CHAPTER 3: LOOKING TO THE FUTURE

3.0 INTRODUCTION

One of the main lessons from the recent past (as set out in the previous chapters), is that technological change, in combination with the further integration of world financial markets ("globalisation") and ongoing changes in customer behaviours will continue to underpin major change. That will, importantly, include further change in the "distribution channels" for financial services and the "unbundling" of services between financial institutions and markets.

In those circumstances, it makes sense to look to "financial functions" as the linchpin of any reform to the financial system, rather than attempting to adhere to an institution based system - especially where those institutions are essentially delineated on a traditional "product delivery" basis. Indeed, it is a fundamental tenet of our submission that financial functions have remained, and will continue to be, relatively stable. On the other hand, traditional institutional divisions will become more and more blurred in the face of the drivers of change set out above. That, in turn, implies that financial reform should encourage institutional forms to evolve to replicate economic functions - rather than attempt to restrict the latter to follow the former.

That, in brief, very much reflects the view that technology and globalisation will continue to change the delivery mechanisms of financial services and continue to undermine the traditional "institution" based framework.

3.1 Functions of the Financial System

At this stage, it is perhaps useful to go back to first principles and ask what a financial sector should be expected to provide:

Following Merton and Bodie[1] (1995) a financial system that is <u>efficient in a</u> "static" sense will provide the following functions, at least cost:

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[1]See Merton RC and Bodie (1995) "A Conceptual Framework for Analysing the Financial Environment": in "The Global Financial Systems - A Functional Perspective", Harvard Business School, Chapter 1.

1. A mechanism to provide for the clearing and settling of payments in order to facilitate the exchange of goods and services;

2. A mechanism to "pool" funds (typically from households) which, through a process of intermediation, can then be used to facilitate investment and trade;

3. A mechanism to transfer economic resources through time, across geographic regions and among industries. Essentially, this involves, inter-alia, meeting the inter-temporal demands of households' saving and spending patterns and the provision of credit - including the use of "collateral" to serve that commitment. Securitisation, on the other hand, is an example of how traditional processes in this area may be changed through greater use of "markets";

4. A well-functioning mechanism to manage uncertainty and to control risk. In particular, such a mechanism would allow participants in the financial system to "pool risks" at any point in time and across time. Traditional classic examples include hedging, investment diversification and insurance. Financial derivatives (properly used) are just one of more recent instruments developed in this context;

5. Flowing out of the above processes, a mechanism that also provides appropriate "price" information and incentives to help co-ordinate decentralised decision-making. In brief, unbiased "price" information is essential, if resources are to be channelled into their most efficient usage and financial assets are to be traded appropriately (in the risk/reward trade-off); and

6. A mechanism that is capable of dealing with the incentive problems created when one party to a financial transaction has information that another party does not, and/or when one party is an agent to the other. Typically, problems arise from "informational asymmetries" and reflect the complex or "opaque" nature of many financial contracts and financial institutions. Put simply, these informational asymmetries underpin much of the drive for informational disclosure provision. (Typically, competitive market models assume perfect knowledge and no transaction costs - conditions rarely met in financial or indeed, in other, markets).

In addition to static efficiency, two additional features are critical for any well-functioning financial system.

(1) **Dynamic efficiency**: To a large extent, dynamic efficiency can be thought of as a complement to static efficiency. What is meant here is that incentives within the system facilitate a competitive interaction between financial institutions and markets. That, in turn, generates a momentum driving further and on-going innovation, or what some have termed an “innovation spiral”. The results of this “spiral” include: lower cost of financial services, increased diversity or choice of financial instruments and improved service levels. Such a momentum is, of course, likely to be increasingly important if domestic financial systems are to remain competitive in an environment of increasingly integrated world financial markets;

(2) **Confidence in the underlying stability of the system**: While allowing for participants within the financial system to take on as much, or as little, risk as they are comfortable with, there still must exist some basic confidence that some core features of the system will be stable. In particular, participants must be confident that they can use the system to exchange value as a means of facilitating trade and commerce. Minimising the “systemic” implications that would arise should this process be undermined is perhaps the main argument for supervision or prudential intervention by the authorities. There is, however, a very fine balance to be maintained. For example, the above does not mean that some participants/institutions within the system cannot be allowed to fail - indeed, unless some failures occur allocative efficiencies deriving from the risk/reward trade-off will be impaired. While we will return to these issues in more detail in the next few chapters, the level of supervision should, as a general rule, be directly correlated to the potential for systemic risk to emerge.

An important point emerges from the above, namely that if it is to adequately review the operation of the financial sector, this Inquiry will need to address all key aspects of the operation of the financial system. While most aspects are explicitly covered in the terms of reference, that is not the case for all of the above functions (some of which are not within the list on which the Inquiry is empowered to make recommendations). The most obvious matters of concern include: the payment system; incentive (tax) structures that can distort choices between alternative financial instruments and institutions; and, to a lesser extent, questions about the level of disclosure required to neutralise "informational asymmetries". Accordingly, these issues are discussed in following chapters of this submission.

3.2 Guiding Principles

In attempting to look to the future, the National advocates a number of guiding principles:

- first, the functional approach (extended from the systemic to the product level) be incorporated as much as possible into the Inquiry's thinking about the future. Indeed, firms should choose their position in the financial system based on their own corporate strategies and the (net) benefit of various corporate forms.

- it is, however, recognised that "institutions" not "products" fail, and hence, in the area of supervision some compromises must be made. That said, the philosophy behind government intervention for supervisory purposes should be clearly identified as relating to:

  (a) systemic risk; and

  (b) the opaqueness of financial transactions and institutions.

- as noted previously, the onus of supervision should be tailored to satisfy the latter objectives, while maximising the (partially conflicting) efficiency objectives. **That is, supervision should ascribe to the philosophy of "as much freedom as possible, supported by as little supervision as is necessary"**;

- the optimal mix of "functionality" and "institutionalism" should be aimed at encouraging the emergence of a **"contestable**" financial market - with a common set of rules applying to functionally similar products, and a philosophy that is driven by the idea that "everyone can participate provided they continue to meet a common set of entry requirements";

- any new system or approach should not be so different as to put Australia significantly out of step with the rest of the world - or at least, not to the extent that it raises questions with offshore regulatory authorities as to the stability of Australian financial institutions;

- it would be preferable that change be implemented with minimal disruption to the existing Australian legal rules and frameworks; and

- the pace of change is likely to be such that over the next decade, no authorities can be confident that they can foresee all new developments. Clearly, flexibility and an ability to move with change will be required by those responsible for overseeing the development of our financial system. Beyond that, however, suggested changes should not be thought of as being “set in concrete”. To that end, we propose that, similar to Canadian practice, regular stock-takes of the financial system be instituted and a review of the appropriateness of the then existing structures be adopted (possibly on a 5 or 10 year time frame).