, and as a result of the added managerial burden of overseeing a wider range of activities).

While some regulation is necessary—to ensure, for example, the transparency of otherwise complex corporate structures, to facilitate risk assessments and capital adequacy arrangements—too strong a reliance on ownership restrictions may involve risks in a rapidly evolving market.

For example, restrictions on the structure of financial conglomerates which require that a bank ensures that the aggregate assets of its non-bank intermediary associates do not exceed 50 per cent of the assets of the bank may become increasingly inappropriate where intra-group risk management processes justify a different balance.

Similarly, PS G1 places obstacles in the way of banks' equity associations with non-financial organisations which might otherwise assist a bank to better meet customer needs.

For example, a bank is currently prohibited from purchasing a mid-sized software company which specialises in the electronic delivery of banking services. Similarly, equity ownership by banks in organisations capable of providing the physical hardware for the delivery of electronic banking services, or retail companies through which banks could expand their customer bases and range of delivery outlets, are restricted.

Recommendation 7.10

Prudential Statement G1 requires, at least, substantial amendment to allow banks the competitive freedom to meet their customers' needs, in an environment where:

- **the traditional boundaries between different types of financial institutions are becoming increasingly blurred, with banks, for example, increasingly becoming general financial service providers; and**
- **rapid technological developments are creating new synergies between financial businesses and some types of non-financial businesses.**

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42 There are mixed views on the desirability of mixed conglomerates.

PS I1: Access to the Payments System

An efficient and safe payments system is at the heart of a modern economy, and securing the integrity of the payments system is one of the major reasons for the existence of prudential supervision. As discussed earlier, ABA is of the view that while anybody should be able to access the payments system indirectly, access to the settlement system should be limited to banks and other financial institutions subject to the same prudential supervision as banks.

7.9 Non–Callable Deposits

Banks are currently obliged to lodge an amount equal to 1 per cent of their non-capital liabilities with the Reserve Bank, for which they are paid a sub-commercial rate of interest. This regulation, introduced by the previous Federal Government, costs the banks about $185 million per year.[43] At one point, this amount was viewed as a payment for the benefits of supervision, however the Governor of the Reserve Bank has recently conceded that NCDs are just a revenue raising measure. The direct costs of prudential supervision should be recovered by other means.

Recommendation 7.11

Since non-callable deposits are now simply a special tax on banks, for which there is no prudential justification, they should be abolished, with the direct cost of prudential supervision recovered by other means.

7.10 Banks (Shareholdings) Act

The *Banks (Shareholdings) Act* sets limits on the proportion of shares in a bank that can held by one person, or entity. By spreading the ownership of banks, this law serves a useful purpose in protecting the interests of depositors.

In the near to medium term future, ownership structures which see banks as subsidiaries of holding companies may become prevalent.

Recommendation 7.12

Ownership requirements under the *Banks (Shareholdings) Act* should be applied to holding companies. There should be no requirement that a holding company must be a bank.

7.11 Stored Value Cards

As described in Chapter Four, one of the emerging trends in the financial service industry is the increased use of stored value cards (SVCs), as a

43 “Financial Regulation and the Financial System Inquiry”, *Reserve Bank Bulletin,* July 1996.

replacement for cash. This emergence raises a number of public policy issues, such as who should be allowed to issue them.

It is imperative that the community has confidence in the integrity of stored valued cards i.e. that they will be able to recover or transfer the value contained in them. Such confidence would be difficult to achieve if any organisation or individual was permitted to issue these cards; it is not difficult to imagine a significant case of fraud, or default, by one operator badly damaging confidence in the entire system of stored value cards. The problem for consumers is that they will have little or no way of determining, before the event, who is an honest or solvent issuer. In itself, this could retard the development of the market for SVCs. This is potentially a significant market failure.

Moreover, stored value cards which become reloadable will be functionally equivalent to deposits. The prudential requirements which are necessary to protect the interests of depositors will therefore equally be necessary to protect the interests of SVC holders. In addition, the same issues pertinent to risk in the payments system will also apply to SVCs—the failure of one institution to honour its obligations could have serious systemic effects.

Since stored value cards are a means of payments, the arguments about access to the payments system apply also to the issuance of SVCs. Thus, ABA believes that only supervised deposit taking institutions should be permitted to issue stored value cards.

Recommendation 7.13

Only supervised deposit taking institutions should be permitted to issue multi-purpose stored value cards i.e. cash replacement cards. Such a restriction will enhance the integrity of the market for stored value cards, maintain consumer confidence that they can access the value in the cards, and minimise systemic risk associated with the failure of an institution to settle its debts.

Recommendation 7.14

There should be no restriction on any fees that the issuers of SVCs may charge. This should be left to the market.

The consumer confidence problem, however, does not arise in the case of pre-paid cards for specific purposes (such as telephone cards)—there is no market failure.

Recommendation 7.15

There should be no restrictions on the issue of pre-paid cards for specific purposes (e.g. telephone cards).

Chapter 8

Consumer Regulation—Current Issues

Key Points

- Consumer regulation should ensure that:
  - consumers are appropriately informed of their rights and obligations;
  - those rights and obligations are consistent with common law, international practice and public policy;
  - consumers are educated as to effective and efficient banking;
  - customer confidentiality is protected; and
  - regulations are imposed on a national scale, and do not impede domestic competition or the ability to transact business offshore.
- Consumer regulation should avoid:
  - being overly prescriptive; overloading consumers with unnecessary information;
  - imposing excessive costs on service providers;
  - penalties on service providers which are disproportionate to any wrong committed; and
  - constraining market outcomes between service providers and consumers who are sufficiently sophisticated to make their own judgements and who do not need to be protected.
- Consumer protection laws in Australia contain too many of this second set of undesirable characteristics. This is particularly true of the Consumer Credit Code, scheduled to take effect in November this year. The Code comprises 184 sections and a further 74 subordinate regulations, requiring twelve forms for use in consumer credit transactions. The Code provides for various sanctions in the case of a breach, including civil penalties, criminal penalties, compensation to the consumer and the setting aside of the relevant contract. It also proscribes numerous existing financial products. It allows the reopening of transactions, a characteristic inconsistent with the principle of disclosure.

- The initial set–up cost to the banking industry of preparing to comply with the Code's provisions has been estimated at around $100 million, with significant ongoing costs. For one major bank alone these are of the order of $14 million. The ultimate incidence of this, in a competitive environment, is likely to fall on customers.

- Banks are subject to various legislative provisions with which compliance is unduly burdensome. Numerous problems can be identified, for example, in connection with the *Financial Transaction Reports Act*. The *Act* is very expensive to administer, and imposes substantial costs on cash dealers. The 'know your customer' rule should replace current identification requirements, and the *Act* should be refocussed solely toward countering money laundering objectives, rather than covering social security and tax fraud.

8.1 The Aims of Consumer Regulation

In principle, consumer protection laws and regulations have the useful aim of informing consumers about the products and services they are buying. They should inform consumers of both their rights and obligations, and ensure that consumers are protected from deceptive and misleading conduct. In brief, consumer regulation should aim to ensure that:

- consumers are appropriately informed of their rights and obligations;

- those rights and obligations are consistent with common law, international practice and public policy ;

- consumers are educated as to effective and efficient banking;

- customer information is reasonably protected; and

- regulations are imposed on a national scale, and do not impede domestic competition or the inability to transact business offshore;

On the other hand, consumer regulation should avoid:

- being overly prescriptive;

- overloading consumers with unnecessary information;

- imposing excessive costs on service providers;

- penalties on service providers which are disproportionate to any wrong committed; and

- constraining market outcomes between service providers and consumers who are sophisticated enough to make their own judgments, and who do not need to be protected.

In summary, consumer protection regulations should aim to be efficiently educative without being paternalistic. Moreover, these agencies charged with implementing those regulations should see their role as being educators rather than police officers, and balance the substantial costs of what they impose (costs largely passed on to the consumer) against the benefits. Regrettably, it is ABA's submission that consumer protection laws in Australia[44] are too heavily weighted towards the second, undesirable, set of characteristics. This is particularly true of the Consumer Credit Code, scheduled to take effect in November this year.

8.2 Consumer Credit Code

Background

The major final policy settings for the Consumer Credit Code were agreed by the Standing Committee of Consumer Affairs Minister (SCOCAM) on 14 May 1993. The objectives, in themselves entirely admirable, were to create a regime of information disclosure and redress to protect the interests of consumers in their capacity as borrowers from financial institutions.

The Code would be uniform in substance across every Australian State and Territory. Each jurisdiction would pass its own law either adopting a Model Code subsequently passed by the Queensland Parliament (the Model Code was passed by the Queensland Parliament in September 1994) or pass alternate but consistent legislation.

The scope of the legislation was agreed by SCOCAM to apply to all consumer credit provided in the course of a credit provider's business where the credit is provided wholly or predominantly for personal, domestic or household purposes and the borrower is either an individual or a strata corporation. The Code covers a vast array of consumer finance products including personal bank overdrafts, credit cards, personal loans, housing loans, consumer hire purchase, consumer chattel leasing, retail credit eg store credit etc.

The Code also applies to mortgages or guarantees related to consumer credit contracts. Aspects of the legislation would apply to credit related insurance contracts, in particular, insurance over mortgage property and consumer credit insurance (insurance which insures the capacity of a debtor to make repayments).

The Code is to commence operation in all jurisdictions on 1 November 1996. It comprises 184 sections and a further 74 subordinate regulations. There are also twelve prescribed forms for use in connection with various consumer credit transactions.

Ministerial second reading speeches in relation to the Code are in the main similar in their focussing on the precontractual disclosure requirements under

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44 There are a range of laws and regulations which affect consumers, including the Contracts Review Act NSW, the Privacy Act, the Trades Practices Act, Consumer Credit Code, Banking Code of Conduct and the EFT Code of Conduct.

the Code. It is asserted that a potential borrower can assess the true cost of any proposed credit transaction, make meaningful comparisons with competing products on offer and better understand his or her rights and obligations.

An important feature of the Code is the extent of the sanctions which may be applied where a credit provider fails to comply with Code provisions. Depending upon the nature of the breach, sanctions involving some or all of:

- civil penalties;
- criminal penalties;
- compensation to the consumer; and
- setting aside of relevant contractual and security provisions.

Section 15 of the Code stipulates a series of matters which a consumer credit contract document must contain. There are some 15 aspects to section 15. Over half of those attract a civil penalty, a criminal penalty and, if the debtor or a guarantor has suffered loss, compensation for the debtor or guarantor, if breached. This situation varies for continuing credit contracts.

Also, if a credit contract imposes a monetary liability on a debtor in excess of any liability permitted by the Code, the credit provider will be exposed to liability for both civil and criminal penalties together with any liability to orders for restitution.

The Code is prescriptive in setting the ultimate charge which might be made for interest under a credit contract. In essence, the Code prohibits interest being charged other than daily in arrears on unpaid daily balances. Where a credit provider charges interest monthly, quarterly or half yearly, interest is to be charged on the average unpaid daily balances for the relevant period.

With the calculation of interest generally, after a transitional period of 12 months from the commencement of the Code, predetermined credit charge contracts will be outlawed (a predetermined credit charge contract can be described as a fixed sum, fixed rate contract repayable over a specified period by equal instalments of principal and interest where the interest charge component does not vary throughout the life of the loan).

The limitations on interest charging under the Code therefore, will exclude certain products such as ‘flat rate’ personal loans and prepaid interest loans, regardless of customer preference for such products.

If the debtor defaults in payment under a credit contract, a higher (default) rate may apply to the amount in default but the credit provider is not at liberty to apply the higher rate generally to the total outstanding balance under the contract. This provision therefore, proscribes a practice previously conducted by some credit providers. Nevertheless, in principle, if a debtor properly understands the consequences of default why should not a credit provider be entitled to enforce such a provision?

Prior to a debtor entering into a contract, the debtor must be provided with a precontractual statement containing certain prescribed 'relevant financial information'. This information comprises some of the matters which must be included in the contract document. However, this information must be displayed in either portrait or landscape format, in tabular form on the first page of the precontractual statement. This document is intended to provide the intending borrower with the financial fundamentals of the proposed transaction and a basis upon which to compare competitors' offerings. The 'relevant financial information' includes:

- the proposed amount of credit or maximum amount of credit (if ascertainable) or the credit limit;
- the applicable annual percentage rates to be applied under the contract;
- the maximum duration of any interest free period;
- the total amount of interest charges payable under the contract on a number of assumptions (i.e. that interest rates do not change and that repayments are made on time) where on those assumptions the contract will be paid out within 7 years;
- details of repayments to be made under the contract including the number of repayments, the period over which they are to be paid and the total amount of the repayments (based on a number of assumptions including that the contract will be paid out within 7 years), the amount of each repayment, when the first repayment is to be made and the frequency of repayments; and
- details of credit fees and charges retained by the credit provider (i.e. not third party fees or charges) and charges for lender's mortgage insurance.

Failure to comply with precontractual disclosure requirements carries a maximum criminal penalty of $10,000. The precontractual disclosure requirements must be carried out in every case and the borrower has no right or power to waive the credit provider's obligation to comply. Most of the financial obligations of the debtor are dependent upon tolerances and assumptions under the Code dealing with, for example, interest rates being non–variable, repayments being made on time, there being no changes to credit fees and charges during the life of the loan etc.

Where flexibility in variation in interest rates and credit fees and charges is very much a feature of consumer lending, the value of technically precise precontractual disclosure based on tolerances and assumptions that such matters are not variable is questionable, particularly where failure to comply with the technical requirements could lead to imposition of a substantial civil penalty.

There are a number of additional provisions in the Code which cut across market forces. These are:

- the power of a court to review interest and charges which are considered unconscionable such as:

  - establishment fees or charges;
  - early termination fees or charges;
  - fees or charges for prepayments; and
  - change to an interest rate.

  ABA considers that market forces coupled with adequate disclosure of present fee structures, for example, payment of an additional three months interest in the event of a loan being repaid prior to maturity, is an appropriate means of regulating these matters.

- the inability of credit providers which incur fees or charges to third parties to include the third party fees or charges with the credit provider's administrative or handling costs in connection with the service provided by the third party. For example, a fee payable by a credit provider to the Land Titles Office for a title search cannot be increased and passed on to a debtor by the credit provider to cover the credit provider's administrative costs of attending to the search.

The Code contains extensive 'reopening' provisions developed along the lines of the Contracts Review Act of New South Wales. The reopening provisions apply to credit contracts, mortgages or guarantees that are considered by a court to be 'unjust'. There is a number of factors (at least 16) to which the court may have regard in deciding whether a contract, mortgage or guarantee is or is not unjust. Such factors include:

- the form and expression of the instrument under review;
- whether or not independent legal or other expert advice was obtained by the debtor, mortgagor or guarantor;
- the extent to which the provisions of the document and their legal and practical effects were accurately explained and whether the debtor, mortgagor or guarantor understood the provisions and their effect;
- what measures the credit provider took to ensure that the debtor, mortgagor or guarantor understood the nature and implications of the transaction and the adequacy of those measures; and
- whether by reasonable inquiry of the debtor at the time, the credit provider could have ascertained whether the debtor could meet its obligations under the contract without substantial hardship, whether the terms of the transaction or the conduct of the credit provider is justified in the light of the risks undertaken by the credit provider and how the particular transaction compares with the terms of comparable transactions involving other credit providers.

In some jurisdictions, this judicial function has been conferred upon non-judicial bodies ie credit tribunals.

The reopening of a consumer transaction on the basis of procedural or substantive fairness is a serious matter given the powers of the court (or tribunal). These powers include granting relief from the whole or part of the obligations under the document in question, release of security and restitution of property. It is inconsistent with the principle of disclosure (truth in lending) for there to be a reserve power to unwind a transaction freely entered into on an informed basis.

Estimates among banks vary on the costs of preparing for compliance with the Code. The cost to the banking industry to prepare for the Code is conservatively estimated at around $100 million.

The ongoing cost of compliance as exemplified by one nationally operating bank's estimates is shown in Table 8.1 below.

TABLE 8.1

INDICATIVE CONSUMER CREDIT CODE COMPLIANCE COSTS

Annual additional paper cost for 68 million A4 80GSM sheets of paper (1)	$ 0.7m
Additional ink cartridges for printing, annually	$ 2.5m
Annual storage costs for increased paper requirements	$ 2.0m
Resource costs directly attributable to increased processing time for loans (approximately 20% increase)	$ 9.0m

Note: (1) To halve this paper consumption advanced technology duplex printers could be employed at a one-off capital cost of $64.6 million.

Source: ABA analysis.

For a joint home loan currently completed in a 10 page contract in duplicate i.e. 20 pages in all, the Code will require five copies of a 24 page contract (i.e. two copies for each customer with one constituting the precontractual statement) or in other words 120 pages in total, an increase of 100 pages per joint home loan.

The same bank has estimated that in simply preparing for the transition of existing contracts which are going to be covered by the Code i.e. mainly credit cards and personal overdrafts, approximately 80,000 man–hours will be involved together with an additional 160,000 man–hours to train staff on all aspects of the Code.

Civil Penalties under the Consumer Credit Code

Introduction

The ABA is of the view that the civil penalty regime under the Consumer Credit Code (the 'Code') is in urgent need of review on the basis that the current system:

- is without parallel in other consumer protection legislation;[45]
- significantly enlarges the power of a court to award punitive damages;
- does not take account of the current deregulated financial environment and the compelling competitive forces in the retail credit market; and
- has the potential to penalise a credit provider in a way which is entirely disproportionate to the gravity of the offences.

Under the Code which is due to commence on 1 November 1996 if a credit provider breaches a ‘key requirement‘ a Court or, as appropriate, a credit tribunal may impose a civil penalty. ‘Key requirements‘ are obligations imposed upon credit providers to include in credit contracts and statements certain information and to ensure that debtors are not overcharged.

The amount of the civil penalty may be significant. A breach of a ‘key requirement‘ may lead to:

- if the application is made by the debtor or guarantor, a penalty of up to all interest charges under the contract from its inception for a breach of most of the ‘key requirements‘. The penalty may exceed this amount if the debtor’s loss is greater.
- if the application is made by the credit provider or the Government Consumer agency, a penalty up to a maximum of $500,000 per contravention for all Australian jurisdictions (except possibly for Western Australia depending on the final form of the Code in that jurisdiction).

There is a considerable number of matters to which the Court or tribunal must have regard in exercising its discretion as to whether to impose a civil penalty.

Analysis

There are no statutory defences available to credit providers to resist a civil penalty claim. A civil penalty may be imposed in addition to criminal penalties (fines) and may extend to an amount not less than a debtor’s loss. There is no clear direction in the Code for the Court (or tribunal) to have regard to notions of honesty and reasonableness of conduct on the part of credit providers and to the nature and extent of conduct (so as to require the Court or tribunal to take account of minor errors or ‘slips‘).

The civil penalty regime under the Code does not compare favourably with the civil penalty regimes under the *Trade Practices Act 1974* or the Corporations Law. Under the *Trade Practices Act*, a breach of the restrictive trade practices

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45 Provisions under Australian legislation imposing civil penalties (pecuniary non-criminal penalties) are relatively rare. They occur under *the Trade Practices Act* in connection with restrictive trade practices, the Corporations Law in respect of certain breaches by directors, and the Credit Acts which became operative in Victoria, New South Wales, Australian Capital Territory and Western Australia in 1985.

provisions does not give rise to liability to a criminal penalty, only a civil penalty. However, the Court is empowered to make compensatory orders where loss or damage has occurred. Only the ACCC may bring an application for civil penalty under the *Trade Practices Act*.

Under the Corporations Law only the ASC, a delegate of the ASC, or a person authorised in writing by the Minister may bring an application for civil penalty and any application for civil penalty is automatically stayed until the final determination of any criminal penalty in respect of the same contravention. Also, under the Corporations Law the Court may relieve a person either wholly or in part from liability to a civil penalty if the person has acted honestly and in all the circumstances ought fairly to be excused.

Under the *Trade Practices Act* and Corporations Law only a Court may impose a civil penalty.

Under the Code there are no such protective mechanisms except perhaps that a Court (or tribunal) may, if it thinks appropriate, order that particulars of an application for civil penalty be withheld from publication.

Public Policy Rationale for Civil Penalties

Under the *Trade Practices Act* the imposition of a civil penalty is regarded as a serious matter and is designed to operate as a deterrent to breaches of the Act's provisions. The courts recognise a punitive element should be present in the imposition of a civil penalty, as the expression would imply.

There is an analogy under common law in the power of a Court to impose exemplary (or punitive) damages in cases involving certain civil wrongs (torts). However, in Australia exemplary damages are generally confined to cases where the conduct of the defendant warrants punishment and, in particular, where it discloses fraud, malice, violence, cruelty, insolence or acts in contumelious disregard of another's rights.

Experience with determinations on civil penalties under the *Credit Acts* has demonstrated that substantial civil penalties will be imposed in respect of conduct falling far short of conduct which under common law is deserving of an award of exemplary damages.

Generally speaking, conduct giving rise to restrictive trade practices under the *Trade Practices Act* and to directors' breaches of the Corporations Law is qualitative in nature in the sense that it inevitably involves conscious decisions to do or refrain from doing particular acts which give rise to public policy and public interest issues. These matters arise from human decision making.

Conversely, under the Code the provision of consumer credit on a large scale involves systemised procedures and decision making. Systems and extensive delegation of authority are necessary to deal with the volume of applications for credit and credit transactions. Additionally, much of the documentary creation for consumer lending will be computer generated and, whilst generally reliable, computers are not immune to error. Centrally based computers which generate consumer credit documentation are capable of and inevitably will malfunction notwithstanding the diligence of those charged with maintaining them, resulting in substantial systemic errors in critical areas under the Code.

In the event of such a systemic error, except in the case of Queensland where only a Court of superior jurisdiction has jurisdiction to determine such matters, a credit tribunal (which is not a Court) will have jurisdiction to enquire into the range of compliance systems and procedures which the defaulting credit provider had in place and to consider in its inquiry factors such as when the credit provider ought reasonably to have become aware of the contravention, what systems or procedures the credit provider had to prevent or identify contraventions and whether the credit provider might have prevented the contravention.

Towards an enlightened system of regulation

The *Credit Acts* were drafted and implemented in a regulated financial system environment. The consequences of non-compliance with key aspects of the *Credit Acts* were potentially calamitous. A credit provider could automatically lose the right to the credit charge under the credit contract and be left with the right to apply to a credit tribunal for reinstatement of the credit charge or so much thereof as the credit tribunal considered appropriate. In the case of certain non-bank financial institutions, some jurisdictions established a licensing regime for credit providers.

Whatever may have been the standards of compliance and regard by the finance industry for contemporary standards of behaviour in the provision of consumer credit in 1985, there would be few, if any, who would say that the experience of the last decade with the *Credit Acts* has failed to bring about the adoption of compliance cultures within the consumer credit financing community. Banks alone have committed around $100 million in a little less than two years in implementing compliance programs and procedures for the Code.

The concept of civil penalties in consumer credit is 'a hangover' from the *Credit Acts*. Civil penalties do not apply for a breach of the consumer protection provisions in Part V of the *Trade Practices Act* (apart from the ability to order compensation for loss) and there is no power to order civil penalties under the *Fair Trading Acts*. The imposition of civil penalties in consumer credit fails to take account of the deregulation of the financial system and of the compelling competitive forces in the retail consumer credit market. There now can be no case on legal or public policy grounds for the imposition of civil penalties on a credit provider acting in breach of the Code where fines and orders for compensation apply.

A case *may* exist for retention of civil penalties for the worst cases, that is to say, those cases where there is contumelious disregard for the law and the rights of the other party to the transaction.

A civil penalties regime, *if it exists*, should have the following protective features:

- only a court of superior jurisdiction may impose a civil penalty;
- only a government consumer credit agency or person authorised by the Minister should have standing to bring a civil penalty application;
- a period of limitation of say, three years should be imposed from the date of contravention and the institution of a proceeding for a civil penalty; and
- the application standard of proof in a civil penalty case should be the criminal standard i.e. establishing a case beyond reasonable doubt. However, if a lesser standard were to apply there should be a clear mandate to the court that it may only find that a case has been established for imposition of a civil penalty on the strongest of evidence.

Case Study of the Consumer Credit Code

Suppose Mary and Lisa, who are sisters, apply for a personal loan from a bank. Mary and Lisa do not reside at the same address. The bank approves their loan subject to their father ("Dad") putting up his home as security. Mary and Lisa also agree to take out a consumer credit insurance policy.

The following paper trail begins.

1. Before Mary and Lisa enter into the proposed credit contract, the bank is obliged to provide each of Mary and Lisa with:
   - a precontractual statement which section 14(5) of the Code allows to be in the form of the proposed contract document. This statement must contain specified financial information in tabular format and, like the final form of the contract, must disclose up to 15 categories of information and potentially more than 50 categories of information; and
   - an information statement called "Things You Should Know About Your Credit Contract"; and
   - a copy of the contract document for each of them to keep and a copy of the contract document for each of them to sign and return to the bank (section 18(1)). (If however the precontractual statement is in the form of the proposed contract document then that would reduce by two the number of documents that needed to be provided at this stage.)
2. Within 14 days of the contract being made, the bank is obliged to provide each of Mary and Lisa with a copy of the contract in the form in which it was made, i.e. signed by them (section 18(2)). Section 18(2) would not apply, however, if the bank gives each of Mary and Lisa a copy of the contract document signed by the bank to keep when it gives them a copy of the contract to sign and return. This exception thus requires the contract to be structured as an offer from the bank which is accepted by the borrowers.

3. Within 14 days of the consumer credit insurance policy coming into effect the bank must give each of Mary and Lisa either a copy of the policy or a written notice containing prescribed details of the insurance (depending on the form of the policy).

   It is important to note that the duplication of documents to Mary and Lisa cannot be avoided. Where there are joint debtors, section 171(3) of the Code provides a mechanism whereby one can be nominated by them to receive notices and other documents on behalf of them all. In that case, a notice or other document given to one of them is taken to have been given to all of them. However, this mechanism is only available to joint debtors who reside at the same address. Therefore, Mary and Lisa have no choice but to each receive each notice and other document given to them for the purpose of the Code. Even if Mary and Lisa did reside at the same address, and gave a section 171(3) notices nomination before the contract was entered into, it is still arguable that a prudent credit provider must give each consumer a copy of each precontractual document.

Document to Mary and Lisa's Dad

4. Mary and Lisa's Dad is a third party mortgagor and, as such, the Code requires him to enter into a guarantee and mortgage. Before he enters into the guarantee, the bank is obliged to provide him with:

   - a copy of the (proposed) personal loan contract (section 51(1)(a));
   - an information document called "Things You Should Know About Guarantees" (Section 51(1)(b));
   - a copy of the guarantee for Dad to sign and return to the bank (but if the guarantee is contained in the mortgage which is permitted by section 50(2) of the Code, the bank would not have to complete this step).

5. Before Dad enters into the mortgage, the bank will provide him with a mortgage to sign and return to the bank. At that time, the bank may give Dad a copy of the mortgage to keep (regulation 60).

   - However, if the copy of the mortgage is not given at this stage then it will have to be provided under Step 7 (see below).

6. Within 14 days of the guarantee being signed and given to the bank, the bank is obliged to provide Dad with:

   - a copy of the guarantee signed by the guarantor; and
   - the (proposed) personal loan contract (if a copy of the related contract has not previously been given to the guarantor).

7. Within 14 days of the mortgage being made, the bank is obliged to provide Dad with a copy of the mortgage in the form in which it was

made (section 39). However, this section does not apply if the bank takes the option of providing Dad with a copy of the mortgage as described in step 5 above.

Conclusion

The total number of documents given by the bank to Mary, Lisa and Dad varies between 11 and 19, depending on the options taken. Whether the minimum can be achieved depends entirely on the structure of the documents and the order in which they are provided.

Recommendation 8.1

The Consumer Credit Code should be substantially simplified and revised to emphasise education of consumers rather than prescriptive process, and all civil penalties for breaches of the Code should be removed.

8.3 Australian Banking Industry Ombudsman Scheme

The Australian Banking Industry Ombudsman (ABIO) Scheme, aims to resolve disputes between consumers and their banks. The Board of the organisation consists of representatives from member banks, while its Council consists of three consumer and three member bank representatives and an independent chairman. The ombudsman is appointed by and answers to the Council.

The ombudsman considers disputes concerning, *inter alia*, possible maladministration by banks, credit contracts, fraud and breaches of written authority.

The ABIO is a voluntary industry based customer dispute resolution scheme established by the banking industry in 1990. The scheme provides individual bank customers who have been unable to resolve their disputes with banks, access to a no-cost dispute resolution scheme covering the majority of retail banking consumer complaints.

The Code of Banking Practice prepared by ABA in November 1993 requires a bank to have available for its customers free of charge an external and impartial process having jurisdiction which is comparable to the ABIO for resolution of disputes.

The ABIO has enjoyed success and is widely utilised and well regarded by the community.

8.4 Financial Transaction Reports Act

This Act is very expensive to administer, costing the banks about $20–$30 million per year. ABA believes that the scope of the Act should be narrowed, by repealing Section 16 or to confine reporting of suspect transactions or suspected breaches of criminal law only. The reporting threshold for significant transactions should be lifted to a much higher level, and in common with many other countries, the Act should not apply to breaches of the tax law or social security law. The Tax Office and Department of Social Security have adequate other means in their own systems to protect against breaches of the law they administer (e.g. the Tax File Number system).

The Act has generated complaints from the public over the stringent account identification requirements and the extent of the Cash Transaction Reporting obligations. On identification procedures, the international practice of being less prescriptive and allowing banks flexibility in identification, based on the 'know your customer' rule, would now be appropriate. Banks should be exempt from the identification requirements of the Act subject to them maintaining a permanent record for at least five years of how they identified the 'customer' and the customer's specimen signature. This would do much to alleviate the anger and frustration of bank customers.

Banks accept the obligation to 'know their customers' and believe it would be best to have that principle applied on a flexible basis rather than through the prescriptive account opening procedures in the Act.

Recommendation 8.2

The 'know your customer' rule should replace current identification requirements, and the *Financial Transaction Reports Act* should be refocussed to money laundering objectives only, and not cover social security and tax fraud.

Chapter 9

Regulatory Form

Key Points

- Maintenance of confidence in the integrity of the financial system, and in particular of the payments system and the deposit–taking institutions through which the public accesses it, requires an effective prudential regulation framework. No disclosure and competition regime on its own can substitute for this, given the realities of access to information.

- The future prudential regulatory framework needs to be applied by a number of independent specialist regulatory bodies due to significantly different risks involved and hence regulatory skills needed, for example a banking supervisor, a life and general insurance supervisor and a securities and capital markets supervisor. In such an environment there would however, be a need for very close and effective coordination among the specialist regulators, particularly in the event of an institution being in difficulty.

- The Council of Financial Supervisors reflects a recognition of this need, but its role needs to be enhanced to better deal with the issue—particularly the supervision of conglomerates (diversified financial services groups). Diversified financial services groups exist already and even with some ‘firewalls’ between the banking, insurance and other businesses within such institutions, loose informal coordination between their regulators will not give satisfactory assurance of the soundness of an institution as a whole.

- The two main models for achieving sufficiently close coordination among specialist regulators are the *lead regulator* model and the *single umbrella regulatory organisation* model. Given the very different specialist expertise involved in banking and insurance supervision, ABA favours the lead regulator model, with explicit attention being given to risk aggregation within conglomerates and systemic risk.

- The ideal banking supervisor is the central bank, which should be responsible for all banks building societies and credit unions, which should come under a single Federal system of prudential supervision, with the regulator having flexibility to determine how the objectives of capital and liquidity regulation are met by mutual organisations.

- There should be no separate regulation of competition issues in the financial sector; rather, the general rules of competition policy should be applied by the Australian Competition and Consumer Commission (ACCC) to financial institutions.

- Consumer regulation should be on the principle of the least possible regulation consistent with the objective of consumers understanding the products they are buying and understanding their rights and obligations in connection to purchasing those products.
- Consumer regulation should be unified across the financial sector, with regulation graduated functionally according to the nature of promises made to consumers (and relevant attributes of institutions making the promises). Regulation in this area should be less *rules*–based and more *objectives*–based than at present, allowing institutions maximum flexibility in how they meet the objectives.

9.1 The Present Starting Point

This chapter discusses regulatory reform—that is, how regulation should be organised: on what principles and in what administrative strictness. As discussed in earlier chapters, Australia currently has a multiplicity of regulators covering the financial sector:

- the Reserve Bank supervises the banks as well as carrying out its responsibilities for the conduct of monetary policy;
- building societies and credit unions are supervised under the Australian Financial Institutions Commission (AFIC) umbrella by the separate State authorities, who also regulate miscellaneous non–bank financial institutions which do not come under the AFIC scheme at present, including friendly societies, trust companies, money lenders etc;[46]
- the Insurance and Superannuation Commission (ISC) supervises life and general insurance companies and superannuation funds;
- the Australian Securities Commission (ASC) acts as the companies registrar, supervises the functioning of the securities markets and has both product and, to a limited degree, what are in effect prudential regulatory responsibilities in respect of ‘prescribed interest’ collective investments, mainly unit trusts;
- the Australian Competition and Consumer Commission (ACCC) is the principal competition regulator for the sector, although with the Treasurer reserving some discretions in respect of banks; and the ACCC also has a broad consumer protection role;
- along with the ACCC, State consumer affairs regulators govern some aspects of the financial sector e.g. credit legislation.

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46 It is proposed that friendly societies come under the scheme in 1997.

While *prudential* regulation is largely *institutionally* based under the present structures just outlined, the other prevailing forms of regulation are a mixture of institutional, functional and product or transactor regulation.

Australia exhibits a degree of overlap, inconsistency and inflexibility in its regulatory structures, and almost certainly greater administrative and compliance cost than would be the case under a more harmonised and less subdivided regulatory framework. That said, the present structures on the face of it work reasonably well, and are certainly widely regarded, domestically and internationally, as of a high standard in terms of integrity.

Nevertheless, overlaps and inconsistencies, and the potential to generate them, need to be minimised in any reform of the regulatory structures. Examples of inconsistencies exist in the area of consumer disclosure. For example, for functionally fairly similar retail financial products, disclosure requirements range from a minimum for deposit products offered by supervised deposit–takers (and indeed, on 'caveat emptor' grounds, for direct purchases of existing equity or debt securities) to full prospectus disclosure for unit trust and similar products, including those conservatively invested (e.g. cash management trusts).

There are also significant differences in capital adequacy requirements under prudential rules applying, for example, between certain banking and life insurance products;[47] these inconsistencies go both ways, some favouring one sector, others the reverse—but all distorting commercial and consumer decisions.

Notwithstanding improved coordination at senior levels in recent years under the Council of Financial Supervisors (COFS), and with the main Federal regulatory agencies all now under one Minister, such problems of overlap, duplication and inconsistency largely remain. In fairness to the various authorities, it should be acknowledged that initiatives have been launched by them to address some of the issues. For example, there is currently a joint initiative of the ASC and ISC to harmonise regulation of investment advice (principally financial planning advice in relation to managed fund, life insurance and superannuation products).

9.2 Challenges to Present Regulatory Form

What is particularly challenging the regulatory system is the arrival and prospective spread over the next 10–15 years of diversified financial services groups, or conglomerates, in an increasingly varied range of configurations—as previously discussed. These developments have been permitted by deregulation and enabled by technology but fundamentally driven by the requirements and preferences of consumers, who have demanded—and

47 For example, a term deposit and a capital guaranteed insurance bond, both invested in the same liquid or short–dated assets.

received—changes to the types and prices of products delivered by financial institutions, and the forms in which they have been delivered.

In a limited sense, we already have many financial conglomerates. For example, most if not all of the established banks now have life insurance and funds management and in some cases various other financial subsidiaries. Equally, there are a few financial services groups which are predominantly insurance or specialist funds managers but which presently hold banking authorities and operate (generally small scale) banking activities. The Colonial group has recently widened the spectrum of models actually operating in Australia. With the takeover of the State Bank of New South Wales, it is the first broadly 'balanced' conglomerate—that is, a conglomerate with comparably sized banking and insurance/funds management arms—to appear in the Australian financial marketplace.

More relevant to consideration of appropriate regulatory structures for the next 10–15 years is the expected evolution of the environment over that time, discussed earlier in this submission. Some trends are speculative but some are widely regarded as very likely to combine; for example, most of the financial services groups based around established banks would at this stage expect to see the balance of their overall businesses (in terms of measures such as assets) shift further over that time frame from their banking businesses towards their funds management and related businesses.

That expected continuing trend and the likely arrival in other ways of additional or more evenly balanced conglomerates in the Australian financial marketplace underline the need for the future regulatory structure to be capable of addressing virtually any configuration of financial services group and to be adaptive to changes in the environment, and in the business structures which evolve in the marketplace to respond to that environment.

The logic here is that a primary concern of prudential regulation will continue to be avoidance of systemic problems—especially in the event of failures, or incipient failures, and that ultimately it is a *group* (i.e. the overall institution) which will either fail or stand behind one of its businesses in difficulty.

A regulatory system is needed which is facilitative of changes rather than imposing very prescriptive or inflexible requirements on institutions in the face of change. This will be in the interest of Australia's competitiveness and, more broadly, in the interest of efficiency, effectiveness, and maximum net benefit to users of financial services. The challenge is for regulation to maintain the stability and integrity of the payments system and other key mechanisms such as the major securities trading mechanisms.

9.3 Broad Principles Revisited

At a basic level the rationale for financial regulation can be put as 'ensuring that promises made are understood and that those to whom they are made can have a reasonable expectation that the promises will be kept'.

A radical interpretation of this principle could be that with sufficiently open disclosure, there is no need for capital and risk management regulation. Competition and competition policy, and an appropriate disclosure regime, would oblige institutions to maintain prudent capital, liquidity etc parameters which were comparable with their leading competitors, and competitive risk management systems.

However, ABA does not believe that such a loose regulatory regime is either feasible or desirable. Maintenance of confidence in the integrity of the financial system—and in particular of the payments system and the deposit–taking institutions through which the public accesses it, require an effective prudential regulation framework—for which no disclosure and competition regime on its own can substitute, given the realities of access to information.

As discussed in Chapter Seven, commerce and the conduct of the community's ordinary financial affairs will continue to depend on the integrity of the payment system core that we have, involving central bank money and banks and to a lesser extent non–bank deposit–takers as agents. In short, ensuring that people can have confidence in the payments system without having to undertake costly and recurrent information searches, will remain a valid aim for the foreseeable future. This in itself justifies prudential regulation of banks, as does the need for consumers to retain confidence that their deposits are protected from falls in the value of bank assets.

Moreover, while there remains some scope for the regulatory framework to contain characteristics which are specific to Australia and which reflect any peculiarities of the Australian market, in broad terms this framework will have to be consistent with the Basle and other international frameworks under which financial institutions throughout the developed world operate. Significant departures from this framework may serve as a poor signal and lead to Australian institutions suffering unnecessary competitive disadvantages in the international marketplace.

It should be noted that in insurance, and not just in banking, there is a parallel case for prudential regulation (supplementing disclosure regulation) to ensure integrity and maintain confidence in risk pools—given especially their substantial importance (alongside market–linked pools) in providing support to Australian households in events such as death, disability and retirement. However, anything that can be mis–perceived as a 'guarantee' should be avoided.

It is particularly important that such mis–perceptions not be allowed to arise with those increasingly important forms of saving, principally superannuation, where, in general, the member (saver) bears the full investment risk. Prudential supervision involving capital requirements etc is warranted in this *market–linked* area only to the extent that promises (e.g. capital guarantees) are made i.e. where there is significant mismatch between assets and liabilities, and where a risk exists to the stability of the financial system.

9.4 Future Prudential Regulation of Financial Services Groups

Given a continuing primary focus of prudential regulation on the integrity of the payments system, it seems a not unreasonable requirement of participants in the financial system that if they conduct a banking business (deposit taking and payment services, together with lending), they conduct it in a distinct corporate entity with its own capital and systems (e.g. risk management systems) meeting appropriate regulatory objectives. This can be described as requiring that the banking business within a financial services group be demarcated from other business activities by 'firewalls'.

What is meant by this, most fundamentally, is that the bank be a separate company with separate capital; and that the products are clearly distinguished to customers (i.e. it is made clear that, say, insurance products offered by the insurance business in a group are not backed by the bank in the group). There is no need, and it would both be economically inefficient and not in the interest of giving a total service to customers, to go beyond this to (say) prohibition of cross–marketing.[48]

It would be desirable to bring all deposit–taking institutions under a common supervisory regime. It follows that unifying their regulation under a single Federal regulator would remove a significant area of duplication and would provide a consistent regulatory framework.

How the standards for access to the system are met and, therefore, status of the institution may need to be different for a mutual organisation, to the extent that this status may involve constraints on its ability to access capital or liquidity; but this can be left to the regulator. That is, while the objectives to be met should be clear, how in detail they are met can be left flexible.

Recommendation 9.1

Regulation of banks, building societies and credit unions should be unified under a single Federal prudential supervisor. The Reserve Bank would be the appropriate supervisor. That regulator should have flexibility to determine how the objectives of capital and liquidity regulation are met by mutual organisations, and the consequent status of those institutions.

It would also make pragmatic sense to apply a similar 'firewall' approach to life and general insurance businesses within a financial group—i.e. to require that such activities be conducted within the group through distinct corporate entities with their own capital etc—and in turn to securities businesses (although if the clients of these businesses bear the market risk, there is not a strong *prudential* case for separation). The emphasis should be on ensuring that

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48 Thinking in the United States appears to be moving to greater flexibility in 'firewall' restrictions between banks and affiliated Section 20 (securities) companies. The Federal Reserve Board recently put forward proposals in this vein. (Source: Institute of International Bankers, communication.)

the separation of all the businesses and their products is made clear to customers, not on restricting the pursuit of synergies among the activities.

In line with the vision for the future evolution of the financial system discussed earlier, and the general principle of competitive neutrality, the regulatory framework should not otherwise be prescriptive about the shape of financial services groups.

There should be no particular prescription against such groups contracting out parts of their processes, or including within a group *non–financial* businesses—such as information technology or other activities closely related to financial service provision. It is not obvious that any business group should be, as a matter of principle, excluded from offering financial services, so long as the financial services activities of significant interest to prudential regulators are conducted via discrete entities allowing it to be ascertained efficiently that these entities individually meet prudential requirements.[49] Technological change, globalisation and customer demand may create possibilities for associations between banks and non-banks. Important issues for prudential supervision may arise as a result.

This invites a number of questions which will be dealt with below—how to assess aggregation of risk to the *group* level, and hence *systemic risk* implications; and whether there is a valid regulatory interest in group ownership structures, and so on.

At present in Australia there is regulation requiring diversity of ownership of banks. It is arguable that such requirements will be less warranted in the future, but to the extent that they continue to apply, they should obviously be applied at the top or holding company level of the group concerned.

In summary, regulation should be prescriptive about the structure of financial services groups only to the minimum extent necessary to allow separate specialist prudential regulators for banking, insurance and perhaps securities business to deal efficiently with identifiable units demarcated by appropriate ‘firewalls’ within which requisite capital, systems etc for each entity are quarantined and which make the separations clear to customers.

Recommendation 9.2

Regulation should be prescriptive about the structure of financial services groups only to the minimum extent necessary.

9.5 Future Regulatory Form

The foregoing suggests that the future regulatory framework can be applied by a number of independent specialist regulatory bodies, for example:

- a banking supervisor;

49 There are mixed views on the desirability of mixed conglomerates.

- a life and general insurance supervisor; and
- a securities and capital markets supervisor.

As discussed below, the separate function of product (or consumer) regulation need not necessarily be combined with any of these specialist regulators, but could be carried out by a separate institution (or institutions). The ACCC is one obvious candidate, the ASC another. As in the case of prudential regulation of non bank deposit taking institutions, there is certainly a strong case for a single Federal regulator to replace all State level regulation of this type.

A difficulty with the model of a set of independent prudential regulators is that the existence of 'firewalls' between separate corporate entities within a financial services group (or broader group containing financial services businesses) does not remove the need to monitor the position of the group as a whole.

Either strengths or weaknesses in one of the businesses of a group (particularly one with a well known 'brand' bestriding all of its activities) may be perceived as having at least some implications for its other activities by those who deal with it. Ultimately a financial services *group* must be able to stand behind its component businesses, and it is thus the group's strength which counts most for avoiding systemic risk, and hence for prudential supervision.

This also suggests that regulatory skills are needed in assessing the *aggregation of risk* from the level of individual financial businesses to a group as a whole. Such assessment must consider both the possibility of *'contagion'* spreading from difficulties in one business to the other businesses in the group; and conversely, the *risk diversification benefits* enjoyed—such that the businesses in the group which are doing relatively well may give, via the group, comfort and strength to one of them which may be experiencing difficulties. Which of 'contagion' or diversification benefits is likely to be predominant in a given group (in circumstances relevant to regulators) depends on how correlated are the conditions in which the several businesses operate, the extent of commonality among customer bases; the nature and strength of public perceptions, and so on.

Equally, the regulatory framework needs the related skill of assessing *systemic implications* of instability emerging within any one diversified financial services organisation. While there are grounds for believing that the most likely source of such instability would typically be the banking business, this may not always be the case.

At the very least, on all these grounds, therefore, there is a clear requirement for close and effective coordination among the specialist regulators, particularly when an organisation is in trouble. The need for such strong coordination among prudential regulators is now recognised.

The Council of Financial Supervisors (COFS) was established following the 1991 Parliamentary Inquiry into Banking and Deregulation, although it operates essentially at top management (policy) level rather than at working level, where close coordination would be particularly important if difficulty arose.

ABA is not convinced that the informal structure of COFS confers on it the ability to satisfactorily handle the complex issues involved in supervising conglomerates and risk in the financial system as a whole, despite the assurances given in the various COFS annual reports. In short, while COFS has been a useful start to giving these issues serious attention, ABA believes that it is time for a new regulatory structure.

9.6 Models for Achieving Close Coordination among Specialist Regulators

The two main competitor models for achieving close coordination are:

- the *lead regulator* model, in which there are independent regulatory organisations, but for each financial services group one of them takes the lead and convenes *ad hoc* groups of specialists as needed when a financial services group as a whole is experiencing difficulties or posing prudential issues which require this coordinated approach;
- a *single umbrella regulatory organisation*, i.e. a single administrative structure integrated at senior management level but containing specialist divisions, organised basically on functional lines but with (at least) distinct banking and insurance arms—given that two of the more important specialist functions will be assessing banking–type assets and insurance–type liabilities. While these are essentially categories of risk assessment, they are very distinct areas of specialist expertise.

In considering the future regulatory framework, it must be borne in mind that change in the marketplace may allow a greater role to be given to self–regulation (and reliance on internal systems), and require reduced intensity of external regulation, while still meeting regulatory objectives. It may therefore also bear upon the model (form) of regulation which is appropriate.

However, whatever the model, it would be desirable in this regard to implement regular reviews at, say, 5, 7 or 10 year intervals (along Canadian lines) so that government itself, at the policy level, can ensure that the regulatory framework remains relevant and appropriate as circumstances evolve.

9.7 The Lead Regulator Model

The *lead regulator* model is operating elsewhere, e.g. the United Kingdom since the late 1980s. It was considered in Australia but rejected by the Council of Financial Supervisors in 1993 in favour of a less formal, consultative approach. The lead regulator model has the advantage that the skills in each regulatory organisation can be specialised to and focused on the particular task—e.g. emphasising the ability to understand bank assets and processes in the case of the banking specialist regulator, emphasising the ability to understand life insurance and general insurance liabilities and processes in the case of the specialist insurance regulator, and so on for the securities markets and product (consumer) regulators.

A possible difficulty with the lead regulator model is that in the case of a broadly *balanced* financial conglomerate, it becomes somewhat arbitrary which regulator takes the lead, and neither need necessarily have all of the desired skills in assessing (in this case, where distinct activities are of comparable size) the *aggregation of risk* to the level of the overall financial services group, and the implications for *systemic risk* flowing from that. In times of difficulty, well designed working procedures would need to be put in place to manage the situation in a coordinated fashion.

This need not be an insurmountable problem, however, provided each regulatory institution has the mix of skills needed to take the lead role. In the Australian context, a lead regulator model will require the Reserve Bank to acquire the skills necessary to assess risk in insurance companies, and the ISC will correspondingly need to acquire the skills needed to assess banking risk. Both institutions will need to upgrade their skills in assessing aggregative risk and systemic implications.

(A related issue is whether, if there are separate regulators for banking, insurance and so on, the banking supervisor needs to be the central bank, as ABA favours. Among advanced countries, about half exhibit this and about half have a separate banking supervisor. That issue is discussed later.)

9.8 The Single Prudential Supervisor Model

The main considerations favouring a single prudential regulator, albeit with specialist divisions within it, are as follows:

- this model is designed to internalise the process of achieving commonality of principles and a consistent approach to generally similar issues across the financial sector; and

- in the case of an institution, one of whose financial services activities is facing difficulty, this integrated model is designed to ensure the maximum level of coordination among functional specialists (including 'banking' and 'insurance' specialists) as well as being able to develop and call up the distinct set of skills of assessment that will be needed in *aggregation of risk* and the risk of systemic flow–on.

A contrary point is that such a regulator may internalise important issues which should desirably be subject to external debate or 'creative tension' between regulators; and that it would be a quite powerful and possibly 'empire building' bureaucracy which might (say) resist reduction of regulatory intensity although objectively warranted.

A more important argument (since some of these points could be made of the other mould) is that the impression might be given that all classes of deposit–taking institutions, each supervised by the one authority, are equally risky (or equally 'safe'). This would not be in the interests of investors looking to balance their portfolios to get the best combination of risk and return.

Perhaps more important, public perceptions may be encouraged that the authorities 'guarantee' not only bank deposits (which they do not) but the products of other supervised institutions accepting funds from the public. There are presumably some grounds for such perceptions where the institution makes some sort of promise or gives some form of guarantee (e.g. providers of capital guaranteed life insurance products) and is regulated; what is important is to ensure that the limits to what regulators are achieving for consumers are well understood. To the extent that mis–perceptions are entertained even in relation to other products (e.g. unit trusts, including cash management trusts which look like variable rate deposits), this is obviously undesirable. Encouragement of such perceptions on a wider basis by having a single regulator (it might be argued) could lead to greater political pressure for redress in time of difficulty.

If the above types of impressions are widespread, this could also encourage management of some institutions to take greater risks, in the belief that if a gamble goes bad the super regulator will bail them out, to avoid contagion effects on the other institutions under its supervision (which would be all the financial institutions in the country). Minimising and managing all such perceptions would be an important issue to address in the single regulator model.

Regulation by Function

A more radical proposal is that the divisions of a single prudential supervisor should be organised by function, in some broad generic sense, rather than by institution. This could, for example, be achieved by identifying distinct financial functions based on the nature of the 'promises' implicit in the underlying transactions.

This model would have the advantage that consistent prudential regulations would be applied to all types of products, regardless of the type of institution which offers them. However, ultimately, as mentioned above, it is institutions which become insolvent, and so pose a potential danger to the financial system. Thus, as a practical matter, *prudential* supervision needs to ultimately be on an institutional basis, although relying on well–conceived functional specialisations. There is perhaps a greater role for a functional model in *consumer* regulation, governing forms of disclosure etc in relation to the nature of promises and the attributes of institutions making them.

Overall, the choice of model in prudential supervision is a matter about which an 'on balance' judgment needs to be made. ABA's judgment is that at this time the issues relevant to the regulation of conglomerates, including the necessary coordination, can best be handled by the lead regulator model with explicit attention to expertise in risk aggregation and systems risk; and strong and well understood coordinating methods, especially procedures to be adopted and expertise to be marshalled in times of difficulty.

Recommendation 9.3

That a system of lead regulators be established to deal with the prudential supervision of financial conglomerates, with explicit attention to expertise in risk aggregation and systemic implications; and with strong coordination arrangements in place especially for situations of difficulty.

9.9 Supervision of the Payments System

Payments services amount to the transfer of ownership of financial securities. At present, securities transferred in settlement of debt are almost always exclusively of the capital–guaranteed variety; in fact, they are generally deposits of one form or another. For this reason, the Reserve Bank, as the banking regulator, has traditionally also been the regulator of the payments system.

In the future, however, a much wider range of instruments will be transferable in settlement of debt, including equity–type instruments. Although it is likely that capital–guaranteed instruments will still dominate debt settlement, they will not monopolise it as they have in the past. This implies that, among regulators, not only the banking supervisor will have a stake in ensuring a stable payments system. A strong coordination role between regulators—if they are not combined in a single regulatory institution—will be necessary to ensure the integrity of the payments system.

9.10 Should the Central Bank be the Banking Supervisor?

In a recent Reserve Bank conference paper, the following five arguments were put for why the central bank should also be the banking supervisor:

(i) This gives it a direct hand in the stability of the financial system, for which it has ultimate responsibility.

(ii) As supervisor, it can better assess the need for lender–of–last–resort assistance to a bank which needs liquidity.

(iii) Supervision of banks gives it information about financial conditions which can be used for the conduct of monetary policy.

(iv) A knowledge of macroeconomic conditions, gained through monetary policy formulation, can be used to foresee threats to bank stability.

(v) Banking supervision is inter–related to the central bank's role in overseeing the payments system.

These arguments carry considerable force (indeed a further point is that central bank supervision, as against supervision by another regulator, may be seen internationally as having a premium 'cachet'). However it is not absolutely necessary to give the central bank ultimate responsibility for the stability of the financial system (i.e. the institutions and mechanisms comprising the system).

This responsibility *could* be given to a separate supervisory regulation, for example, with the central bank being given responsibility solely for *macroeconomic* stability (or more narrowly, price stability), pursued through monetary policy.

About half of the advanced countries assign only the latter mission to their central banks, with a separate regulator supervising banks in a prudential sense. The reasoning is that:

- there can sometimes be a conflict of objectives (e.g. after the 1987 stock market crash) between control of the overall money supply and objectives of augmenting troubled but sound institutions' liquidity; and
- a single clear mission (inflation/stability of the currency) is a better, sharper basis for central bank performance and accountability.

The central bank could liaise with the banking supervisor as to whether a bank which is in trouble is fundamentally insolvent or just temporarily illiquid. In any case, the same kind of coordination between people with different responsibilities has to occur now on the issue of provision of liquidity, *within* the Reserve Bank. As to other points, in practice monetary policy decisions do not seem to be informed significantly by information gained from the prudential supervision of banks. And similarly, bank supervisors do not seem to use broad information about the macroeconomy as a major input to judgements about the stability of particular banks.

Finally, similarly to the arguments about liquidity support, there is no reason why the central bank cannot liaise with a separate banking supervisor, if need be, on payments system issues—as happens in half the advanced countries—although this creates another coordination issue.

On balance, ABA believes that the Reserve Bank is the best institution to be the banking supervisor and, moreover, should be responsible for banks, building societies and credit unions which should come under the Federal banking supervision regime. AFIC and the role of State authorities in this would disappear.

9.11 Future Form of Competition Regulation

It should not be forgotten that the objective of competition policy is to deliver benefits to consumers that an otherwise unregulated marketplace would not deliver. That is, consumers benefit from efficient, competitive markets. Competition policy should seek the attainment of such outcomes—without necessarily prescribing particular market structures.

There is no obvious reason why there should be specialised regulation of competition issues in the financial sector. Rather, as discussed in Chapter Six, the general rules of competition policy should apply. As discussed in that chapter, in this sector however, there is a need to have a power that can be exercised by the Minister responsible for the regulatory framework (the

Treasurer) to allow or disallow mergers involving banks, strictly on prudential grounds i.e. to preserve confidence in the financial system by acting quickly to deal with an actual or incipient failure.

The *public interest* reasons that justify such an expedited process for dealing with a failing banking institution should be weighed consistently with the way public interest considerations are weighed in other sectors. That is, the benefits should be weighed against any diminution of competition. Moreover, such a power should be exercised, on prudential grounds, only on the advice of the relevant regulator(s).

9.12 Future Form of Consumer Regulation

As noted earlier the most basic of all planks of regulation in the financial sector is disclosure regulation—helping ensure that promises that are made are both understood and can be reasonably expected to be kept. The approach to consumer regulation should be unified across the financial sector, with disclosure requirements graduated consistently according to the functional nature of the promise being made; and taking into account relevant prudential requirements that are met by the institution making the promise.

It would be possible to have product or consumer regulation carried out across the sector by specialist regulatory arm like the United Kingdom's Personal Investment Authority. That Authority has endeavoured to apply *objectives–based* (rather than *rules–based*) regulation—i.e. to allow institutions flexibility in how they meet the objectives. In the Australian environment, given that national responsibility for consumer issues already resides with the ACCC, one organisational solution would be to integrate product/consumer regulation for financial products and services and place it with that body, but adopting an objectives–based approach along UK lines. Ideally, as noted, this would apply to State–based consumer regulation as well as Commonwealth.

As far as regulatory *intensity* is concerned, the aim should be for *the least possible* regulation consistent with the objective of consumers understanding the products they are buying, and understanding their rights and obligations when they purchase those products. There should be more use of an objectives–based approach rather than an approach of policing rigid rules. The 'culture' of the ACCC, or other national consumer regulator for this sector, should in effect be to regard itself as chief educator, not chief police officer.[50] As noted earlier, this means that the Consumer Credit Code needs to be drastically revised, in philosophy, away from paternalistic prescription towards a sensible, cost–efficient, regime which is clearly focused on objectives, rather than pre–occupied with processes and penalties.

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50 In an address to the National Press Club on 31 July 1996, ACCC Chairman Professor Alan Fels stated that "the Commission *plays a role analogous to that of the police* in administering the law, with the Courts and Australian Competition Tribunal making the final decisions" (emphasis added).

It should also be possible to somewhat relax disclosure requirements for those products where the institution supplying them is subject to significant prudential regulation, as such regulation is in itself intended to protect the interests of consumers.

9.13 Future Form of Securities/Capital Markets Regulation

The present responsibilities of the Australian Securities Commission combine:

(i) company registration and regulation;

(ii) supervision of the functioning of securities markets (but with some responsibilities in this regard devolved to the exchanges);

(iii) disclosure regulation for some categories of financial products (e.g. unit trusts); and

(iv) miscellaneous regulation of (effectively) a prudential character (e.g. rules on redemption of units in collective investment vehicles where there is asset/liability mismatch).

The first of those responsibilities is large in scope but is only loosely related to financial market regulation. The second could be a free standing function, particularly if the overall regulatory structure for the financial system continues to be one of separate regulators plus coordination mechanisms. Alternatively it could be one specialist arm of a single financial regulation. Again, this is a matter of judgement. (The status quo would leave securities markets regulation with company regulation.)

Product/consumer regulation now exercised by the ASC should in any event be integrated with that for other financial products; and any prudential regulation of collective investment vehicles could be assigned to the specialist insurance regulator—assuming that that regulation covered any prudential aspects of managed funds—i.e. basically market linked products (assets in most cases matched to liabilities, minimising or avoiding needs for prudential controls).

9.14 Summary

In summary:

- competition policy for the sector should be administered by the national general competition regulator, the ACCC;
- product/consumer regulation should be integrated and administered nationally;
- prudential supervision requires at least three specialties:
  - banking
  - insurance (with managed funds, to the extent that prudential issues arise)
  - securities/capital markets.

ABA's preferred model is that of lead regulator, under which there are independent regulatory organisations, but for each financial services group one of them takes the lead and convenes *ad hoc* groups of specialists as needed when prudential issues require a coordinated approach; and under which the necessary skills in assessing risk aggregation in conglomerates and systemic implications are developed.

Chapter 10
Commercial Activities of the Reserve Bank of Australia

Key points

- The principal roles of the Reserve Bank are prudential supervision of licensed banks and the implementation of monetary policy. The Reserve Bank also acts as banker to the government, requiring it to operate in the financial marketplace which it regulates. This has the potential to cause conflicts of interest.

- While the Reserve Bank operates with a large degree of autonomy from the government, many other nations have chosen a greater degree of autonomy for their central bank. Acknowledging the potential for conflicts, the New Zealand Government has tendered out most of its central bank's 'banker to government' functions, which was won by Westpac.

- The Reserve Bank is currently involved in a number of areas of commercial activity. A review should be conducted to determine, against relevant policy principles, whether this is appropriate. There is a possibility that the Reserve Bank cross-subsidises services to government of a type which are available from other providers. Such activity would be inconsistent with national competition policy. The Reserve Bank, given its official position, should make transparent the information needed to determine whether and to what extent such activities are cross–subsidised.

- In carrying out commercial activities the Reserve Bank has numerous advantages over private financial institutions. The Reserve Bank is not required to earn market rates of return, nor does it face market tests, nor is it subject to the prudential requirements imposed on the licensed banks. The Reserve Bank is also generally exempt from FID, debits tax and sales tax. To restore complete neutrality, ABA suggest that where relevant the Reserve Bank's commercial activities be carried out in a separate commercial subsidiary, subject to the same rules as apply to all government business enterprises.

- ABA suggests that all banker to government services be opened to competitive tender, to ensure the most efficient provision of services. There are sufficient private sector providers to ensure that banker to government services would be provided on a competitive basis.

- ABA also suggests that non-essential commercial Reserve Bank Information and Transfer System (RITS) services be put out to tender.

Again, there is sufficient private sector capability in this area to ensure that such services are delivered competitively on a fully commercial basis.

10.1 Introduction

The Reserve Bank of Australia (Reserve Bank) performs a number of functions on behalf of the Australian government. Its principal roles are prudential supervision of licensed banks and the implementation of monetary policy. An additional role is to act as the banker to government. The Reserve Bank is empowered to act independently, although it receives considerable input from government on matters of monetary policy.

The Reserve Bank therefore has a duty to oversee the activities of the financial markets and maintain economic stability, but it is also empowered to operate in the financial marketplace itself—through its role as banker to government. This function of the Reserve Bank has the potential to cause conflicts of interest. This chapter examines the role of the Reserve Bank, how its involvement in commercial activities could potentially compromise its core functions, and what principles should govern such involvement.

10.2 The Role of the Reserve Bank

The *Reserve Bank Act (1959*) gives the Reserve Bank a broad charter, with the ultimate goal of "ensuring that [the Bank's] monetary and banking policies contribute toward the economic prosperity and welfare of the nation". The Reserve Bank's core functions are supervising the financial system and being banker and adviser to the Federal government. The Charter of the Reserve Bank (Section 10 of the *Reserve Bank Act*) sets out the Bank's duties:

> "It is the duty of the Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank under this Act, the *Banking Act* 1959 and the regulations under that Act are exercised in such a manner as, in the opinion of the Board, will best contribute to the stability of the currency of Australia; the maintenance of full employment; and the economic prosperity and welfare of the people of Australia."

The Reserve Bank is granted all of the abilities of a commercial bank, but is required to use its powers only as a central bank. Sections 8 and 27 of the Reserve Bank Act empower the Reserve Bank to undertake commercial activities which "are necessary for the purposes" of the Act (Section 8), and the Reserve Bank "shall, insofar as the Commonwealth requires it to do so, act as a banker and financial agent of the Commonwealth" (Section 27).

The Reserve Bank is therefore empowered to be the banker to government, and to undertake any commercial activities which allow the Reserve Bank to fulfil its statutory objectives. The principal activities of the Reserve Bank are:

- monetary policy;
- financial system stability and bank supervision;
- services for governments; and
- issuance of notes and coins.

Services for governments includes acting as a banker to overseas bodies and agencies.

It is generally accepted that all four of these activities are both acceptable and to a degree necessary functions of the Bank.[51] The Reserve Bank was not established to provide competition to the commercial banks; rather, its responsibility is for control over the financial system. The Reserve Bank therefore provides oversight of market activities, operates in the market itself, and also has a duty to the Government. These lines of responsibility may at times be conflicting, and may conflict to a degree with general policies including national competition policy principles.

While a statutory authority, the Reserve Bank is not a government department, and is designed to operate with a maximum degree of autonomy from government. The Federal Government does retain influence over the Reserve Bank through appointments to its board, and the requirement that the bank report to Parliament on an annual basis. In the event that the Reserve Bank and the Treasurer clash over an issue, section 11 of the *Reserve Bank Act* provides for the Treasurer to put the matter to the Government, who can then direct the Reserve Bank to pursue a course of action—provided Parliament is informed of the issue in question.[52]

Many nations have chosen to provide for a greater degree of legislative autonomy for their central banks than Australia, including Germany's Bundesbank, New Zealand's Reserve Bank, and the US Federal Reserve. These central banks have been granted far greater autonomy in their pursuit of price stability than Australia's Reserve Bank. The New Zealand government has also contracted out most of the central bank's 'banker to government' functions to Westpac.

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51 Supervisory activities could be carried out by another authority, but are necessary functions; arguably, service provision to government is an inherent function, but it is a matter of degree. Where competitive private provision of these services is available, central bank provision is clearly not "necessary".

52 No Australian government to date has used the mechanism described in Section 11 of the Banking Act to exert control over monetary policy.

10.3 Criteria for Assessment

It is the belief of the ABA that the Reserve Bank may be currently involved in a number of inappropriate areas of commercial activity within the auspices of its 'services to governments'. The contentious activities are those which have the potential to compromise the Reserve Bank's core functions, or those that could be performed comparably well by the private sector yet are seen to be 'given' to the Reserve Bank, in conflict with the principles of national competition policy that all Australian governments have now adopted. Many potential providers of banking services to government believe that the Reserve Bank acts as a monopolist in providing its banking services, and the Reserve Bank should not be involved in the provision of many of these services. Where it is involved, this should be on neutral competitive terms with other providers.

The Reserve Bank does not enjoy State and Federal government business as a right—it must provide comparable levels of service and price as those found elsewhere. Acting on a commercial basis is not straightforward, as the Reserve Bank is not able to recover costs through margin lending since the interest spread on transactions with the Commonwealth is zero. Instead the cost of services provided to governments must be recovered primarily through fees. Assuming the Reserve Bank itself does not engage in cross–subsidisation of any kind, this should therefore mean that governments will source services from the private sector when there is no conflict of interest and the private sector provider offers superior quality and price.

In the case of some services required by government, it would appear possible that this may not be the case. While the Reserve Bank accounts are available for public scrutiny, the costs of provision of specific services are not separately available. Thus the information on which to assess (at least *ex post*) whether there is cross–subsidisation of services is not publicly available. The current pricing of many services leads the ABA to believe that the provision of some services may not reflect their true cost.

If there is no cross-subsidisation this should be made transparent to show that the Reserve Bank is operating consistently with national competition policy principles.

These principles were articulated in *National Competition Policy, Report by the Independent Committee of Inquiry* ('Hilmer Report', August 1993). Among the six fundamental elements of the national competition policy since adopted by all Australian governments are these:

- review and removal of regulatory restrictions on competition;
- review and reform of inappropriate structures of public monopolies; and
- competitive neutrality when government businesses compete with private firms.

More recently, the National Commission of Audit addressed the issue of what principles apply in determining whether government provision of particular services was justified at all. The Commission argued that there were two key reasons for government itself being involved in service provision activities in the community: social equity and market failure. When the provision of a service by government is warranted by either or both of these rationales, the government should ensure that:

- the desired outcome of the activity is clearly defined, and constantly evaluated;
- activities or services are arranged so as to minimise agency costs;
- government should separate the policy and funding of objectives from the delivery of the service; and
- government services should be delivered efficiently, and where possible exposed to competition from the private sector.

Taking up the principles espoused by the Hilmer Report and the National Commission of Audit, ABA identifies the following criteria again which the commercial operations of the Reserve Bank can be assessed:

- Is the activity within the Reserve Bank's powers as currently defined under the Act?
- Is the activity essential to, or does it enhance the provision of, the core activities and functions of the Reserve Bank (e.g. maintaining the integrity of the financial system)?
- Does the activity give rise to any conflicts of interest with any other activities of the Reserve Bank, and if so, are suitable mechanisms available to address such conflicts of interest?
- Is the activity being provided on a competitive basis, ie are the services being provided by the Reserve Bank on a fully commercial basis:
    - Are the full costs of provision of each service attributed to it?
    - Does the Reserve Bank achieve a rate of return on capital employed in the activity which is comparable and/or competitive with returns generated by similar activities undertaken by other parties, e.g. the banks?
    - If so, is any such return provided to the government in the form of revenue?
    - Is the activity being subsidised by taxpayer funds, or cross–subsidised by other activities within the Reserve Bank? What information is available to determine this?
    - If the activity is being subsidised, is this (if so) a temporary arrangement until the activity reaches a certain mass to generate profit, or is it a permanent (underwriting) arrangement?
    - Is the activity subject to commercial taxation arrangements (eg corporate income tax equivalent, FID)?

  - Do potential competitors have, on neutral terms, access to the market for the commercial activities being provided by the Reserve Bank?

- Does the activity enhance or impair market efficiency and the overall competitiveness of the economy:
  - Does the Reserve Bank's activity, in particular areas, deny banks the opportunity to compete on commercial terms for the particular business, either now or in the future?
  - What is the general impact on product innovation and pricing?

- Does the activity give rise to a public good (that is, a benefit to the community above and beyond that is provided to the contracted customer) which would not arise if the activity were provided on a competitive basis?

- Are there any other specific public policy decisions which impact on a decision as to whether or not the Reserve Bank should undertake the activity?

It is the opinion of the ABA that there may be commercial activities currently being undertaken by the Reserve Bank which do not conform to these criteria and that these should be reviewed.

Recommendation 10.1

Commercial activities undertaken by the Reserve Bank should be reviewed to determine which are inappropriate for the central bank. Where it does continue to engage in commercial activities, this should be transparently on a full commercial (not cross–subsidised) basis and on neutral terms of competition with other providers.

The government maintains the ultimate control over the nature, degree and extent of commercial activities undertaken by the Reserve Bank. It can either:

- enact legislation which alters the power of the Reserve Bank to undertake commercial activities or the basis on which it does so; or

- act executively to alter the way in which the Commonwealth sources its banking services.

The following section outlines the primary functions of the Reserve Bank which give cause for concern, and the specific activities which may be regarded as inappropriate. The section also suggests that the above recommendation may best be pursued by the Reserve Bank carrying out all of its commercial activities via a separate commercial subsidiary.

10.4 Functions of the Reserve Bank

Banker to Government

The Reserve Bank performs the transactions banking business for the Commonwealth and some of the State governments. The Reserve Bank operates an electronic data interchange (EDI) facility, which allows government departments to settle commercial transactions electronically with customers of the Commonwealth Bank. EDI provides a fast, secure electronic payments system, which the Reserve Bank has stated it wants to expand to include many other banks.

The Reserve Bank also offers a bulk electronic payments system—Government Direct Entry System (GDES). The Reserve Bank recently bid for, and won, the contract to handle direct debit and credit payments for the Department of Social Security. Reserve Bank customers are also provided with ReserveLink, the Reserve Bank's PC–based desk–top banking package. The basis for the provision of this package is not clear—it is however a service which would not be provided in the private sector without some form of cost recovery.

Media reports have suggested the Reserve Bank has considered expanding its relationship with Australia Post by engaging Post Offices to act like bank branches processing electronic exchanges of cheque and payment data. This may see the extensive network of Post offices operate like a de facto branch network.

Securities clearing, registry and settlement services

The Reserve Bank operates securities clearing, registry and settlement services, conducted under the Reserve Bank Information and Transfer System (RITS). The system is now the major clearing organisation for debt securities in Australia and exclusively carries out the Commonwealth Government's securities related business. The RITS system has also been earmarked to underpin the introduction of the RTGS payment system, which is timed for introduction in late 1997.

Banker to overseas bodies and agencies

The Reserve Bank performs similar banking services to foreign governments and bodies like the IMF and the World Bank—offering primarily account and currency exchange services.

10.5 Potential Conflicts

Competition

The Reserve Bank does not use a margin between borrowing and lending rates to finance the provision of its services like a traditional bank. It is therefore almost solely reliant on fee income to cover its costs. However, the Reserve Bank is not required to earn market rates of return, it does not face market tests which force it to justify its use of funds, nor is it subject to any of the prudential or other requirements imposed on the licensed banks. This will give the Reserve Bank a distinct advantage when it tenders for work in competition with private providers.

If the Reserve Bank is not subjected to the competitive pressures of the market, it faces no need to justify how it provides and prices its banking services. Due to the nature of its reporting, it is difficult to ascertain whether services are provided efficiently.

For this reason, as recommended below, all the Reserve Bank's commercial activities should be undertaken by a commercial subsidiary. These activities should be costed and charged individually. In its 1994 Annual Report, the Reserve Bank stated that "pricing of most [business] services now meets the test" of full cost recovery. However, the Reserve Bank does not separate out these activities, or provide evidence of this cost recovery in its financial reporting.

Recommendation 10.2

All commercial activities undertaken by the Reserve Bank should be separately and transparently costed, so that they can then be charged individually on a fully commercial basis.

ABA considers that it would greatly assist the implementation of the foregoing recommendations if all of the commercial activities of the Reserve Bank were carried out by a separate commercial subsidiary, subject to the *Commonwealth Authorities and Companies Act 1994,* whose provisions are designed to ensure competitive neutrality, accountability and transparency.

Recommendation 10.3

All of the commercial activities of the Reserve Bank should be undertaken by a separate commercial subsidiary subject to *the Commonwealth Authorities and Companies Act 1994.*

It is also quite possible for example that the cash management of the Reserve Bank in its dealings with government is not optimal. Funds which the Government raises, either through taxation or borrowing, must be transferred to the departments which will spend them. As timing of these revenues is not closely aligned with the timing of disbursements, substantial fluctuations can occur in the public account. The New Zealand experience, whereby government departments now bank with a private bank, suggests significant improvements can be achieved in the management of the Government's funds. Similarly, the Government has a large portfolio of outstanding debt and financial assets (currently about $100 billion), which must also be managed as efficiently as possible.

The Reserve Bank has the additional advantage over private financial institutions that it is generally exempt from Financial Institutions Duty, Debits Tax and Sales Tax.

The Reserve Bank debt securities settlement system (RITS) has an effective monopoly over the Commonwealth Government securities market, which in Australia accounts for a large proportion of the debt market.

Conflict of Interest

The two most important functions of the Reserve Bank, monetary policy and prudential supervision may potentially be affected by the Reserve Bank engaging in commercial activities. For example, implementation of monetary policy could be affected by the need to guarantee the integrity of RITS settlement.

The Electronic Data Interchange system would also appear inconsistent with the Reserve Bank's role as a supervisor. EDI is essentially a payments service, and the provision of such a service by the Reserve Bank is fundamentally inconsistent with its supervisory role over the payments system. There is an inherent conflict of interest in having the principal regulator of a banking function also involved in the provision of the function. The decision to separate the prudential supervision function from the Commonwealth Bank in 1959 was premised on a perception of the government that the role of banking supervisor was incompatible with the role of active competitor in the banking markets.

Flows to and from the public account essentially are a tool of monetary policy. The timing and nature of these flows may therefore relate more to monetary policy considerations than the need for efficient funds management.

System integrity

The transactions banking business services undertaken by the Reserve Bank are not related to its monetary policy and prudential supervision functions. As such, the provision of these services by the Reserve Bank is not related to the integrity of the system of prudential supervision, or the implementation of monetary policy. New Zealand has shown that these 'banker to government' services can be effectively contracted out to the private sector.

Market efficiency

Commercial banks are prevented from competing with the Reserve Bank in the provision of many 'banker to government' services. This has enabled the bank to develop a degree of monopoly power in the provision of many of these services. This base of business has also allowed the bank to expand its services into other areas of traditional or developing trading bank business—such as direct debit.

10.6 The New Zealand Experience

New Zealand has introduced arrangements whereby Westpac provides transaction banking services to most Government departments. The Crown Account is still held at the Reserve Bank of New Zealand (RBNZ) and at the end of each banking day, the net impact of Government transactions still leads to flows of funds between the banks and the RBNZ.

The RBNZ maintains its central monetary policy role, although any institution in New Zealand can make a market in Government Securities provided it meets normal counterparty creditworthiness standards. Open market operations transactions are not conducted exclusively with settlement banks, but when transactions are settled they all ultimately alter the supply of settlement cash. The RBNZ has no preferred classes of financial institutions with which it will deal.

The RBNZ maintains monetary control by adjusting the supply of, and influencing the demand for, deposits held with it by the banks. These deposits are held voluntarily as part of the interbank settlement process.

On a day–to–day basis, the system is quantity–based. The RBNZ targets a fixed amount of these ‘settlement cash’ deposits (known as the ‘cash target’) through daily open market operations. The system can fall short of settlement cash, in which case one or more banks will be forced to sell short-dated bank bills to the bank in exchange for settlement cash. The RBNZ directly limits the supply of discountable bills, and enforces a penalty cost of 1.5 per cent above market rates on those bills.

The RBNZ has influence over the cash target, the supply of discountable bills, and the penal cost of discounting. Government flows must, in the end, be settled from credit balances of RBNZ settlement cash. The RBNZ Financial Markets Department, therefore manages the supply of settlement cash daily by offsetting much of the impact of government (and other RBNZ) transactions on settlement cash. These operations and management of the issue of seasonal Treasury Bills also amount to a short-term cash-management operation for the Government, and have the impact of stabilising the balances in the Crown’s own account.

Transactions undertaken by the banks and their customers have to be settled at the end of each day, New Zealand’s banks have agreed to arrange transfers among themselves for net flows, and these transactions take place in the form of book entries—deposits held at the RBNZ (settlement cash). (In Australia Austraclear, and in New Zealand Databank, provide a computerised service to enable the banks to determine their net positions with one another at the end of each day.) This agreement to use deposits at the RBNZ as the basic means of settlement creates demands for settlement cash.

This system of private sector inter-bank settlement does not imply strong monetary control. However the necessity of the banks to have to make daily transactions with the RBNZ, makes it impossible for the banks to circumvent the RBNZ control framework completely. These transactions relate to the

RBNZ’s roles as the sole supplier of currency, and as a commercial banker for government.

Government banking arrangements have been separated from the RBNZ so that transactions in the public account no longer affect the amount of cash in the system. New Zealand has also been moving towards a clearer separation of the NZ Debt Management Office (NZDMO) which is the Crown’s corporate Treasury Arm.

Relevance to Australia

In Australia the extent to which the demand for settlement cash is guaranteed depends crucially on the Reserve Bank’s role as the sole supplier of bank notes and as the commercial banker to government. Therefore it may not be appropriate to transfer the Commonwealth Public Account (CPA) to the private banks, without a considerable revamp of the monetary policy control process. If the Reserve Bank is to compete with the private banks, it is clear that the CPA service should be fully costed by the Reserve Bank and funded by the Government.

The New Zealand experience suggests that the transaction business of the Commonwealth and the State Governments who still use the Reserve Bank could usefully be put out to tender. Consistent with the New Zealand approach, cash management reform is critical to the success of any proposal to allow private banks to take over the business of Government departments.

10.7 Banker to Government—Options

It would appear that there are a number of potential difficulties associated with the central bank acting as the banker to government. Problems with market efficiency, financial system integrity, and potential conflicts of interest combine to limit the extent to which the Reserve Bank should perform certain commercial services. Overcoming these concerns requires a refinement of the responsibilities of the Reserve Bank. A number of options could be taken.

Option one

All banker to government services to be put out to tender, with the Reserve Bank not permitted to participate.

Option two

Services to be put out to tender, with the Reserve Bank permitted to tender, provided it does so on a fully commercial basis, and transparently (i.e. with relevant information provided in *ex post* reporting).

Option three

Services are separated from the Reserve Bank's prudential supervision and monetary policy functions. A separate Reserve Bank-derived government business enterprise would need to be established to house these commercial functions. This enterprise would be required to operate on a fully commercial basis, in neutral competition with the private sector, subject to due processes of transparency and accountability. The establishment of a GBE under this option should be regarded as an interim step in the process of divestment and/or competitive tendering of 'banker to government' services.

In respect of these options, ABA notes that:

- there are sufficient private sector providers to ensure that a tender of 'banker to government' services would result in the provision of these services on a competitive basis;
- the Reserve Bank should not be involved in the provision of commercial services which distract its attention from core functions such as the operation of monetary policy and prudential supervision;
- the Reserve Bank should avoid areas of activity which give rise to potential conflicts of interest; and
- it is, and seems likely to remain, difficult to ensure that the Reserve Bank will tender on a fully commercial basis and to ensure ongoing competitive neutrality.

10.8 RITS—Options

In respect of the future treatment of the Reserve Bank Information and Transfer System (RITS),(and in particular recognising RITS' role in RTGS) the following options could be adopted:

Option One

Non-essential commercial services currently undertaken through RITS be put out to tender.

Option Two

The operations of RITS be restructured so that non-essential commercial services are provided as a division of a separate Reserve Bank derived GBE established to house its commercial functions. This GBE would be required to operate on a fully commercial basis, subject to due processes of transparency and accountability. The establishment of a GBE should be regarded as an interim step in the process of divestment and/or competitive tendering of 'banker to government' services.

In respect of these options, ABA notes that:

- there is sufficient private sector capacity to ensure that a tender of non-essential services currently undertaken through RITS would result in the provision of these services on a fully commercial basis;
- the Reserve Bank should not be involved in the provision of commercial services which distract its attention from core functions such as the operation of monetary policy and prudential supervision; and
- the Reserve Bank should avoid areas of activity which give rise to potential conflicts of interest.

10.9 Banker to Overseas Bodies

The Reserve Bank provides banking services for some international organisations, such as the World Bank and the Asian Development Bank, as it does for the Commonwealth. This activity includes maintaining accounts and arranging currency exchange. While many of these services reflect the 'banker to government' services (as previously outlined), it is possible that some international agencies and bodies prefer to deal directly with a government body/bank. In this area, prior consultation is obviously required before opening business to competitive tender.

Recommendation 10.4

Any move to tender out services as 'banker to overseas bodies and agencies' (e.g. the World Bank) which are currently undertaken by the Reserve Bank should be subject to prior consultation with the bodies and agencies concerned.

10.10 Accounting Requirements for the Reserve Bank

In undertaking the exercise of assessing the Reserve Bank's commercial activities, it became readily apparent that financial information regarding those functions was not publicly available, and therefore was not subject to public scrutiny—as is the case for other activities of government.

The need for greater accountability is highlighted by the recent reimposition of a fee on banks. The 1995 Reserve Bank Annual Report discloses the operating costs of financial systems surveillance as 10 per cent of total operating costs of $167.6 million, or $16.8 million. Yet in the 1995 Budget, the Government imposed a fee for the banking licence and supervision of $185 million (calculated by way of a 5 per cent penalty on the interest rate paid by the Reserve Bank on banks' non-callable deposits held with it). This equates to over ten times what is required to perform the supervisory services. Indeed, the fee being paid by the banks more than covers the entire operating costs of the Reserve Bank.

The Reserve Bank as a minimum should be required to account separately for its different services, functions and divisions. For example, monetary policy function, foreign exchange operations, financial system surveillance, banking services, registry services, settlement services, note distribution, note production, economic policy research, corporate services etc. In other words, the Reserve Bank should be required to account for money just like a government department accounts for programs and sub-programs (including expenditure and receipts).

The Reserve Bank of New Zealand (RBNZ) provides a good guide as to how this is done in practice. It accounts for activities by function (monetary policy formulation, market operations, financial systems oversight, currency operations, foreign reserves management, banking services, overseas investment commission secretariat, other outputs and registry services—operated through a subsidiary company). In this manner it is possible to assess which functions are generating profits, which ones are covering their costs and which ones require direct subsidisation.

It is also important to note that, in New Zealand, banks used to be charged an annual fee under section 79 of the RBNZ Act, approved by the Minister of Finance, to offset the costs of financial system oversight (this fee was recently discarded to rely more heavily on market disciplines). Also, under the RBNZ Act, banking and settlement account services are expected to be self-funding.

In its June 1996 Report to the Commonwealth government, the National Commission of Audit set out clear guidelines for appropriate accounting and reporting requirements for government, departments and agencies. As the Reserve Bank is a public financial enterprise controlled by the Commonwealth, it should be subject to the general standards set for government. This is confirmed in the Federal government's recent policy statement on 'Competitive Neutrality'.

Any accounting, reporting and disclosure improvements would greatly assist in assessing the commerciality of current Reserve Bank activities, and be a precursor to any future proposals for the creation of a government business enterprise to house the commercial activities.

Recommendation 10.5

In accordance with the guidelines set out in the Report to the Commonwealth government of the National Commission of Audit, the Reserve Bank should be required to implement transparent accounting arrangements for its operations, so as to provide genuine accountability for its commercial (and other) activities.