CHAPTER 4: BUILDING BLOCKS OF A NEW STRUCTURE

4.0 INTRODUCTION

In what follows, the National's approach is to set out broad objectives, rather than precise formulation of legislative or regulatory changes. Indeed, it is essential to have a "model", incorporating "guiding principles", which can be used to evaluate specific changes from a competitive and supervisory perspective over any transitional period.

4.1 PROMISES - TIME AND PERFORMANCE

At its most basic level, the financial system can be thought of as comprising a number of "promises". Each of those "promises" in turn, has two key dimensions:

- a time criterion: i.e. from the investor's (or holder of the promise) viewpoint, can the promise be translated into cash (or exchanged of value) on demand, or does it have a pre-specified time path (fixed term investment). Associated with this, is the nature of the promise; i.e. is it "unconditional" with respect to time (e.g. debt/equity type instruments) or is it only payable given certain pre-specified criteria regardless of time (e.g. general insurance and income protection); and
- a performance criterion: is the instrument's "performance" set by some pre-determined formulae (e.g. interest), or is it purely on a "best endeavour" basis (e.g. investment linked products). Associated with this, does the instrument include a "capital guarantee" dimension, or is it "buyer beware"?

Although the above examples mainly refer to business and household investment-type decisions, the same criteria apply equally to their funding decisions. In addition to these, time and performance criteria, financial instruments also provide different "types" of promises.

The following table provides one (but by no means the only), schema to differentiate according to the nature of the services delivered by financial promises:

Table 4.1

Financial Functions

Function	
• Income Risk Management Promises	
• Saving Promises	
• Exchange of Value Instruments	physical: e.g. cheques / cash electronic: stored value / EFTPOS / smart card/ direct entry/ charge card/ electronic "online" cash market related: forex / derivative instruments that fall due for payment
• Debt Instruments / Promises	
• Equity Instruments / Promises	
• Asset Related Risk Management Instruments / Promises	

In the past, these services have initially been delivered by a financial instrument from a financial institution. Table 4.2 below, highlights the traditional positioning of financial institutions in that regard.

Two points, however, need to be re-emphasised when looking at this table:

- as noted previously (see Chapters 1 and 2), there has been a good deal of blurring in the traditional "niches" occupied by financial institutions; and
- very importantly, market-related financial instruments now play an increasingly significant role in just about every aspect of these functions.

Thus, market-based instruments already:

- play a significant role in the exchange of value process (see table 4.1);
- provide alternative ways of taking exposures to price movements in financial instruments (e.g. equities);

Table 4.2
A Simple Illustration of Functions, Offerings and Institutions

Functional Building Blocks Meeting Cashflow/Risk Management Needs	Examples of Current Offerings	Traditional Institutional Positioning
Market-related risk management	Interest rate & Currency Derivatives	Market & investment advisers
Liability related risk management	Life Insurance,	Life & Insurance Company
Term Saving/Investments	Unit Trusts, Managed funds- i.e. prospectus based	Superannuation fund manager and/or Finance Company.
Term Saving/Investment	Term deposits no prospectus	Bank, Building Society, Credit Union
Call Saving/Transactions	Passbook, Transaction Accounts, ATM	Bank, Building Society, Credit Union
Exchange of value	Cheque/ Cash/ EFTPOS	Bank
Debt Intermediated (indirect) Disintermediated (Direct)	• Overdrafts, Credit cards, Term Loan Leasing, Mortgages • Company Debentures, Community paper, Securitised assets	Banks, Building Society/Credit Unions, Finance Companies. Market, brokers , investment advisers
Equity	Shares	Market, brokers, investment advisers
Asset-related risk management (Asset protection)	Car, Fire, Mortgage, Creditor Insurance	General Insurance Company

- provide ways for changing the terms and conditions of underlying financial promises (e.g. fixed/variable swaps); and
- provide alternative means to "pool funds", to be used in the disintermediation process (Securitisation). However, this has not yet extended to some of the more "opaque" debt instruments (such as, small business debt).

4.2 A HIERARCHY OF BURDEN

Clearly, at the functional level, there is a hierarchy in the burden of the promises attaching to financial instruments. Thus, for example, a promise to pay a specific sum on demand is more onerous on the promisor, vis-à-vis, a promise to generate an income stream based on a "best endeavours" basis deliverable some time in the future. Typically, the most onerous promise (full payment on demand) is also the basis for settlement of trade and, as such, can have widespread consequences if dishonoured - precipitating default spreading from one party to the next. This phenomenon of financial contagion is the one most likely - if allowed to go on unchecked - to generate a lack of confidence in the overall stability of the financial system - and hence, large-scale economic disruption.

In many ways, the risk of financial contagion is inherent in aspects of the intermediation process. Intermediaries reduce the need for a lender to acquire information about borrowers, as depositors rely on the intermediary's judgement. By pooling the risk of withdrawals of funds, intermediaries increase liquidity and can also hold a portfolio of assets which are less liquid than their liabilities. These processes are fundamentally built on trust. Loss of confidence or trust will clearly impair the process of financial intermediation. The critical element, however, is not so much the failure of an individual intermediary, but the danger that the repercussion of failure spreads well beyond that intermediary.

From the above description, it is obvious that key elements of this process are:

- liabilities of financial intermediaries that are readily convertible (face value demand deposits); and
- liabilities of financial intermediaries that can serve as a transaction medium.

In terms of Tables 4.1 and 4.2, this is very much encapsulated by instruments for exchange of value and very liquid savings/transaction accounts - indeed, put slightly differently, these could be redefined as a liability that is withdrawable within 24 hours and/or may be paid to, or used by, third parties on the instruction of the depositor.[1]

The other feature of the above process that adds to the risk of financial contagion is the presence (on the balance sheet of the same institution) of substantial assets that are not liquid - or at least are not redeemable without substantial discount. The combination of the above three features is, of course, very much a feature of "banks' " balance sheets - and explain the particular emphasis placed on banks by regulators with a view to avoiding systemic risk.

It is, however, possible to re-design a financial system that separates out the combination of highly liquid demand and transactional liabilities from illiquid assets. Indeed, Merton and Bodie[2], arguing along purely functional lines proposed a solution that involves:

- any institution wishing to offer highly liquid demand and transactional liabilities be required to back them up, on a dollar for dollar basis, against Government securities;
- a set of alternative rules - based on purely functional grounds - governing other liabilities and assets (a la Table 4.1); and
- minimal (supervisory) intervention by governments - mainly focused on improving disclosure of information.

While it is highly likely that such a system would satisfy a "purely functional" outcome and would be "relatively safe" as regards systemic risk, it would also:

- as pointed out by Kaufman and Benston[3], lead to significant allocative inefficiencies in the intermediation process. That is, the cost of such a regime on institutions who typically provide such services would make it unlikely that they would be as willing to enter into the more "opaque" and riskier forms of debt funding - such as to small business and personal

[1]See, for example, E. Gerald Corrigan, then President of the New York Federal Reserve Bank, in "Keep Banking Apart", Challenge November/December (1987).
[2]See (1) and Merton, RC and Bodie, Z "Deposit Insurance Reform: A Functional Approach", Carnegie-Rochester Conference Series on Public Policy 38 (1993) pp. 1-34.

loans. (The National, for example, would be required to hold around $25 billion of government securities to support its current activities.) Here, it could also be noted that financial instruments are unlikely to provide effective alternatives, given the very nature (opaqueness) of such lending; and

- effectively implement "narrow" banking and, among other things, mitigate the need for banks. As such, it would represent a radical departure from financial structures currently (and prospectively) in operation in offshore financial markets - and could well cause Australian financial institutions to be treated with a good deal of scepticism by offshore regulators and monetary authorities.

4.3 A PRACTICAL VIEW - NATIONAL'S RECOMMENDATIONS

Ultimately, what the above means is that the objective of maximising dynamic and static efficiency, while maintaining confidence in the underlying stability of the system, inevitably (as argued by Corrigan[2] and many others) involves compromises. That, of course, is not the same as arguing for maintenance of the status quo. Indeed, as argued earlier the "no change" option does not exist, given the pressures already (and increasingly) generated by the global, technological and consumer drivers of change.

The "compromises" that the National is advocating could be described as attempting to narrow the differences between the treatment of like financial products, but critically opening up to all an ability to participate in any part of the financial system, provided certain entry criteria are met - with the latter, in turn, set very much with a view to maintaining confidence in the integrity of the Australian financial system.

Among other recommendations, these changes include the introduction of financial conglomerates, where the holding company is a non-bank financial institution and allows for non-bank participation in the payment system. The current "special" position of banks in the financial system should be very much thrown open to competitive pressures. The resultant increased contestability of markets means that regulatory and competitive definitions of

[3]Kaufman, George G and Benston, George J, "Risk and Solvency Regulations of Depository Institutions: Past Practice and Current Options", New York University Graduate School of Business Administration (1988).

banking need to be broadened significantly. That in many ways is moving the existing financial framework to make it more compatible with the emerging market reality. These changes, in turn, suggest the need for some streamlining of supervision and structures that deliver practical co-ordination of the regulations of financial institutions and regulators. The National is also advocating greater "ex-ante" disclosure of information by all financial institutions (both as regards financial products and the institutions that stand behind them) and the introduction of functionally-based training criteria for staff of financial institutions.

Given greater contestability of financial markets, it also follows that current taxation arrangements (including FID and BAD), that distort the pattern of the flow of funds between competing financial institutions and products, need to be normalised.

4.3.1 National's Proposals

We turn now to the details of the National's proposals.

Table 4.3 below provides a brief overview of the current restrictions on financial institutions, and as such serves as something of a benchmark for the following discussion.

From the previous discussion, it is clear - from a systemic viewpoint - that a good deal of attention needs to be placed on maintaining the integrity of institutions that wish to participate in the areas of exchange of value/transactional accounts and of demand (fixed face value) saving instruments. The new schema advocated by the National is set out in Table 4.4.

Table 4.3: Comparison of Existing Regulations

	Legal Structure				Ownership		Prudential Requirements			Deposit Taking/Lending & Other Services						
	Limited Liability Company	Co-operative	Mutual	Trustee	Restrictions on Concentration①	Cross-Ownership Restrictions ②	Risk weighted Capital Requirements③	Liquidity Requirements ④	Exposure Limits ⑤	Accept Deposits without a Prospectus	Accept Deposits on Balance Sheet	Accept Superannuation Deposits on Balance Sheet⑥	Make Loans	Draw Cheques on Own Name	Issue Cheques⑦	Other Services via Wholly-owned Subsidiaries
Banks	✓	✖	✖	✖	✓	✓	✓	✓	✓	✓	✓	✖	✓	✓	✓	✓
Non-bank Depository	✓	✓	✓	✖	✓	✓	✓	✓	✓	✓	✓	✖	✓	✖	✓	✓
Non-depository Non-bank	✓	✓	✓	✓	✖	✖	✖	✓	✓	✖	✖	✓	✓	✖	✓	✓

① Banks: Individual equity holdings are restricted to a maximum of 15%. Unless approval is granted by the Commonwealth Treasurer.
Non-bank Depository Institutions: Individual equity holdings are restricted to a maximum of 10%. Applies only to non-mutual building societies.

② Banks: Require approval to hold significant equity in any company (bank or non-bank).
Non-bank Depository Institutions: Require approval to hold significant equity in any company (bank or non-bank).

③ Banks: Require a minimum risk-weighted capital ratio of 8%.
Non-bank Depository Institutions: Require a minimum risk-weighted capital ratio of 8%.

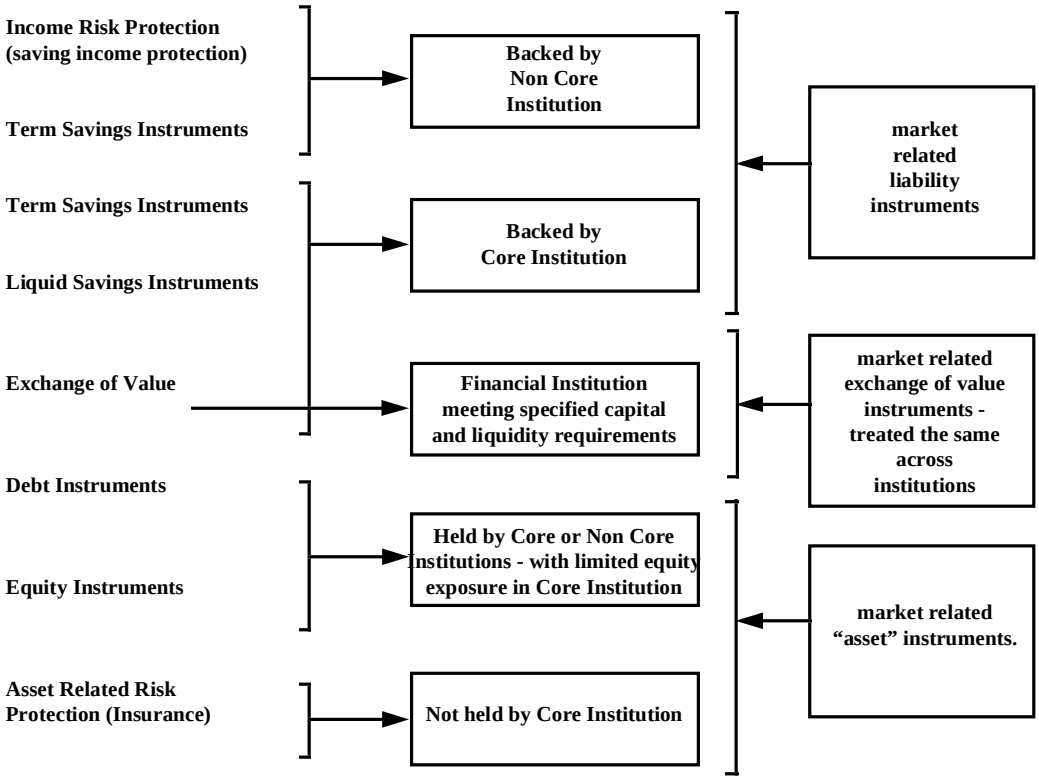
④ Banks: Require a prime assets ratio (PAR) of not less than 6% and non-callable deposits held with the Reserve Bank of not less than 1% of total liabilities less shareholders funds.
Non-bank Depository Institutions: Must satisfy emergency and operational liquidity requirements.
Non-depository Non-banks: Must satisfy minimum liquidity requirements - where they apply

⑤ Banks: Must not exceed maximum exposure limits on lending without approval.
Non-bank Depository Institutions: Must not exceed maximum exposure limits on lending without approval.
Non-depository Non-banks: Must not exceed exposure limits prescribed in prudential standards -where they apply.

⑥ Non-depository Non-banks: Provided it is a registered superannuation fund.
Depository Institutions have recently been allowed to accept some deposits (RSAs) on balance sheet.

⑦ Non-bank Depository Institutions: Can issue cheques in association with a bank or through an industry based special service provider
Non-depository Non-banks: Can issue cheques in association with a bank.

Table 4.4



As can be seen from Table 4.4, the National is advocating a dual track approach in the area of exchange of value - that is, either via a "core institution" or a financial institution meeting specified capital and liquidity requirements.

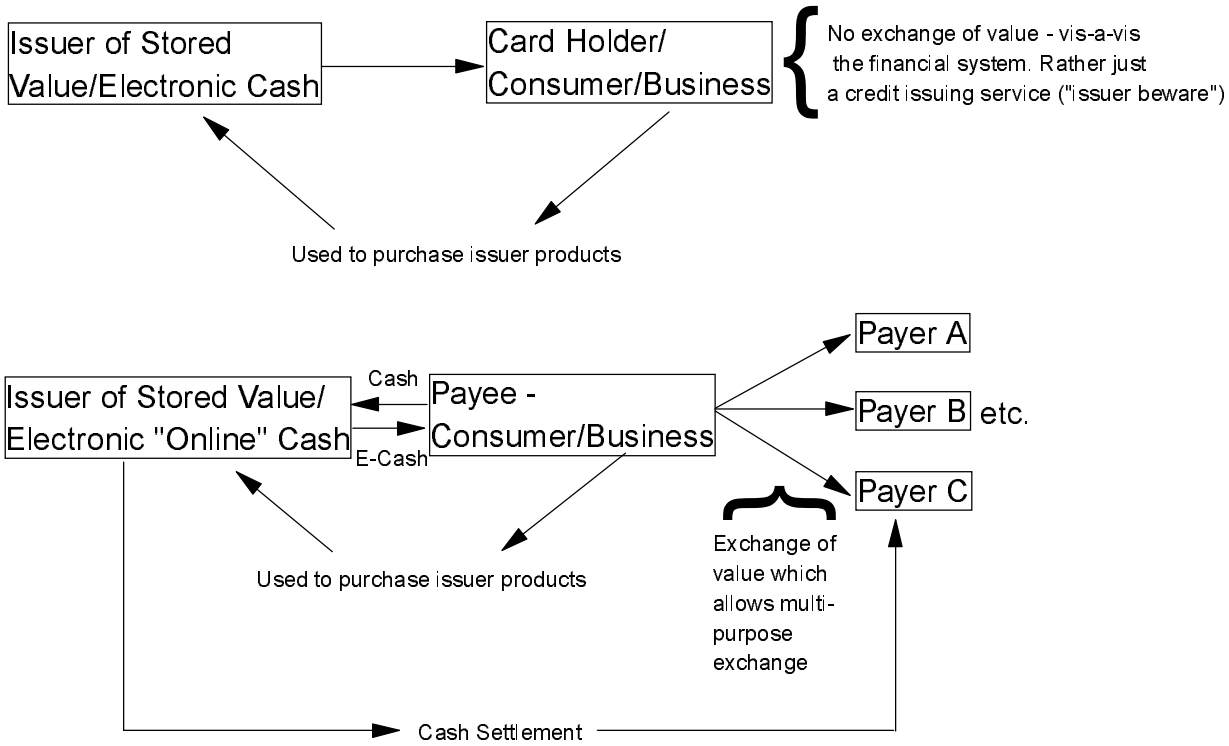
4.4 PAYMENTS SYSTEMS

Before moving on to these issues in more detail, it is first necessary to define more precisely what we have in mind in the area of "exchange of value". Essentially, it is a mechanism that allows/facilitates payments to third parties.

The main payment systems we are familiar with today are: cheques, cash and, increasingly, EFTPOS as a means of exchanging value (with the need to have settlement processed through banks and a limited number of industry providers, with exchange settlement accounts held at the Reserve Bank of Australia); and the charge card systems, which facilitate payments to a defined range of third parties, but without the cross-institutional settlement requirements. It is

widely expected that usage of smart cards and on-line electronic payment platforms will increase dramatically (see Chapter 2 page 4 and 18). Aspects of that process, however, could have profound systemic implications. In essence, electronic cash "represents a return to privately issued currency"[4] to the extent that they provide a multi-dimensional exchange of value facility as illustrated below:

Figure 4.1: Payments Systems



To date, we have enjoyed stable and secure payment systems in Australia. This has revolved around the fact that the majority of payment <u>value</u> has passed through payment providers who:

- are prudentially supervised deposit taking institutions; and
- with clearing and final cross institutional settlement regulated and closely controlled.

Payment providers that fall outside of the above have been largely comprised of charge card schemes. These schemes have focussed on the large volume, small value transactions end of the market, hence the financial risk involved has been comparatively low. They provide third party payment capability for their cardholders, however, payees/merchants must have a contractual arrangement with the payment provider. Settlement and clearing, therefore, occurs directly between the payment provider and the payee/merchant.

[4]See Harper, I.R. and P. Leslie, Working Paper 7, Melbourne Business School, October 1994, p18.

It is in this latter, unsupervised environment that the new technology driven electronic payment systems will develop and prosper. Efficient and convenient communication channels will facilitate providers of such systems being based either on or offshore.

The traditional view is that as no cross institutional settlement is involved, then systemic risk is non-existent. We consider that as use of the new payment systems extends into satisfying business trade needs and cash substitution escalates, accumulated value in the system/s will increase significantly to the extent that failure of such schemes/providers would have a detrimental effect upon the overall stability of Australia's payment infrastructure and public confidence in the electronic medium involved.

The monetary value of the risk is the amount owing by the payment provider to the participants, i.e. value due to payees for unsettled transactions and/or value held on behalf of payers (e.g. stored value, electronic online cash). Clearly, if growth in these electronic payment systems is anywhere near what is expected, rules need to be established: either as to which set of institutions are allowed to issue these instruments[5]; or, the level of capital and the integrity of the systems required, before a non-core financial institution is allowed to issue such instruments.

4.5 CORE INSTITUTIONS

Returning to our new schema, Table 4.4 above introduced the concept of a "core" institution. The rationale for such an institution derives out of the need to have a set of institutions dealing in the exchange of value and at call savings areas that can be perceived by the public to be subject to more comprehensive supervisory standards with both capital and liquid resources to back them up. Also, if we are to participate in international financial markets, there will inevitably need to be a concept approximating a "bank". Extending the liability side of core

[5]The Working Group on European Union Payments Systems (WGEUPS) 1994 Report to the Council of the European Institute on Prepaid Funds, for example, recently concluded "[i]n economic terms, it is clear that the money received by the issuer of an electronic purse is a bank deposit. It is indeed a claim which the card-holder (or account holder) has on a third party and which can be used to make cashless payments to a wide range of providers of goods and services. Such deposits contrast with deposits which are payments in advance for which the range of goods or services to be purchased is well defined and limited in scope. Therefore, in economic

institutions to include "term" saving instruments, would to a large extent, achieve that objective. The differentiating feature between saving instruments in core and non-core institutions would be in relation to the treatment of the depositor, should the core or non-core institution experience difficulties (see below).

To be registered as "core" an institution, would be required to:

- hold a fixed proportion of its liabilities "at call" with the central bank. This criteria is essentially a liquidity buffer. At present, this function is partly met by the NCD requirement - although, the payment of sub-market rates for these funds relates more to fiscal or revenue raising objectives than a true liquidity instrument [and this aspect should be abolished]. While the exact level of the liquidity buffer should be determined by the appropriate supervisor, a requirement of around 1 percent of liabilities minus shareholders' funds would not be unreasonable;

- hold an additional fixed proportion of non-shareholder liabilities in "near cash". To leave no doubt that the purpose of the requirement is to stand behind the core institutions' exchange of value, liquid savings and term saving instruments, it would be inappropriate to calculate such a ratio on the asset side of the institutions' balance sheet (as per the current PAR regime). Also, reflecting the increasing international dimension of financial markets, "near cash" should include not only Australian Government securities, but also government securities of major OECD economies (e.g. G-7 economies). Again, while the exact level of the "near cash" requirement should be determined by the appropriate supervisor, a figure of around 5 percent of liabilities less shareholders' funds would not be unreasonable;

- hold capital of at least 8 percent of risk weighted assets. The holding of capital is the ultimate link between the liability side of the core institutions' balance sheet and its assets. The level of capital should be set at acceptable international standards - currently 8 percent of risk weighted assets. While Australian experience suggests that the current risk weights should be reviewed, that is probably best done in an international context, rather than in isolation. That said, the National would suggest that the Inquiry recommend that the

---

terms, the reasons which led public authorities to reserve deposit-taking to a specific category of institutions should also apply to the issuers of electronic purses."

Australian authorities raise with the Bank for International Settlements (BIS) an alternative set of risk weights that, inter alia:

  - lowers significantly the risk weights on housing (currently 50 per cent to no more than 25 per cent); and
  - provides for greater differentiation between "graded" debt and other debt (it makes little sense to risk weight the debt of an AAA graded company the same as an ungraded corporate or small business debt);

- the core institution also must have ready access to new capital via the market;

- the main restrictions on the asset side of the balance sheet of a core institution would be:

  - prohibition on the carrying of "insurance" products on the balance sheet. That restriction basically reflects the different nature of insurance risk (and is commonly recognised as such in most overseas countries) see Chapter 2;
  - limitations on the core institutions' ability to take on direct equity. This could be set at a maximum ratio (perhaps 10%) of shareholders' funds;

- the core institution is subject to the most comprehensive supervision of any financial institution but the focus of the supervision moves from "prescriptive" to an "inter-active" nature and greater public disclosure. This would involve some streamlining of existing regulatory returns.

- the core institution would be required to have a diverse ownership structure (not more than 15 percent of the capital held by any one stockholder). Also, there would be a limit on large exposures (as per current 'bank' regulations). Normal corporate rules for directors would apply. In the first instance, the appropriate enforcer of these criteria would be the relevant supervising body, albeit "on behalf" of the Treasurer (with the latter maintaining a power of discretion).

In return, the core institution:

- has automatic - but not monopolistic - access to the system of exchange of value;

- will, like banks today, have some features that provide an additional element of security to the public:

    ⇒ in a more market-oriented financial system, it is not appropriate for the Central Bank to provide either an explicit or implicit, depositor guarantee. Accordingly, it is the National's view that explicit reference to depositor protection be removed from the Reserve Bank Act.

    ⇒ Core institutions will continue to have the ability to raise savings from the public without a prospectus (see below).

Instead, the monetary authorities' undertaking to core institutions should be restricted to:

- an undertaking that the relevant supervisor will oversee the tidy exit and/or wind-up of the assets of any core institution should it experience difficulties; and

- as part of that process, depositors of core institutions will have the "first call" on the assets of that institution - a right not extended to borrowings by other financial institutions.

Thus, referring back to Table 4.4, the difference between a savings instrument in a core and non-core institution relates to the nature of the "guarantee" given to the capital component of the savings investment. In principle, a savings investment can be thought of as involving a capital component held with a financial institution which, in turn, generates an income stream. That income stream, in turn, can be determined by either referring to an interest formulae or one based on exposure to the equity market, commodities, property or a balanced portfolio. However, only in the core institutions does the depositor get the additional security of the "first call on assets". In that context, the Government's proposed treatment of retirement savings assets would fit well within the core institution model.

Clearly, the above structure for core institutions is closely related to existing bank structures. Indeed, consistent with the National's guiding principles of efficiency and international acceptance, the maintenance of bank-like structures remains highly desirable. The more important matter is to provide the means to facilitate more competition into all aspects of the financial system.

4.6 EXCHANGE OF VALUE

For non-core institutions the requirement to issue directly term savings instruments will depend on the type of product, as set out in Chapter 7. Beyond that, the degree of burden in issuing prospectus' should be significantly reduced and in time removed (to be replaced by our suggested disclosure regime).

An important example of increasing competition, as noted earlier, is our proposition that non-core institutions be allowed to participate in the payment or exchange of value system. Given the systemic implications involved in this part of the financial system, a number of safeguards must be implemented. These include:

- Any participant in exchange of value must be an Australian registered financial institution, thereby allowing it to come under the auspices of a relevant financial supervisor. (A similar requirement - called Regulation K - was recently introduced in the USA to provide for the same concerns[6]);

- The financial institution must be adequately capitalised. As the institution may not have "assets" on its balance sheet, this requirement is most likely to take the form of a lump sum capital (possibly $50m or more). Although this may provide some grounds for re-consideration in relation to special service providers (such as, CUSCAL), the current system seems highly arbitrary, in that it allows some mutuals direct access to the payment system on the basis of the financial position of their industry, but larger, better capitalised stand-alone mutuals, such as AMP, National Mutual, etc. are excluded;

[6] Bank Administration Institute (1996), Building Better Banks: The Case for Performance-Based Regulation, McKinsey & Company.

- In addition, given the systemic implications, it is vital that these institutions have an ability to meet demands on the liquidity created by payment systems (refer to Figure 4.1 above). On that basis, government (G-7 or Australian) securities should be held on a dollar for dollar basis against outstandings held on behalf of participants (payees and/or payers); and

- Also, in line with its registered/licensed status, the financial institution would need to have the integrity of its payment delivery and settling procedures monitored by the relevant supervisory authority.

These changes, together with the introduction of Real Time Gross Settlement (RTGS), would contribute to significantly improving the "security' of the payment system to meet the new electronic environment, while at the same time, boosting competitive focus in those areas.

4.7 HOLDING COMPANY STRUCTURES

In addition to this reform of the payment systems, the National strongly believes that all parts of the financial system should be made more "contestable". At present, banks can compete in non-bank areas through financial holding companies - where the holding company is the bank and there are some limits on the relative uses of the non-bank subsidiary vis-à-vis the bank. The reverse, however, i.e. a non-bank fully owning a bank subsidiary, is not generally allowed.[7]

It is the National's view that **the** single change that will create the greatest improvement in contestability across the financial system - and thereby create an ability for all potential competitors to participate - would be to introduce holding company structures that allow both domestic and foreign-based financial institutions to fully own "core institutions".

The issue of how to deal with financial conglomerates, is perhaps the issue most exercising the minds of financial analysts, academics and regulators today. Some of the issues that arise include: appropriate corporate structures (e.g.. how to deal effectively with "contagion" across the group); how to ensure competitive neutrality between conglomerates and specialised

participants; and on the regulatory side, who should "do it" and what is the appropriate capital/liquidity standards etc.[8] Some of these issues, including some of the key lessons, are set out in more detail in Appendix 2.

Drawing on that experience, the National would advocate the following rules to be applied on a holding company which includes as a subsidiary a "core institution":

- the holding company must be a registered Australian financial institution (and hence supervised). While ultimately it might be possible to fully integrate industry and banking, (i.e. allow industrials to have a dominant interest in the holding company), the structure proposed below, of a series of separate legal entities under the holding company, delivers nearly all the efficiencies of a diversified conglomerate - without raising the potential for conflicts of interest associated with industrials owning banking or "core" institutions.[9];

- the holding company must have diversity of ownership (with no one owner with more than 15 percent of the capital). This, in fact, would be the same requirement as per a stand-alone core institution carried through to the holding company;

- there would need to be a "net" large exposure limit applied across the conglomerate as a whole (possibly set at around 30 percent of total "net capital");

- the combination of the first two criteria above would, in isolation, exclude foreign financial corporations. That is not the aim - on the contrary, the aim is very much to encourage international competition within the domestic financial system. Thus, if the domestic holding company can trace its ownership to an offshore financial institution (not necessarily a bank) that satisfies all the other relevant criteria, it will be deemed as satisfying the conditions necessary to operate as a conglomerate directing a core institution in Australia:

---

[7] Exceptions to these rules are however already arising: e.g.. the CML takeover of the SBNSW and, if it were to go ahead, the proposed Suncorp/Metway Bank merger.

[8] See for example "The Supervisors of Financial Conglomerates" A Report By the Tripartite Group of Bank, Securities and Insurance Regulations, July 1995 (the so called "de Swan Report").

[9] See Corrigan's (2) cited above, especially pages 32 - 34, and Dale R., "Regulating Investment Business in the Single Market", *Bank of England Quarterly*, November 1994, pp.333-340.

- the only proviso here is that the foreign parent be consolidated on a group basis in a "BIS" consistent jurisdiction.[10]

- on neutrality grounds, the current 50% withholding tax on foreign branches should be abolished and would not apply to the conglomerate;

- under the holding company, subsidiaries (including core and other entities) are to be structured as separate legal entities with a requirement that each entity must, separately, satisfy the specified capital, liquidity (and any other) requirements imposed by the supervisor. In addition, this should allow the holding company the possibility of operating a number of core institutions (i.e. multiple licences). There are no "funding firewalls" between subsidiaries. However, where offers are made to the public, directors of the subsidiary must satisfy the criteria "of operating in the best interest of the customer" - this implies that a subsidiary can fund from another's customer base, but must do so at "market" rates;

- in addition to the separate legal structures, it would need to be clearly identified that under the holding company structure the "core" institution remains isolated "in law" from a subsidiary, should the latter experience difficulties;

- as discussed in the next chapter, one of the key efficiency drivers in mergers and financial conglomerates is the opportunities it provides to "cross sell." To utilise this opportunity, it is vital that, while maintaining confidentiality and privacy requirements within the conglomerate, no artificial barriers remain, or are erected, to obstruct the free flow of information on customers' needs across the conglomerate; and

- given that subsidiaries are structured as separate legal entities with a requirement that they separately (on a "net" basis) satisfy capital and liquidity standards, it follows that overall capital requirements for the conglomerate will be significantly influenced by the type of products offered and the regulations applying to them.

[10]Broadly similar criteria have recently been advocated in the USA.

4.8 NON-CORE INSTITUTIONS

In that context, it is worth turning to a brief discussion of some of the key points relating to the current (and, in the case of the Life Insurance Act, prospective) regulation governing capital/liquidity requirements for life insurance, superannuation funds, general insurance and investment advice (broking etc).

These issues are summarised in Appendix 2. Some of the key points, however, are:

- current and proposed changes to the legislation for life insurance mean that regulation of this industry is already very much structured on a functional basis;

- in particular, the level of the "resilience reserve" (aimed at ensuring the on-going ability of life and super funds to meet their requirements) is importantly determined by:
  - product mix;
  - asset mix and portfolio diversification;
  - product terms (e.g.. surrender value basis);
  - the level of the guarantees.

- this means, together with the requirements for general insurance, that non-bank financial institutions (or, in the future, a "non-core" subsidiary of financial conglomerate) covering the full spectrum of non-bank products, can have a very different capital requirement, according to the spread of their offerings. Some indication of this diversity is shown in the following table which is based on work commissioned by the National for this Inquiry.

Table 4.5

Nature of Business	Excess Reserves Likely for a Typical Fund: % of Liabilities
Capital Guaranteed Business	10-15
Investment Linked Business	0.5-1

Whole of Life and Endowment Insurance	5-10
General Insurance	35 *

* For pure risk, a minimum solvency requirement was around 11.5 percent of liabilities, whereas the figure reported above equals the average of excess, liquidity of a sample of 23 general insurance companies.

- The above figures imply that a life insurance firm operating with significant exposure to "capital guaranteed" and "pure risk" business could be required to hold around 8-10 percent in excess liquidity (or notional capital). Given the new life office standards, newer entrants (and especially funds managers) are likely to restrict their exposures to these higher "capital" required offerings and, on that basis, could be required to hold between 4-6 per cent in notional capital.

- On the basis that 'functional' regulation is already effectively in place, the National does not see the need for more fundamental reform in this area. There would, however, be merit in:

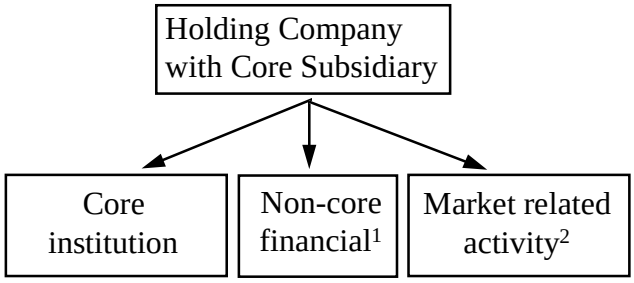
  - allowing the expense reserve and the new business capital reserves of life offices (essentially additional reserves to allow for costs of closing down and for expanding networks, respectively) to be held at the company level, rather than the proposed practice of placing them individually in each fund;

  - removing the requirement to hold additional reserves if more than 25 percent of a fund is held with a subsidiary bank (or, in the future, a core institution). If maintained, this feature would act to significantly increase the cost of raising funds across the subsidiaries of a financial conglomerate. It also makes little practical sense, in that, it takes no notice of the "rating" of the bank involved (thus holding a larger proportion of the fund in a higher rated bank attaches a penalty, whereas diversifying to five or more lesser ranked banks does not). More to the point, such treatment is inconsistent with a more market based approach to financial regulation; and

– a key area of reform will be to implement a new disclosure and distribution regime to facilitate more informed choice. (These issues are addressed later in some detail in Chapter 7.)

Drawing the above together, and recognising that notional capital for non-core subsidiaries will vary according to the activities undertaken, it is possible to illustrate, by way of a simple worked example, the type of capital structure a holding company (including a core institution as a subsidiary) may face.[11]

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.

In the above illustration, the minimum required capital requirements are 8 percent, 4 percent and 1 percent, respectively for the core, the non-core and market related activities. For the latter, it should be noted that we would envisage areas of trading, such as foreign exchange and OTC derivatives, to continue to be regulated on a purely functional form - and hence, it is open to the conglomerate to either do it in the core institution or to set up a separate "trading" entity. In the simple illustration above the minimum total capital required of the conglomerate would be 4.7 percent (net). Excess capital could be held in the holding company, or within the

[11]More detailed worked examples of methodology that provides for appropriate treatment of capital in conglomerates is set out in the "de Swann" report (obiter cite) pp. 100-114.

subsidiaries, according to wherever the holding company expects it to generate the best returns - and thereby contributing further to efficiency in the allocation of capital.

Although covered in Appendix 2, it is worth noting that there is some debate about whether such a holding company should be required to hold capital in excess of the "minimum sum required of the component subsidiary" (i.e. more than 4.7 percent above). That in large part relates to the perceived risk of "contagion" across subsidiaries.

Against that:

- studies are increasingly (see especially Saunders and Walter (1994) and Benston (1994)) pointing to, if anything, a lowering of risks by combining banking and insurance. Rather, the largest element of risk appears to be associated with trading activity (which in Australia is already largely concentrated in banks); and

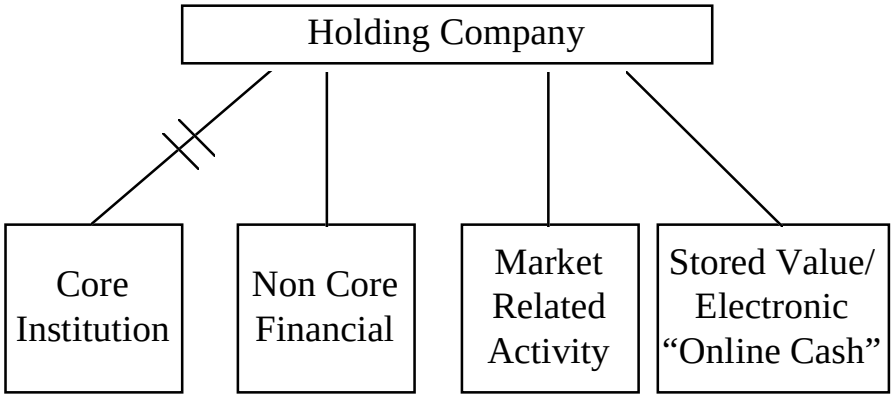
- indeed, there is evidence of conglomerates encountering counter-cyclical revenue streams in their various banking, securities and insurance subsidiaries (see Watt, Richert and Mohanty 1993). Similar arguments were also made to the recent meeting of the International Monetary Committee in Sydney by the Chairman of the Executive Board of ING, Aad Jacobs and by the Managing Director of Barclays, Andrew Buxton.

On balance, the National is of the view that neither a capital premium nor discount should be applied to these financial conglomerates. What is obvious, however, is that while, on balance, there may be no overall increase in systemic risk from our holding company proposals, this will only hold if adequate risk management systems are set up within the conglomerate. Further, those internal risk monitoring systems will need to be more flexible and sophisticated than those required by stand-alone entities.

- In these circumstances, the National advocates the introduction of a "trigger" mechanism - whereby it will be up to the conglomerates to convince the appropriate supervisor that internal risk management systems are in place. Such discussions should be "consultative" in nature and not "prescriptive".

Before leaving the issue of holding company structures, there are examples where some large offshore institutions would fail the diversity of ownership test (e.g.. GE Capital). While the above structure will not allow them to set-up subsidiaries that are core institutions, our schema would still allow significant participation in the financial system - including payments (provided the appropriate capital, and liquidity conditions are put in place) - as shown in table 4.7.

Table 4.7



The final issue to be addressed in this chapter relates to the treatment of mutuals. As noted previously, there appears to be quite mixed treatment of mutuals under the current system - both as regards access to the payments system and their ability to raise deposits without a prospectus (refer Table 4.3).

It should be noted that it is not easy to fit "mutuals" into a simple schema. In the past, mutuals have not been allowed to own banks, primarily due to the difficulties these legal structures entail in accessing capital in times of distress.

Although somewhat arbitrary, one possible way forward would be the following:

- a mutual can compete in the payment system, provided it satisfies the rules for a financial corporation operating in the payment system (as set out above);

- a mutual (domestic and foreign) can operate as a core institution, or as a holding company with a core subsidiary, provided it meets the rules for core institutions (including capital);

- Where legal restrictions are such that access to “capital” is not available, the mutual would be required to operate as a non-core institution. In the special case of building societies and credit unions, they would continue to have the ability to raise deposits without a prospectus, provided their reserves are not lower than the equivalent capital standard of a core institution.