OVERVIEW AND RECOMMENDATIONS

In its terms of reference[1], the Treasurer has charged the Financial System Inquiry with a "mission" to address three key issues:

- to review the results of financial deregulation post the Campbell Report;
- to examine the current drivers of change and those that will play a key role in the future evolution of the financial system and its impact on the key participants; and
- to suggest recommendations on how the system should be changed with a view to putting in place a structure that **over the next decade or so** will foster a competitive, efficient, flexible, innovative but prudentially sound and fair financial system and in so doing contribute to a more competitive and hence better performing Australian economy.

The National Australia Bank (the National) submission to this Inquiry addresses these key concerns.

Chapter 1, of the submission focuses on post-Campbell developments. It argues that the major macroeconomic objectives of Campbell have largely been met. In particular, concerns about the efficiency of monetary policy and prudential stability have been addressed by, inter alia, removing limitations on banks' ability to compete - and thereby stemming the previous large flow of financial assets into the non-supervised sectors of the financial system. Clearly, however, there were difficulties along the way, as participants came to terms with new opportunities and structures. Although clearly painful at the macro-economic level, ultimately it was the shareholders of the financial institutions, rather than consumers of their products, who carried the main burden of the mistakes of the 1980s.

At the micro-economic level, Chapter 1 argues that while they have taken time to clearly show through, there have also been significant advances, especially in:

- the reduction in the price of intermediation - as margins for all financial institutions have reduced - and greater competition has developed from market-based instruments; and

[1] The Inquiry's terms of reference are set out in Appendix 1.

- the quantum improvement in the choice and quality of the financial services available.

The change momentum has accelerated in recent years. Although previous financial deregulation continues to play its part, other key drivers have become significant. These importantly include: the dynamics of a low inflation environment together with a greater preparedness of consumers in that environment to move up the risk spectrum; tax structures that treat broadly similar saving investments differently in Australia, especially, the previous Government's superannuation policy; greater acceptance and use of market-based alternatives to provide a wider range of risk-adjusted returns to investors (and hence, the rise of the "mutual" or "managed" funds industry) and to reduce direct borrowing costs (eg. securitisation); technological advances, particularly in the area of product distribution; and greater integration of world financial markets (globalisation).

Financial institutions world wide have reacted to significant changes in the flow of funds within their economies (see Chart 1.9 for the Australian context and Charts 1.18 and 1.21 for the international dimension), and have employed technology to compete increasingly in "non-traditional" areas within their own financial systems and across geographic borders.

The result has been convergence or a "blurring" of the traditional roles of financial institutions and the emergence of a greater range of competitors in "core" and "niche" markets (see Chart 1.19 and Chart 1.20). Not surprisingly, there has also been an increase in attempts to obtain the benefits of scale in "financial processing" - both through bank mergers and a trend to financial conglomerates.

Chapter 2, discusses the next phase of these trends. It provides views on where the increased use of technology to satisfy customers' demands and to unbundle financial processes, as well as increased globalisation may lead (see Charts 2.1 to 2.4). By necessity, some of the projections must be speculative. That said, the speed at which alternative distribution mechanisms have already been adopted (see Chart 1.40 and Table 5.1) and the proven propensity of Australians to adopt technology quickly, means that these projections may be conservative.

In this context, it is also important to note that most of the technology under discussion is not new. It is either under trial or is in actual use in various regions, including Australia (see Chart 2.6). That is, we cannot afford to ignore these projections on the basis that the technology is not yet fully implemented. Rather, if we are seeking to implement a financial structure that will remain efficient, innovative and secure **over the next decade**, these trends need to be accommodated by policy-makers now.

In **Chapter 3**, after defining what it is that we expect a financial system to provide, the National advocates **a number of guiding principles for change**. These include the need to:

- adopt, as much as possible, a "functional", rather than an "institutional" approach, while recognising that it is "institutions that fail not products";
- inject more competition into the financial system - by the creation of more "contestable" markets;
- produce a "light touch" in the area of supervision, with the focus primarily on market discipline, rather than "prescriptive" supervision, and the extent of that supervision being directly related to the potential to generate systemic risk;
- introduce a more simple and meaningful disclosure regime to better facilitate the process of informed choice;
- take an evolutionary approach in that any new structure should not result in offshore monetary authorities doubting the integrity of our institutions; and
- institute regular reviews of the development of the financial system.

Chapter 4, sets out the key recommendations that the National is proposing for reform of the Australian financial system. These recommendations are directed at allowing financial market participants to operate in any part of the financial sector they choose (or alternatively, to become a full-service provider) provided that certain "entry" requirements are satisfied. Some of the key points include:

- allowing financial institutions (and not just banks) to operate in the payments system, provided specified capital and liquidity requirements are met;

- redefining the role of banks as core institutions - with a much reduced "special" role in the financial system;
- creating structures that enable any financial institution to operate as a core institution, provided a consistent and coherent set of entry and operating requirements are met;
- this includes, importantly, permitting the establishment of holding company structures that facilitate the emergence of financial conglomerates that are not necessarily headed up by banks - and provide greater scope for foreign financial institutions to operate in the Australian financial system (a detailed review of international developments in this area is outlined in Appendix 2); and
- suggests that simpler more transparent systems of disclosure and distribution be established to facilitate better consumer choice (see Chapters 7 and 8).

The implementation of these proposals will have major implications for the regulation processes required to oversee the financial system. These include both competition policy and regulatory structures. It also provides an opportunity to establish a more rational, functionally orientated disclosure and advisory accreditation regime.

Chapter 5, addresses the issue of competition policy and mergers (see also Appendix 2 and 4). It is the National's view that market realities, together with on-going technological developments, underline the importance of addressing competition as "a process" and not simply as a function of the number of participants in an industry.

The National also believes that the interpretation of the "market" for competition policy should align with current industry realities. It is our view that the current interpretation of Australian competitive policy is overly restrictive as it relates to market definition. These points are reinforced by the recommendations contained in Chapter 4 (and the comments in Appendix 2 and 4). In particular, it argues that the "six pillars" policy is now outdated, and for competitive policy purposes markets should:

- at the very least, be defined nationally; and
- incorporate the full range of financial services - with divisions mainly specified in terms of "wholesale" or "retail" services.

Chapter 6, discusses an appropriate structure for financial supervision in Australia. The combination of market forces and technological developments have already been recognised internationally as requiring more co-ordination between financial supervisors. This has resulted in some countries moving to mega-supervisory structures (eg. Canada) and others to lead-supervisory structures (eg. the United Kingdom). Domestically we have seen, following the Martin Report, the establishment of the Council of Financial Supervisors (COFS). However, the changes involved in implementing the National's recommendations would mean that the current gradual path to better co-ordination is no longer sufficient. The National is advocating a system that brings together the current regulatory bodies under one over-riding structure. In so doing, however, it has suggested processes for close co-operation between the Reserve Bank of Australia (which would be mainly responsible for monetary policy under the National's proposals), the new Supervisory Board (which will be responsible for prudential supervision and disclosure/consumer matters), the Australian Competition and Consumer Commission (ACCC - which retains responsibility for competition policy) and the Commonwealth Treasury (see Figure 6.2).

If the full benefits of efficiency are to be tapped, it is vital that informed choices can be made by all participants - including consumers. Accordingly in **Chapter 7**, the National advocates a new more functionally-orientated approach to consumer disclosure. The aim, as well as tidying up a multitude of conflicting regulations, will be to improve disclosure levels both as they relate to product features and to the institutions standing behind them. These measures are supplemented by the implementation of new functionally based rules for distribution (including accreditation standards) for liabilities of financial institutions.

Chapter 8, deals with similar disclosure issues for the assets of financial institutions. In addition, it addresses the need for a nationally co-ordinated approach to the protection of personal information, changes to deeming arrangements and discusses the participation of the Reserve Bank of Australia in the financial markets. Given the full range of the National's changes, it follows that any remaining distortions could, in the new environment, provide even more difficulties than is currently the case. This means it is important that more neutral tax treatment is introduced into the area of savings instruments (see Chart 1.8) and that the FID/BAD issue be addressed.

In summary, the National's recommendations focus attention on ways to increase contestability in all areas of our financial system, and to improve its efficiency and integration with world financial markets. At the same time, the National's recommendations provide for a more meaningful level of disclosure aimed at facilitating the process of informed choice. Following from that, the National has also recommended regulatory changes - both to the supervisory structure and to the proper interpretation of competition policy - that are in keeping with a more competitive framework, while maintaining the prudential integrity of the Australian financial system. The National's recommendations are evolutionary rather than revolutionary.

Recommendations

In addition to adopting the general principles set out above, the key recommendations made by the National include:

2.1 Existing Commonwealth, State and Territory laws which either prevent or restrict the use of digital signatures be amended as appropriate.

3.1 The regulatory environment be subject to a 5 (or at most 10) year regular stock-take to assess its effectiveness and efficiency.

4.1 Banks be re-defined as "core" institutions along the lines set out in **Chapter 4**, pages 4.12 to 4.15. Important changes here include:

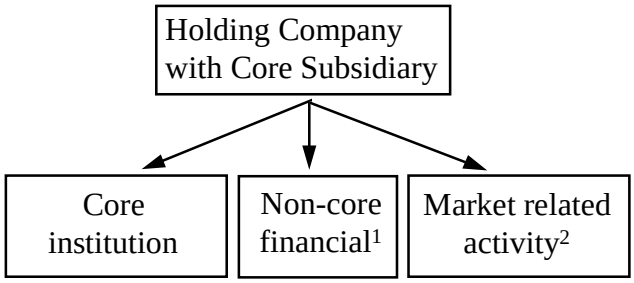
- the main "safety" provision for core institutions relates to the proviso that depositors have first call on the assets of a "core" institution should it encounter financial difficulties. That is not extended to "non-core" institutions;
- liquidity requirements being re-specified in terms of the liability side of the core institutions' balance sheet;
- the type of supervision; and
- the ability of financial institutions to own and operate core institutions.

4.2 "Non-core" financial institutions also be allowed access to the payments systems provided certain capital, liquidity and supervisory standards are met. These (see Page 4.15 & 4.16) include:

- minimum capital of $50 million;
- a requirement to hold Australian (or G-7) government securities on a dollar for dollar basis, against payments "exchange of value" issued; and
- "systems" be supervised on the same prudential basis as for core institutions.

4.3 Holding company structures be allowed that would enable financial institutions (both banks and domestic/foreign/non-banks) to own and operate core institutions as subsidiaries. The main criteria applying to these structures and their supervision are set out at pages 4.17 to 4.19 (See also Appendix 2).

Table 4.6

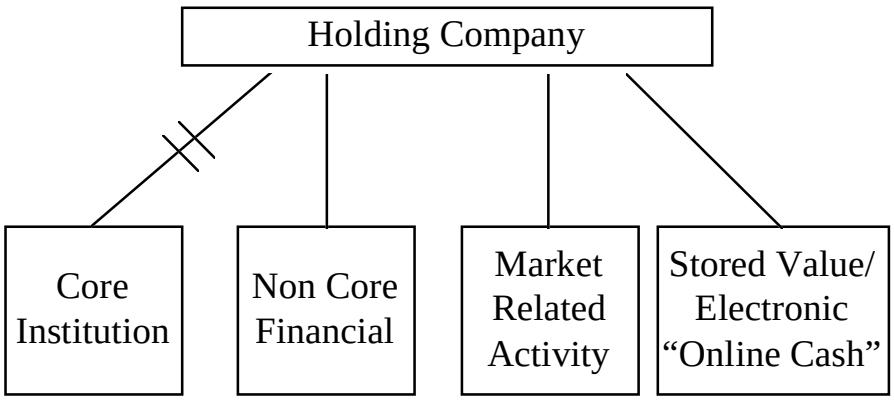


Assets	40%	30%	30%	
Minimum Level of Capital/Excess Liabilities	8%	4%	1%	
				Total
	3.2	1.2	0.3	4.7%

(1) Life, Superannuation, General Insurance.
(2) General investment advice plus any trading activities not carried out in the "core" subsidiary.

4.4 Where a financial institution does not satisfy the specified criteria it would still have the option of establishing a conglomerate to participate in all other areas of the financial system (including exchange of value) - as shown in the table below:

Table 4.7



4.5 Expense reserves of life offices be held at the company level rather than the proposed practice (under the new terms of the Life Office Act) of placing them individually in each fund.

4.6 The proposal under the Life Office Act - that additional capital be held if more than 25 percent of a fund is held with a subsidiary company - be abolished.

4.7 Consistent with the recommendations in **Chapter 7**, non-core institutions be allowed to take deposits directly from the public - without a prospectus - when the capital and liquidity reserves behind that product or institution is at least as onerous as required for the "core" institution. That would currently include building societies, credit unions and "capital guaranteed" products under the Life Office Act.

4.8 The relevant Australian regulatory authorities discuss with the Bank of International Settlements the possibility of re-defining risk weights for core institutions with a view:

- to lowering the risk weight for fully secured housing; and
- to distinguishing between "rated" company debt and "non-rated" debt.

5.1 The Inquiry strongly endorse, for the purpose of competition policy, that the market be broadly defined. In particular, the definition should recognise that the market:

- is "national" in geographic boundaries; and
- covers all areas of financial activity with the main division being along wholesale and retail lines.

5.2 Considering the trends already evident in domestic and international financial system, together with the changes advocated by the National, the previous Government's "six pillars" policy be overturned.

In its place, each merger proposal should be examined in the context of recommendation 5.1 and the need to encourage "the process of competition". That outcome would imply less weight being placed on the number of participants and would not require any change to the terms of the Trade Practices Act.

6.1 Regulatory structures be changed to bring together the current regulatory bodies under one over-riding structure.

6.2 The divisional structure of the resultant "Mega-Supervisory" Board and the integration with other bodies with responsibility for the operation of the financial system be as follows:

- banking;
- exchange of value/payments;
- insurance, superannuation and mutuals;
- financial markets;
- institutional co-ordination and general legal administrative policy;
- consumer issues.

Table 6.2

MEGA-SUPERVISORY BOARD

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Division	Core Institution	Other Financial Institutions	Market Oversight	Exchange of Value	Institutional Co-ordination & Policy	Consumer
Coverage	Core Institutions	Life/Super/ Mutuals	ASC and ASX type regulations	Payments, Stored Value, Forex and Futures	Conglomerates General/Legal Administrative Policy	- Product - Institutional - Adviser

The overall system to comprise:

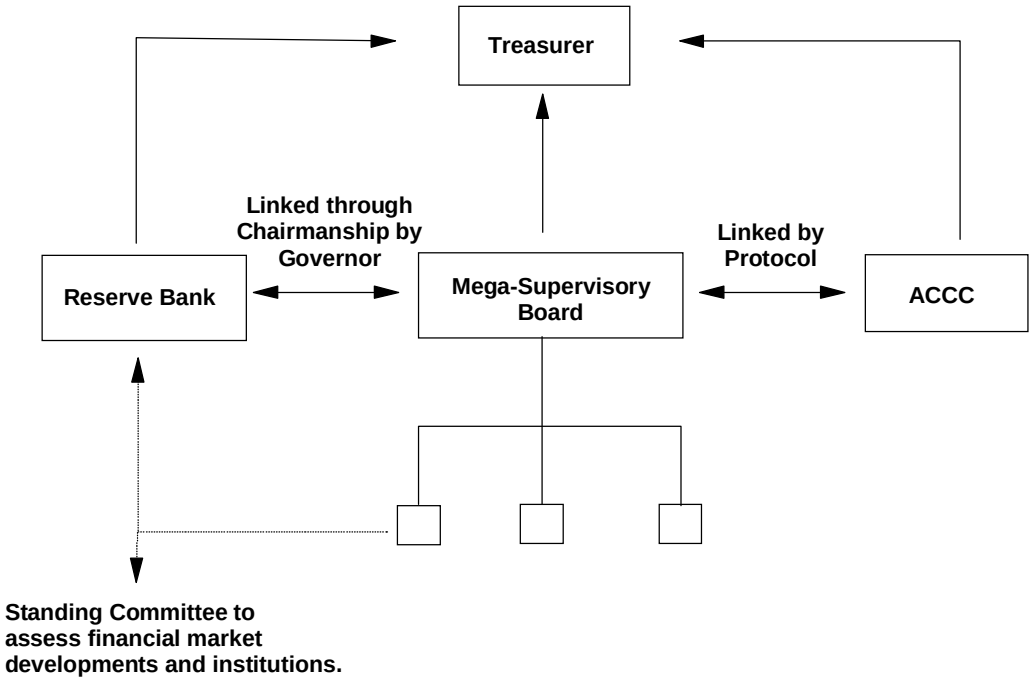
- the RBA, with responsibility for the formulation of monetary policy;
- the Mega-Supervisory Board, responsible for stability of the financial system, prudential supervision, consumer advice and information disclosure;
- the Board would consist of the heads of the functional units above (see table 6.2), together with the Governor of the Reserve Bank; and
- the ACCC, with responsibility for competition policy generally, including the financial sector.

The linkages in this framework to be:

- the RBA Governor's Chairmanship of the Mega-Supervisory Board;
- a standing committee of officials from the RBA, Treasury and the Mega-Supervisor; and
- a protocol between the ACCC and the Mega-Supervisory Board, setting out responsibilities with regard to Section 52 of the Trade Practices Act. The National advocates that the ACCC view these issues from the perspective of competition policy while the Mega-Supervisory Board from a product/institutional disclosure perspective.

This institutional framework and the key linkages are summarised in the chart below:

Chart 6.1



7.1 The disclosure regime for retail liabilities of financial corporations should be more product focused rather than institutionally based.

7.2 There should be consistent tests applying to products types across all institutions. These tests should take account of the risk profile of the product such that:

- fixed priced products should disclose information about the product, costs (including fees) and details of any guarantees;
- products and/or institutions where a prospectus is not required, would include fixed price style products of core institutions, and products/institutions where regulatory requirements require capital backing at similar levels to core institutions (eg, building societies, credit unions and certain“capital guaranteed” products of life offices); and

- other market linked savings and risk products would be required to meet a more rigorous "prospectus style" test - albeit the use of electronic prospectus should significantly reduce the cost of that process.

7.3 All institutions should improve general disclosure by making publicly available and clearly displayed information about their credit rating, capital and reserves, cash and near cash, ownership structure, impaired assets (for core institutions) and a reference setting out where to seek further information should that be required. The information should be up-dated quarterly and directors are directly liable for the accuracy of that information.

7.4 There should be a consistent set of principles governing the distribution of financial services products (see pages 7.9 to 7.10).

7.5 Those providing advice should be suitably qualified and trained, having regard to the nature of the advice given and products sold. Advice however, should not be mandatory.

7.6 It is recommended that there be a single industry based disputes resolution mechanism covering complaints about liability products.

7.7 There should be a single regulator responsible for administrating and monitoring information disclosure and distribution standards.

8.1 Together with existing State, Territory and Commonwealth legislation affecting consumers, the Uniform Credit Code, through the auspices of COAG and SCOCAM, should be substantially simplified and revised to better emphasise its basic aims. The review of the Code should be aimed at the education of consumers about the features of credit contracts, rather than prescribing the process. Civil penalties for breaches under the Code should be removed, with dispute resolution being through the appropriate industry dispute resolution process.

8.2 Administration of all consumer regulations, whether they be related to liability or asset products, should be under a single supervisor. This is consistent with the

National's recommendation that regulation over the financial sector should be based on functional precepts rather than being purely institution based.

8.3 Privacy concerns should be recognised by the Commonwealth Government as a national concern, with prescriptive legislation having the potential to disrupt the efficient functioning of the market and the efficient adoption of new technologies. In full consultation with the private sector, including comment on draft legislation, the Commonwealth Government should introduce over-arching privacy legislation which establishes a series of privacy principles with implementation being the responsibility of industry. Privacy legislation should be administered by a national body and funded by the Commonwealth Government.

8.4 It is recommended that the distortions associated with FID/BAD are removed. Further, and consistent with other changes advocated by the National, it is recommended that current distortions in the tax treatment of financial instruments be removed.

8.5 It is recommended that the "know your customer" rule replace the current identification requirements of the Financial Transaction Reports Act and that the aims of the Act be focussed on preventing money laundering rather than also covering taxation and social security fraud.

8.6 It is recommended that the Government review its deeming arrangements under the Social Security Act and base deemed interest rates on market rates.

8.7 All commercial activities undertaken by the RBA should be conducted on a commercial basis. To help achieve that objective, commercial activities undertaken by the RBA should be undertaken by a separate commercially structured subsidiary and be subject to the Commonwealth Authorities and Companies Act 1994.