

Executive Summary

The International Banks and Securities Association of Australia (IBSA) welcomes the Inquiry into the financial sector, as it presents a good opportunity to resolve current problems and, more importantly, to put in place a framework to manage the future of the sector. There is great potential to create a strong, vibrant financial sector that efficiently services the needs of the domestic economy and, in addition, can earn significant foreign income. Effective competition in the sector is essential to achieve this end and investment and merchant banks, that are largely foreign owned, play a critical role in this regard. It is important for the further development of the sector that a level playing field is created for all financial institutions, by eliminating tax and regulatory biases. Failure to properly develop the financial sector will carry a high cost, in view of the increasing globalisation of financial markets. On the other hand, success will bring significant economic rewards.

A stocktake of the outcome of financial sector deregulation is worthwhile for several reasons. Firstly, as a starting point, the stocktake must identify the economic role of the financial sector and all of its constituent bodies. There is considerable merit in this exercise, as the depth and breadth of the financial sector's contribution to the economy is rarely fully appreciated. Perceptions about the role of the financial sector and its value in this regard are important factors that influence the stance of policy makers and others with regard to developments that affect the sector.

This submission identifies a broad range of services through which the financial sector and, more specifically, investment and merchant banks facilitate the efficient operation of the economy. These include traditional payments and savings/credit intermediation services and, more recently developed services, notably risk management. Australia has an extremely sophisticated financial sector by international standards and this is to the clear advantage of its users. Economic performance is enhanced by the efficiency and sophistication of the financial sector.

Investment and merchant banks, which are by and large foreign banks, operate as both licensed banks and merchant banks (money market corporations) and play a key role in the financial sector, as outlined in the submission. They are largely a product of deregulation and have provided a sharp competitive edge to competition in all markets across the financial sector. Their clients are mainly the corporate sector and government, and competition for this business is intense. They are less prominent in retail banking but, nevertheless, have given the market a badly needed shake-up by heightening competition in key deposit and credit product lines.

Another good reason for undertaking a stocktake is the absence of a consensus about the benefits from financial sector deregulation. Analysis in the submission clearly demonstrates that there were substantial net benefits from liberalisation of the financial sector. These emerged through greater competition that spurred finer pricing, innovation and enhanced operational efficiency. This translated into lower financial transactions costs and realistic interest rates that provide a fair return to savers, by taking proper account of economic

conditions. Other benefits include greater choice of products, services and providers for both corporate and retail users and better market access, especially for retail consumers. In response, the depth of the financial sector, as measured by financial assets and credit aggregates, increased significantly.

It is emphasised that the *quality* of financial services offered to consumers also improved in the aftermath of deregulation. For example, banks now offer standardised capped interest rate loan facilities to commercial and home mortgage borrowers (banks can hedge the resulting interest rate exposure using derivatives), companies use electronic banking packages to efficiently process their transactions and deposit account holders have continuous access to their accounts through ATMs.

Investment and merchant banks were at the forefront of these changes. It was the impending entry of foreign banks in the mid-1980s that forced the major trading banks to increase returns to depositors and improve their overall efficiency levels. Upon entry, the investment and merchant banks maintained the competitive pressure, drawing upon their innovation skills. More recently, they have stiffened competition in funds management and substantially lowered the cost of home mortgages, through securitisation.

However, it is in the business of corporate finance, project finance and capital markets that the investment and merchant banks have made the deepest impression. These markets in Australia are now amongst the most competitive financial markets in the world. Margins are fine and there is a good spread of significant market players. The investment and merchant banks dominate important markets, like private infrastructure financing and offshore funding, and are world leaders in some aspects of their business. The range and quality of financing and risk management facilities available to Australian industry provide it with a competitive advantage in international trade.

There are several indirect benefits to financial market regulation that tend to be overlooked. Some important aspects in this regard are:

- Market determined interest rates improve in economic and commercial decision making;
- The operation of a flexible, market orientated monetary policy, in preference to the old system of controls that distort financial and economic activity;
- The markets impose greater financial discipline on borrowers, including government;
- A reduced role for government in production, through privatisation;
- Infrastructure development through private financing;
- Better integration into the global capital markets and economy;
- A better balanced financial sector and economy to absorb internal and external shocks.

Therefore, there is strong evidence that financial sector deregulation has been a success. That is not to say that there have been no attendant problems; the asset price spiral in the 1980s was exacerbated by difficulties of adjustment to liberalised credit markets. On balance there has been a significant net benefit to the Campbell Inquiry inspired series of reforms. The inevitability of deregulation, given technological and global development, means that the managed manner in which deregulation was implemented was of immense benefit to the economy. This is a major contribution from the Campbell Inquiry.

The application of ongoing technological developments in banking and the globalisation of financial markets will remain critical factors in shaping the future of the financial sector. Today, our banks and other financial institutions must compete in an international market for wholesale financial services; for example, 60% of trading in Australian dollars takes place in foreign financial centres, while companies bank offshore and list on overseas exchanges. This competition will intensify in the future and is likely to extend to the retail market; for example, US fund managers may target business from Australian residents and reliable internet banking facilities will soon be available from centres elsewhere in the world.

Australia attracts a share of international financial business; for example, investment and merchant banks operate offshore banking units (OBUs) and sell corporate advice throughout the region. In addition, a number of significant financial regional headquarters (RHQ) operations have been enticed to locate here. However, the Australian financial sector will struggle to hold its own in this environment, unless impediments to its development are removed.

The maintenance of a competitive financial sector is critical to its future success. All institutions must be placed on a level playing field, from a regulatory and tax perspective. Financial institutions should not be disadvantaged relative to each other, or relative to their international competitors. Foreign banks will play a critical role in maintaining the competitive balance in the sector, especially if mergers take place between some of the major trading banks. Branches are the most efficient form of operation for most foreign banks, but they are placed at a disadvantage to the other banks by their interest withholding tax treatment. It is problems of this type that must be addressed in order to provide for a secure future for the sector.

IBSA acknowledges the need for regulation of financial markets and views it as a tool to enhance the industry's performance. In this respect, there is a critical need to maintain proper balance in regulation. It must not be too intrusive and should accord with international standards. The shape of the financial sector is changing; for example, the role of non-banks is increasing and financial conglomerates are emerging. This poses great challenges for regulators. The regulatory framework must be sufficiently strong and flexible to accommodate this. A number of alternatives are available to effect this, including the mega-regulator model. Having regard to the relevant issues, the best approach is to strengthen the Council of Financial Supervisors and adopt a lead regulator model for the supervision of financial conglomerates. To enhance the efficiency and sensitivity of regulation, the Council should

have full responsibility for competition in the financial sector. Banks should pay for the cost of prudential supervision in accordance to the privilege accorded to them by it.

Every effort must be made to enhance the efficiency of the financial sector and its constituent markets and institutions. Financial institutions duty (FID) is a serious obstacle in this regard. It is extremely costly to comply with, iniquitous and indiscriminate in its impact. It also damages the international competitiveness of the financial sector. This tax fails several fundamental tests of efficiency and should be abolished.

There are a number of obstacles besides FID that must be tackled for Australia to reach its full potential in international financial services trade. These are worth addressing because the potential returns are large and the potential losses from doing nothing are even greater. There is a need for a strong political commitment to the concept of Australia as an international financial centre, allied with effective marketing of this. There must no doubt in the minds of potential entrants, as RHQ's or otherwise, about the Government's commitment to the success of the financial sector and that problems, as yet unforeseen, will be competently dealt with. Centres like Singapore have an advantage over Australia in this respect, at the moment.

Federal and State government facilitation programmes should be placed in a unified framework and national co-ordination of marketing should take place through a body similar to the Tourism Task force. In addition, a single desk approach should be taken to the process of negotiating with business to expand or relocate to Australia.

The Inquiry presents a unique opportunity to market Australia as an international financial centre. Australia has significant competitive advantages, but some of these have a 'use by' date. The Government should immediately affirm its commitment to Australia as an international financial centre and provide a significant down-payment on this, by announcing appropriate changes to the OBU and RHQ regimes.

The Inquiry comes at an important time in the development of the financial sector. It can lead the way to its successful development by recommending a framework that will eliminate current problems and produce appropriate policy responses to trends that are yet to emerge. IBSA offers this submission to assist the Inquiry Committee in its work and strongly advocates that it adopt the recommendations therein in its report to the Government.

Summary of Recommendations

Priority recommendations are in bold type.

1. Regulation

- ◆ *IBSA recommends that all initiatives for reform of financial regulation be justified by reference to the underlying public policy objectives and that strict principles to govern the implementation of financial regulation, so that it is efficient and least intrusive on commercial activity, be adopted. Further, all regulation should be the subject of periodic critical review.*
- ◆ *IBSA recommends the institutional approach to financial sector regulation is retained, with enhanced co-operation between institutional and product regulators.*
- ◆ **IBSA recommends that the Council of Financial Supervisors be retained as the co-ordinating body for regulators of the financial sector**
- ◆ **IBSA recommends that the Reserve Bank retain responsibility for both monetary policy and prudential supervision of banks.**
- ◆ **IBSA recommends that the Council of Financial Supervisors adopt a lead supervisor model for supervision of conglomerates.**
- ◆ **IBSA recommends that:**
 - The Council be given statutory recognition, but as a co-ordinating body only;**
 - The Council be comprised of representatives of the financial regulators, with the Governor of the Reserve Bank as Deputy Chairman and an independent Chairman, appointed by the Treasurer;**
 - The Council report directly to the Treasurer;**
 - The Council be made responsible for competition in the financial sector;**
 - The Reserve Bank's present role as bank regulator is not compromised.**
- ◆ *IBSA supports the Corporations Law Simplification Program proposal to regulate dealings in securities under the Corporation Law, rather than under section 52 of the Trade Practices Act, and further recommends that, as a matter of principle, the distinction between wholesale and retail consumers of financial services is properly reflected in all consumer protection regulation.*
- ◆ *IBSA recommends that, having regard to the effective exclusion of retail depositors from their business, foreign bank branches should no longer be required to inform depositors that the depositor protection provisions of the Banking Act do not apply to them, as a practical matter that balances competition in the wholesale funds market.*
- ◆ *IBSA recommends that PAR should be significantly reduced with the implementation of the real time gross settlements system for high value domestic payments.*

- ◆ **IBSA recommends that non-callable deposits be abolished for all banks. At a minimum, they should be eliminated, or greatly reduced, for foreign bank branches.**
- ◆ **IBSA recommends that the Reserve Bank adopt greater flexibility in setting its criteria for the ownership of foreign bank branches by concentrating on the substance of parent ownership risks, without compromising the integrity of the licensing system.**
- ◆ *IBSA recommends that the authorities should promote competition in the market for stored value cards, and other payments media, and encourage licensed foreign banks (subsidiary and branches) to participate in the market.*

2. Competition and Taxation

- ◆ **IBSA recommends that, with a view to balancing competition in the financial sector, interest withholding tax on intrabank funding by foreign bank branches be abolished forthwith.**
- ◆ *IBSA recommends that interest withholding tax be abolished over the medium term, with a view to promoting further development of the domestic non-government fixed interest market.*
- ◆ **IBSA recommends that the State and Federal governments announce their intention to abolish Financial Institutions Duty forthwith and immediately begin to plan for this.**

3. International Competitiveness of the Financial Sector

- ◆ **IBSA recommends that the Federal and State Governments significantly upgrade their efforts to establish Australia as an international financial centre and location for RHQs, co-ordinate and concentrate their efforts in this regard and unambiguously state their intention to preserve the international competitiveness of the financial sector in the future.**

4. Other Issues

- ◆ *IBSA supports the concept of a Financial Markets Council to improve the dialogue between industry and government, so that policy is more responsive and industry properly understands the Government's concerns.*
- ◆ *IBSA supports government efforts to liberalise trade through APEC and recommends that pressure be maintained to achieve more open financial markets in the region.*
- ◆ *IBSA recommends that the Government should promote the concept of a regional bank, similar in function to the Bank for International Settlements, to better co-ordinate activities by the Asia-Pacific central banks and promote Sydney as a location to base its secretariat.*

The International Banks and Securities Association of Australia

The International Banks and Securities Association of Australia (IBSA) is the national organisation which represents the interests of investment banks and securities companies operating in Australia. It was established in 1979 from a merger of the Accepting Houses Association of Australia and the Issuing Houses Association of Australia (formed in 1972). IBSA was known as the Australian Merchant Bankers' Association until 1993, when the name was changed to indicate the changing nature of wholesale financial markets in Australia.

The Association has been closely associated with the development of Australia's financial markets, both banking and securities markets, and represents the industry members' interests to Federal and State Governments and all the regulatory agencies involved in the industry.

The Association's members are the industry leaders and comprise both Australian and foreign owned institutions including the operations of the major international banks and investment banks which operate in Australia. The members include:

- the Australian operations of foreign owned banks operating in Australia's wholesale financial markets as either a branch, a subsidiary or a representative office of their parent;
- the Australian operations of foreign owned investment and merchant banks;
- the wholesale banking activities of Australian banks;
- Australian investment and merchant banks.

Members are vitally concerned with Government policies which impact on the operation of the market place and they actively participate in the activities of the association. The Association's mission is to represent and promote Australia's financial markets and its Members as a fundamental part of those markets.

IBSA is recognised as the representative body of its members. Government relations are the essential function of the Association. The development and maintenance of communication with Government ensures sound long-term relations with those Government departments, authorities and key individuals whose activities and decisions may affect the industry. IBSA monitors Government developments which may have an impact on members and keeps members informed of new legislation and regulations which are likely to have an impact on members' activities.

The Association works closely with Federal and State Governments, and with such bodies as the Reserve Bank of Australia, the Australian Securities Commission and other Federal and State instrumentalities. It also maintains close working relationships with financial market operators and other industry groups.

List of IBSA Members

ABN AMRO Australia Limited
AIDC Ltd
BBL Australia Limited
BNP Pacific (Australia) Limited
BOS International (Australia) Limited
BZW Australia Limited
Banca Commerciale Italiana
Bank of America NT & SA - Sydney Branch
Bankers Trust Australia Limited
CS First Boston Australia Securities Limited
The Chase Manhattan Bank
Citibank Limited
Credit Lyonnais Australia Limited
The Dai-Ichi Kangyo Bank Limited - Sydney Branch
Deutsche Bank AG
Dresdner Australia Limited
The First National Bank of Chicago
Fuji International Finance (Australia) Limited
Hambros Australia Limited
Indosuez Australia Limited
Lloyds Bank NZA Limited
Macquarie Bank Limited
Merrill Lynch International (Australia) Limited
Mitsui Trust Finance (Australia) Limited
Morgan Guaranty Trust Company of New York
Morgan Stanley Australia Limited
NatWest Markets Australia Limited
Overseas Union Bank Limited - Sydney Branch
Rabo Australia Limited
Rothschild Australia Limited
SBC Warburg Australia Limited
Salomon Brothers Australia Limited
Sanwa Australia Limited
Schroders Australia Limited
Societe Generale Australia Limited
State Street Bank and Trust Company - Sydney Branch
Sumitomo International Finance Australia Limited
Tokai Australia Finance Corporation Limited
UBS Australia Limited
United Overseas Bank Limited - Sydney Branch