

Part 1. Financial Sector Post-Deregulation

1. Introduction

Financial sector deregulation that occurred around the time of the Campbell Report and after, has transformed the Australian financial sector.¹ Most importantly, liberalisation of financial markets removed artificial rigidities in interest rate and exchange rate pricing arrangements and controls over the allocation of capital. These restrictions had greatly impaired the efficient operation of the financial sector.

Several other events prompted by financial deregulation improved the operation of the financial sector too. In particular, competition between financial institutions intensified, partly in response to more complex lines of interaction with the rapidly developing interest rate, foreign exchange and equity markets. Foreign bank entry to the market provided the steel to competition, initially in wholesale financial markets and, more recently in retail markets. Retail consumers have benefited both directly and indirectly from the development of the investment banking sector.

Globalisation of financial markets and technological development combined with financial deregulation to radically alter the shape of the financial sector over the last fifteen years. These factors are linked to each other; for example, development of communications capability has greatly assisted globalisation of markets, that was made possible by the removal of barriers to international capital flows. Meanwhile, the financial deregulation was prompted in many cases by the threat of financial market globalisation.

The first objective of this part of the submission is to review the development of the financial sector since the early 1980s and evaluate progress in lifting the performance of this sector against a range of benchmarks. Of necessity, an evaluation of the success of financial deregulation is subjective because it is uncertain precisely how the financial sector would have developed under a continuing regime of heavy regulation and it is difficult to delineate the precise impact of deregulation on the macroeconomy. Bearing in mind these qualifications, there is compelling evidence that deregulation was beneficial to the Australian financial system and the economy.

Investment and merchant banks in Australia, which are by and large foreign owned banks, played a unique and important role in generating development of the financial sector. This is manifest across a range of criteria. For example, they have produced greater competition, increased efficiency and lower costs for financial services. The nature of their contribution in this regard has shifted over time, in line with the complexion of their business. This is an ongoing process, shaped by domestic and international events, which must be nurtured to produce most benefit.

The second objective of this part is to identify and reveal the essential contribution of investment banks to the operation of the financial sector. This provides a platform to consider current difficulties, analyse likely future developments and develop a response to meet

¹ A chronology and description of financial deregulation measures is not presented here because this material is readily available in a comprehensive form elsewhere (for example, Reserve Bank of Australia, *The Deregulation of Financial Intermediaries*, 1991), the Inquiry is aware of the main events (which are not contentious) and this will avoid probable repetition with other submissions to the Inquiry.

forthcoming challenges. This will assist the Inquiry to fulfil its brief to provide a stocktake of the results of financial sector deregulation since the early 1980s. It should also be a useful input to the Inquiry in its analysis of the driving forces behind change in the financial sector, and assist it to make a judgement about its future direction and likely outcomes. These findings are central to the formulation of the Inquiry's conclusions and its recommendations to prepare the financial sector to best serve the economy into the next century.

The second section in this part begins by providing an overview of the financial sector and its role in the economy. Although this is discussed elsewhere (and no doubt in other submissions), it is necessary to reconsider it here to outline the implicit framework that underpins analysis in the submission and to present a perspective that differs in some respects from more traditional analysis.

The financial sector provides a range of services to facilitate the efficient operation of the economy. Investment and merchant banks have a particular role to play in this regard, participating more actively in some areas than others. The third section provides an overview of investment banks, their activities, their place in the financial sector, their role in the economy and how this has changed over time.

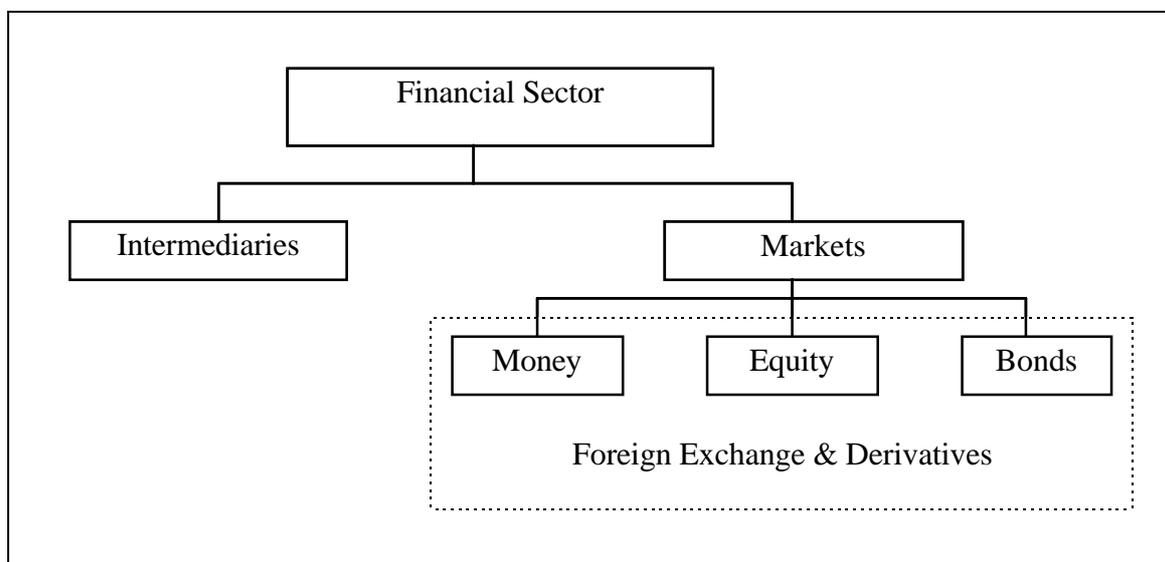
This is expanded upon in section four which presents an evaluation of financial deregulation beginning with a review of macroeconomic issues and is followed by a more detailed consideration of micro issues. The fourth section outlines problems that prevent investment banks from contributing in full to the operation of the financial sector and to the country's economic performance. Finally, a summary of the impact of financial deregulation is given.

2. The Role of the Financial Sector

In the first instance, it is important to outline the structure of the financial sector to help scope the submission. The financial sector comprises two basic elements; financial intermediaries and financial markets (see figure 1). In general, as financial systems develop both components grow in economic importance but financial markets increase in relative importance. This drives in large part from the response of the finance, business and personal sectors to financial deregulation measures, upon which financial sector development is based. This was the experience in Australia from the early 1980s.

Financial intermediaries are the dominant players in financial markets and the two are very much complementary. However, the relative importance of different types of financial institutions shifts to reflect the changing nature of the financial sector. In Australia, this has meant that investment and merchant banks and funds managers now have a much more important role in the financial sector than they had in the past.

Figure 1. The Financial Sector



There are three main types of financial intermediary; deposit takers, funds managers and insurers. In different ways, they each ‘intermediate’ or facilitate the transfer of funds and risk. They link savers and borrowers and redistribute financial risk between economic entities. Deposit takers are split into banks and non-bank deposit takers, mainly building societies and credit unions. Banks may be further split into trading banks (like Westpac, ANZ and the regionals) and investment and merchant banks (mainly foreign owned banks, like the Chase Manhattan Bank and ABN Amro). The trading banks offer a broad range of banking services to retail consumers and companies, while investment banks are much more focused on the commercial sector. Trading banks are the cornerstone of the payments system. Some institutions undertake one specialised intermediation task, like deposit taking and lending, while others provide a broad range of services through some form of conglomerate structure. For example, both banks (like Bankers Trust) and insurers (like AMP) participate in the funds management business.

The financial markets in Australia are the money, bond, equity, foreign exchange and derivatives markets. Only the first three transfer funds between savers and borrowers, though

the foreign exchange market links overseas financial markets (as well as facilitating international trade). Derivatives are used to manage risk arising from financial instruments. The main participants in the financial markets are the financial intermediaries, which account for the bulk of trading on them. An important function of financial markets is to act as a clearinghouse within the sector for institutional liquidity and risk. Financial intermediaries also transact extensively on the capital markets as part of their normal business, for the most part managing funds either directly or indirectly on behalf of their retail and corporate clients.

2.1 Financial Sector Products and Services

Activity in the financial sector is driven by uncertainty, information asymmetry and transaction costs. The financial sector provides a range of services that allows companies, governments and individuals to efficiently manage these problems. Indeed, if the economy was 'perfect' in the economic sense, with absolute certainty and no rigidities, there would be no need for the financial sector.

Financial intermediaries and markets interact to produce a range of services;

1. Payments mechanisms,
2. Liquidity management,
3. Savings and credit intermediation, and
4. Risk management (including hedging).

Payments mechanisms and liquidity management facilities are the cornerstone of the financial sector. Transactions balances held at banks form a base for credit intermediation, which is extended by savings deposits and other instruments. Risk management facilities are at the leading edge of financial sector development and it is only over the last decade that it has become a significant part of the financial sector's output.

1. Payments Mechanisms

Payments mechanisms facilitate the transfer of value between entities, usually in exchange for goods or services. They are absolutely critical to the operation of the economy because they facilitate trade, both locally and internationally. The main payments facilities are cash, cheques and electronic transfer mechanisms. Trading banks have had a clear comparative advantage in the provision of these facilities for small value payments and a set of industry owned facilities, like Austraclear and SWIFT, have been developed to facilitate high value payments.

2. Liquidity Management

The need to manage liquidity and the financial sector's capacity to provide the necessary facilities are closely linked to the payments system. Because businesses and individuals operate in an uncertain environment, they need to maintain a monetary buffer to provide funds to meet unforeseen demands for payment and to absorb unanticipated receipts. Demand (and similar type) deposits provided by trading and investment banks can be used in this manner, as can overdraft facilities and other loan stand-by facilities. Banks' capital base and prudential supervision by the Reserve Bank help establish each bank's credibility and the security of deposits. Greater depth in financial markets and lower transactions costs over the past decade have increased their capacity to provide an alternative liquidity management facilities for financial institutions and large companies.

3. *Saving and Credit Intermediation*

Not all of the liquidity balances maintained at banks are required by depositors at any given point in time. Thus, by virtue of aggregation, banks need only retain a fraction of these deposits in highly liquid assets and can on-lend the remainder at a longer maturity than the underlying deposits. An important economic benefit from this asset/liability maturity transformation is more productive investment.

Banks' deposits are also used as an outlet for savings, especially by households. Savings deposits increase the base from which banks can provide credit to government, business and individuals. Trading banks have large branch networks that have traditionally given them an advantage in the deposit market, especially in the retail area. Investment and merchant banks rely mainly on the professional and offshore markets for their funding.

There are significant economic benefits to this. Banks offer specialisation and scale benefits that translate into more economic information gathering and assessment systems, with information internalised and costs spread amongst all bank clients. The cost of finding projects suitable for loan financing and verifying their worth is reduced, as are the subsequent costs of loan monitoring and enforcement. Put another way, credit intermediation transaction costs in the economy are reduced. In addition, bank specialisation in credit intermediation improves the accuracy of credit pricing, as reflected in loan interest rate margins. These factors transcend into a better economic performance.

Notwithstanding the advantages of banks, the existence of active securities markets means that direct lending (for example, through the bond market) is still optimal in some circumstances. An important difference between bank loans and securities is that the former are largely non-marketable, while liquidity is a key attribute of securities. A stylised fact is that large entities with strong credit ratings dominate the market for debt securities. Scale factors are influential. Small companies are not rated by credit rating agencies and they would issue insufficient securities to meet market liquidity requirements. Lower investor search, verification and monitoring costs for large companies (derived from their established reputation), together with the liquidity premium, enable them to borrow more cheaply in securities markets.

The equity market complements bank loans and debt securities by providing companies with access to equity funding and investors with the opportunity to participate in projects on a profit sharing basis. More recently, it has provided a valuable means for the government to divest itself of commercial enterprises, leaving these institutions better placed to access capital and with the potential of significant efficiency gains. This provides companies with a source of stable funding and greatly broadens the range of investments available to investors.

Stockbrokers and investment banks are the key players through which investors and companies access the equity and debt security markets. They are not intermediaries in these markets because they do provide capital directly from their balance sheets. However, they provide the back-up services, from advising to underwriting, and make the critical link between investors and companies raising capital.

4. *Risk Management*

Derivatives are vital risk management tools because they facilitate the trading of risk, including hedging, so that risk is transferred to those entities most willing to hold it at the market price. For example, importers and exporters can exchange their future foreign exchange commitments on the forward market and increase certainty for each. In contrast, on-balance sheet products, like loans and deposits, are ill-suited for active management of risk arising from changes in the market price of financial instruments.

Derivatives have many economic advantages at both the microeconomic and macroeconomic levels. For example, they increase the awareness of risk and its price transparency, improve the accuracy of risk pricing (especially for that embedded in financial products), facilitate the re-configuration of product and project risk profiles and can provide greater certainty for investment. By improving certainty, the need for cautionary balances is reduced and the life of physical capital investments can be extended. The full value of these benefits is rarely appreciated in full. The net benefit from derivatives is reduced by the cost of establishing suitable management control systems for them.

Derivatives are largely provided by the treasury operations of the larger trading banks and by the investment banks. The latter provide greater depth to the markets and are particularly important as niche market players for certain products and at the innovative edge of the market spectrum.

2.2 Different Investors and Different Product Risks

The nature of the risks associated with financial products varies considerably; for example, market linked investments, like shares and unit trusts, are different from bank deposits, which guarantee return of capital to the investor. In addition, there are different types of investors; the extremes are sophisticated investors who have a professional understanding of financial products and retail investors who are unsophisticated and much less informed and skilled. Both factors must be recognised in the design and implementation of market regulation.

To illustrate the product differences, consider equity shares and deposits. Equity shares are 'direct' market investments on which the investor absorbs the full market risk of the investment. This includes risk from general share price movements and idiosyncratic company risks. Unit trusts provide investors with a facility to access the equity market on a low cost basis, by utilising scale economies, and have the same basic risk qualities as direct shares investments.

In contrast, bank deposits entail much lower risk from an investor's perspective, as bank capital absorbs the credit risk from the loan that provides the income stream supporting the attendant interest payments. Of course, banks do go broke, but the nature of market governance and prudential regulation (especially depositor protection mechanisms) is such that these events have been rare and depositors recoup the bulk of their funds. Financial regulation must recognise the different risk characteristics of products.

Financial instruments involve elements of uncertainty, leverage and future commitment. Thus, by their nature, they can be quite complex. The users of the financial sector are financial institutions, governments, the corporate sector and individuals. They each vary in character, have different levels of financial acumen, skill and resources for analysis. In general, financial institutions, governments and large companies are the most financially sophisticated and require least supervision. Small business and individuals are least well placed to understand

and efficiently use complex financial instruments and are excluded from wholesale markets, like that for over-the-counter derivatives. It is impossible to make a clean distinction between sophisticated and unsophisticated entities, as there are many shades of grey between the two extremes. However, there is sufficient clarity to recognise in regulation the different protective needs of different groups.

Therefore, the need for explicit consumer protection varies with the type of product and the type of financial instrument being purchased and with the sophistication of the user. For example, market linked investments entail a much higher level of risk to investors than do bank deposits. Meanwhile, professional investors are much better equipped to assess these risks than is the average householder. In view of this, it is vital that financial sector regulation takes proper account of the risk associated with each product and the consumer's need for protection. Disclosure of risk to investors is important in this regard, but the investor must take ultimate responsibility for their decision.

Consumer protection is a vital aim of financial regulation, but perhaps its key objective is elimination of systemic risk. The low risk feature of bank deposits is critical to support the payments system, as holders of liquid balances require secure rapid access to the full value of their deposits. An efficient payments system is vital to the smooth operation of the economy. Tight regulation of the payments system to maintain its integrity and avoid economic disruption is a consequence of this. In practice, implementation of financial regulation extends well beyond the direct controls on the operation of the payments system. The breadth of financial regulation and the principles that should guide it are discussed in detail in Part 3 of the submission.

2.3 Summary

The financial sector produces a range of inter-related services. All participants in the economy, from governments and large corporates to small savers, utilise and benefit from them. The economy would not function properly in the absence of an efficient financial sector. Therefore, it is essential that the correct regulatory and tax framework is put in place to generate and sustain an efficient financial sector. Domestic and international experience clearly demonstrates that the financial sector works best if market forces direct it, subject to modest regulatory checks. The Campbell Report recommendations addressed many of the regulatory and tax problems that existed at the beginning of the 1980s. Most were implemented with a good degree of success. However, significant impediments to the achievement of a truly efficient financial sector remain. These issues are dealt with in Part 3.

3. The Role of Investment and Merchant Banks

Investment and merchant banks are largely foreign owned, so analysis of their role in the economy also serves as a review of the economic contribution of foreign banks. For ease of exposition, this group is referred to as investment banks in the remainder of the submission.

Investment banks play a vital role in the operation of the financial sector. They are primarily involved in wholesale banking and the financial markets. This covers a broad range of activity including traditional credit intermediation, securities, foreign exchange and derivatives trading, investment management, corporate advisory services and stockbroking. In addition, the competitive stimulant that they have injected into the financial sector has provided significant benefits to retail consumers of financial services.

Investment banks are defined as a group by the range of financial services that they provide and are structured as both licensed banks and money market corporations. They differ from the large trading banks, state banks and regional banks in three important respects:

1. Their direct involvement in retail banking is small; their client base is mainly companies, financial institutions, governments and foreign entities (termed the ‘professional market’);
2. They offer a range of specialised products and services that are focused towards the professional market;
3. Nearly all are foreign-owned, which in part explains their small level of retail business.

There is no ‘model’ investment bank, as many offer specialist products and services. Rather, as a group, investment banks service the financial needs of the corporate sector, government and other financial institutions. As with other institutions in the financial sector, the investment banks have modified the character of their business over the past decade. Reflecting their innovative character, investment banks adapted to changing market conditions and actively sought out new opportunities. More recently, this has extended to segments of the retail market, where investment banks have both directly and indirectly stiffened competition and generated significant benefits for retail consumers. The economic contribution of investment banks since deregulation is considered in more detail in section 4. Firstly, a profile of investment banks and their operations is given.

3.1 Origin of Investment Banks

The evolution of investment banking in Australia is very closely tied with the entry of foreign banks. At the time of the Campbell Inquiry, foreign bank representation was restricted to two foreign owned bank groups,² which had limited branch representation. These had been established before the long standing prohibition to foreign bank entry. Foreign bank participation in the Australian financial markets was restricted to correspondent relationships with Australian banks, offshore lending through representative offices and ownership of merchant banks. These were largely unregulated and had managed to gain a small but

² Bank Nationale de Paris and Bank of New Zealand; both government owned.

increasing share of the banking market. In the late 1970s, the merchant banking sector accounted for about 5% of financial intermediary assets.³

The Campbell Committee recommended that the Australian banking market be substantially opened to foreign banks in a managed fashion. In 1984 foreign banks were invited to apply for bank licences. There were 42 applicants, of which 16 were accepted (somewhat more than was anticipated by some successful applicants). Thus, began investment banking in its modern form.⁴ In addition, Macquarie Bank emerged from Hill Samuel's operations in 1995.

The financial sector was opened to foreign banks with one key objective; to provide an immediate increase in competition in banking. It also served to rationalise the operations of non-bank financial institutions in the market, by formally making them banks and subject to banking controls. Perceived benefits to greater competition included efficiency gains, lower transactions costs, innovation and better servicing of consumer needs. It was anticipated that foreign banks would gain a sustainable foothold in both the wholesale and retail banking markets.

After a difficult beginning, the foreign banks have successfully adapted to the Australian banking conditions and make a substantial contribution through their competitiveness, innovation and natural international linkages. The required retail experiment by the initial entrants were unsuccessful, with the notable exception of Citibank which is a leader in the provision of sophisticated retail banking products and services.⁵ Foreign banks as a group have paid their dues and operate efficient and profitable businesses. Their role in both wholesale and retail banking has increased markedly in importance in the 1990s. Foreign banks with a full banking licence held 15% of bank assets at mid-1996. Money market corporations, a large proportion of which are foreign merchant banks, held an amount equivalent to 8% of total bank assets. By the nature of their business (outlined below), foreign banks earn a relatively high proportion of fee income, so asset based measures understate their share of business within the financial sector.

Employment by IBSA members, who account for the bulk of the foreign bank sector, was 9,400 at mid-1996. This represents a 30% growth in employment (adjusted for membership changes) over a three year period. When a specific skills need is identified that cannot be met locally, the foreign banks utilise the resource base of their parent bank. This is a useful method of transferring overseas expertise to Australia, which benefits the financial sector as a whole. In the year 1995/96, foreign banks brought 60 specialists to Australia under the IBSA Labour Agreement, on a short-term basis (two to four years).⁶ These account for only a small proportion of members' total employment (1.5% at the beginning of 1996).

3.2 Operating Structures

³ Edey and Gray (1996), *The Evolving Structure of the Australian Financial System*, Reserve Bank of Australia, Conference on the Future of the Financial System, July.

⁴ Merchant banks had contributed to economic development, for example, through financing of mineral projects in the 1960s.

⁵ The Reserve Bank required the new banks to offer some form of retail operation; evidence to the Martin Review (paragraph 10.6), reported in *A Pocket Full of Change - Banking and Deregulation*, House of Representatives Standing Committee on Finance and Public Administration, AGPS, November 1991.

⁶ The Labour Agreement was developed jointly between the Department of Immigration and Multicultural Affairs, the Department of Employment, Education, Training and Youth Affairs and the Australian Council of Trade Unions, represented by the Finance Sector Union. The Agreement enables temporary entry of specialist banking professional to Australia to meet identified skill shortages.

Investment banks operate either as licensed banks or as ‘merchant banks’ (otherwise called money market corporations). Initially, foreign-owned banks that held banking licences operated as a subsidiary of the parent bank.⁷ In December 1992, the government adopted in legislation the recommendations of the 1991 Martin Review and authorised the issue of bank licences to foreign banks who wished to operate as a branch of the parent bank.⁸ Foreign banks had lobbied for the right to operate as a branch and the motivation for the policy change was a desire to further increase competition in the financial sector. Whereas the initial opening of the banking market to foreign banks had retail market competition as one key target in its sights, expectations for branch banking were much more focused towards competition in the treasury and corporate finance markets. Overseas Union Bank from Singapore was first to receive authority to trade as a branch, in April 1993.

A majority of foreign banks operate in Australia as branches, rather than as subsidiaries. Which structure the foreign-owned entity chooses to operate under depends on a range of factors determined by the regulatory and tax framework, as well as their individual commercial imperatives. Table 1 summarises some of issues, which are discussed below. Special arrangements facilitate the transfer of assets and liabilities between a foreign bank subsidiary or merchant bank and the branch to which it is being converted on a tax neutral basis (for example, assets can be transferred without incurring stamp duty and capital gains can be rolled over into the branch).⁹

Table 1 Consequences of Different Foreign Bank Structures

	Merchant bank	Foreign bank - licensed as	
		Subsidiary	Branch
<i>Prudential</i>			
Capital Requirements	x	✓	x
PAR/NCD Costs	x	✓	✓
RBA Reporting	x	✓	✓
Parent Guarantee	✓	✓	x
Bank Status	x	✓	✓
Audit	✓	✓	x
Retail deposits	x	✓	x
Depositor protection	x	✓	x
<i>Other</i>			
Capital	✓	✓	notional for tax
ESA account	x	✓	✓
Section 128F funding	✓	✓	x
Foreign tax credits	✓	✓	x

Notes: Merchant banks are structured as money market corporation. Source for some material is KPMG.

The granting of a banking licence authorises the holder to provide certain financial services in a manner that has significant commercial value. The most important of these is the right to

⁷ Exceptions are Bank of China and Bank of New Zealand (now operating as a subsidiary of National Australia Bank) which operated as branches, based on an authorisation that pre-dates the Campbell Inquiry.

⁸ This change was announced as part of the Government’s “One Nation” policy statement in February 1992.

⁹ This is achieved through the Financial Corporations (Transfer of Assets and Liabilities) Act 1993. Its aim is to place the branch in the position that the subsidiary would have been in, had the subsidiary not transferred its assets and liabilities. These arrangements were to expire at 22 December 1996, but are to be extended for another two years.

accept deposits from the public without the need to issue an accompanying prospectus. In addition, banks are supervised by the Reserve Bank, which provides depositor confidence in the security of their investment. (Foreign bank branches are an exception; they are prevented from accepting retail deposits and the depositor protection provisions of the Banking Act do not apply to them.) These features provide banks with access to retail bank deposits, which are a relatively cheap funding base for their operations and provide a valuable competitive edge to banks, especially in their payments and lending business. From the authorities' perspective, the privilege accorded is substantial and must be measured by reference to the need to maintain the integrity of the payments system, as discussed above.

Another benefit from acquiring a banking licence is the right to hold an Exchange Settlement Account (ESA) with the Reserve Bank. These are settlement accounts for transactions between banks and for transactions with the Reserve Bank. Holders of ESAs can issue cheques in their own name and participate directly in the cheque clearing and settlements system. Banks can also settle certain transactions on a same day basis and participate in the market for same day funds. Some non-banks had accessed this market through their ownership of authorised money market dealers but with the advent of Real Time Gross Settlements (RTGS) the dealers have been terminated and this avenue has been closed.

A market for intraday funds seems likely to develop when RTGS is introduced in late 1997 and non-banks may face significant charges for the use of intraday funds to meet shortfalls in their liquidity during the day. Holders of bank licences will have access to funds to meet liquidity through automatic repurchase facilities with the RBA. Non-banks face a further disadvantage in the RTGS environment, as they will have no control over the timing of their payments through the system and will be reliant on their servicing bank in this regard. These aspects of the RTGS are likely to increase the value of a bank licence.

Licensed banks are accorded special status in the financial and economic community, which has commercial advantage. For example, counterparty credit risk is lowered in loan, securities and investment transactions and this is recognised explicitly in the capital adequacy guidelines (see the Reserve Bank's Prudential Statement C1). In practice, this favours banks over non-bank financial institutions and the corporate sector, but does not discriminate between licensed banks and merchant banks. The special status of banks is ultimately reflected in a lower average cost of funds. Operating as a branch facilitates the use of one pool of capital for various activities, which can add to the depth of capital and to its more efficient use.

The main disadvantage of operating as a licensed bank rather than a merchant bank is greater regulatory oversight by the authorities. In particular, Reserve Bank prudential supervision conditions must be met and details of operations reported to the Reserve Bank. These include the requirement to place one percent of their total liabilities (less shareholder funds) as a non-callable deposit at the Bank, the requirement to observe a minimum risk weighted capital ratio, the requirement to hold at least six per cent of their total liabilities in the form of 'prescribed prime (PAR) assets. Also, a range of other controls on bank activities with respect to ownership, equity investment and business operations, amongst other things, must be respected. The extent of restrictions imposed by these controls varies and changes over time. For example, at present most banks hold well in excess of the required level of risk adjusted capital and as a matter of course would hold minimum levels of liquid assets. On the other hand, the capital adequacy weights are too rigid and prescriptive and non-callable deposits impose a major cost on banks, because they provide a very low rate of return (five percentage points below market rates).

Foreign-owned subsidiary investment banks that change their status to that of a bank branch benefit by being able to take advantage of their parent's balance sheet strength and draw on its capital and resources. This enhances their capacity to undertake certain types of business, allows banks to participate in more transactions and deals with larger exposures. The strength of the parent's balance sheet can also provide for a lower average cost of funds for banks. These provide an additional incentive for merchant banks to seek a branch banking licence in addition to those outlined above. However, the loss of access to retail deposits is a disadvantage faced by foreign licensed bank subsidiaries that convert to branch status.

A range of other factors affect the conversion decision, one of which is managerial control mechanisms. Parent banks of branches have greater legal and prudential responsibility for these entities, than if they were a capitalised subsidiary. As a consequence, the local entity tends to be subject to greater management oversight by head office. There are commercial advantages and disadvantages to this; for example, resourcing may be improved but operating flexibility may be reduced. This will be influenced by cultural factors that can vary across country of origin, as well as across individual banks. Therefore, the importance of these issues is not uniform across banks and the net balance is difficult to gauge from an industry perspective.

Perhaps the most important factor in evaluating the conversion decision is tax. Merchant bank and licensed bank subsidiaries of foreign banks that change their status to that of a branch face significant tax penalties in doing so. In particular, bank branches are denied access to funds that are free of interest withholding tax. As a consequence, some foreign banks conduct their operations through both a branch and a non-bank. The branch usually focuses on treasury activities, while corporate lending is conducted through the non-bank subsidiary (that can access funds free of interest withholding tax).¹⁰ This is an artificial and unnecessarily expensive structure that is contrary to the intent of increasing competition by opening the market to branch banking. The payment of interest withholding tax (at half the normal rate) on intrabank funding (from their parent or related entities) cannot be avoided by branches. In addition, a notional equity equivalent of four percent of *total* funds received by the branch is applied, so only 96% of interest paid is deductible for tax purposes.

Current Position

There were 19 foreign bank branches and 13 foreign bank subsidiaries operating in Australia at mid-1996, as shown on table 2. In addition, there were a large number foreign owned subsidiary investment banks trading as money market corporations (merchant banks), see table 3.¹¹ Some foreign banks maintain representative offices as a link between their Australian clients and their overseas operations. Representative offices cannot undertake banking business. The global trend towards bank mergers has reduced the number of foreign banks operating in Australia as both licensed banks and as merchant banks. For example, NBD and First National Bank of Chicago merged in 1995, Manufacturers Hanover merged with Chemical Bank in the early 1990s and Chemical Bank later merged with the Chase Manhattan

¹⁰ The branch must conduct all of the foreign bank's intermediation operations. The only exception is intermediation conducted by the subsidiary involving funds borrowed under section 128F of the Income Tax Assessment Act (funds free of interest withholding tax).

¹¹ There were 139 entities categorised as money market corporations at mid-1996, many of which were related through parent company ownership. Most money market corporations are owned by foreign banks, some of which also operate entities here as licensed banks.

Bank in 1995. Some foreign owned-bank operations have been taken-over by local banks; for example, Bank of New Zealand was purchased by National Australia Bank.

Table 2 **Foreign Licensed Banks in Australia**
(Assets \$ million at May 1996)

Foreign Subsidiary	Assets	Foreign Branch	Assets
Arab Bank Australia Ltd	181	Bank of America NT & SA	1,427
Asahi Bank	525	Bank of China*	2,141
Bank of Singapore (Australia Ltd)	863	Banque National de Paris	5,556
Bank of Tokyo Australia (Ltd) [#]	2,964	Barclays Bank Plc	1,363
Bankers Trust Australia Ltd	5,973	BOS International Australia Ltd	-
Hong Kong Bank of Australia Ltd	3,554	Credit Suisse	401
IBJ Australia Ltd	2,692	Deutsche Bank AG	4,693
ING Mercantile Mutual Bank Ltd	695	Midland Bank Plc	2,039
Lloyds Bank NZA Ltd	1,304	Morgan Guaranty Trust Co of New York	757
Mitsubishi Bank of Australia Ltd [#]	110	Overseas Union Bank Ltd	540
Natwest Markets Australia Ltd	3,116	Rabobank	-
Primary Industry Bank of Australia Ltd	2,525	State Street Bank and Trust Company	900
Standard Chartered Bank Australia Ltd	851	The Dai-Ichi Kangyo Bank Ltd	1,539
		The Chase Manhattan Bank NA	2,735
Foreign subsidiary and branch		The First National Bank of Chicago	596
Citibank Ltd	8,727	United Overseas Bank Ltd	507

Notes: # Bank of Tokyo Australia and Mitsubishi Bank of Australia merged at the beginning of April 1996. * Bank branch subject to depositor protection provisions of the Banking Act. Bank of New Zealand has been a NAB subsidiary since 1992 and NBD is merged with the First National Bank of Chicago - these are not listed in the table. Source: Reserve Bank of Australia bank list for end-1995, updated by IBSA. Assets data are from Table B10 of the Bank's *Bulletin*.

Table 3 **Principal Merchant Banks**
(December 1995)

Corporation	Total assets Dec-95 \$mn	Parent base	Corporation	Total assets Dec-95 \$mn	Parent base
BBL Australia	705	Belgium	McIntosh Securities	322	Australia
BNZ International Aust.	77	Australia	Merrill Lynch Int'l Aust	1,311	USA
BOT Australia	146	Japan	Mitsubishi Trust Aust.	986	Japan
BT Australia	1,517	USA	Mitsui Trust Finance	931	Japan
Cathay Finance Int'l	74	Taiwan	Nippon Credit Australia	983	Japan
County NatWest Aust.	685	Australia	NM Rothschild & Son	1,485	Switzerland
Credit Lyonnais Australia	971	France	Sakura Finance Aust	1,618	Japan
Daiwa Finance Australia	575	Japan	Sanwa Australia	1,605	Japan
DB Australia	3	Germany	Schroders Australia	1,077	UK
Dresdner Australia	1,573	Germany	Societe Generale Aust.	4,339	France
Fuji Int'l Finance (Aust)	1,636	Japan	Sumitomo Int'l Finance	2,041	Japan
Graham & Company	175	Australia	Sumitomo Trust Finance	1,230	Japan
IBJ Australia Corp.	19	Japan	Svenska Australia	80	Sweden
Hanil Finance Australia	323	Korea	Takugin Australia	115	Japan
Indosuez Australia	880	France	Tokai Australia Finance	1,204	Japan
JB Were Capital Markets	447	Australia	Toronto Dominion Aust	1,646	Canada
KEB (Aust.) Holdings	430	Sth Korea	Toyo Trust Australia	527	Japan
LTCB Australia	1,292	Japan	UOB Australia	142	Singapore
MBA Finance	4	Japan	Yasuda Trust	484	Japan

Source: Money market corporation data taken from KPMG's 1996 *Financial Institutions Performance Survey*.

Table 4. Typical Investment Bank Services

Corporate finance	Advice Debt and equity financing Other facilities	Mergers & acquisitions Project finance Infrastructure finance Structured finance Tailored loan facilities Syndicated loans Debt security issues Equity issues Offshore debt funding Leasing Trade finance Global corporate finance services Underwriting Guarantees, letters of credit etc
Money market	Deposit taking & cash management Trading Financing Derivatives	Arrangement, placement/distribution
Foreign exchange	Spot/forward/swaps Options and exotics	
Equity market	Advising Broking & trading Underwriting Equity derivatives Private client business	
Debt market	Advising Trading/market making Financing Fixed interest derivatives	Arrangement, distribution, underwriting
Electronic banking	Currency transactions Payments processing Documentation	
Payments	Standard facilities (cheques etc) Global custody & payments	
Securitisation	Debt origination Distribution	
Funds management	Retail Wholesale	
Commodities trading	Bullion Exchange traded derivatives Commodity hedging facilities	Local and global Local and global
Offshore banking	OBU	Lending (incl. syndication), guarantees, underwriting, advisory services, Foreign exchange and securities trading, Funds management
Economics	Macroeconomic research Sectoral analysis Client advice	
Retail banking	Deposit taking Mortgage lending Personal finance	

There has been a firm movement away from subsidiary bank and merchant bank operations to branch banking since this option was opened in 1992. The introduction of RTGS could reinforce this trend over the next few years. However, the current interest withholding tax arrangements are a major impediment to banks changing their status to that of a branch. Allied with the other costs of becoming a licensed bank, especially the penal interest rate paid on non-callable deposits, this presents an unacceptably high entry barrier to full licensed banking for many merchant banks.

3.3 Operations of Investment Banks

Investment banks provide a broad range of financial products and services, as shown on table 4. Their primary business involves investment and capital raising (or savings/intermediation) and risk management activities. They also offer specialised liquidity management facilities and payments delivery mechanisms. Some investment bank activities are conducted through subsidiaries for regulatory and commercial reasons; for example, many investment banks own stockbrokers and funds managers. The business of investment banks is now briefly reviewed.

3.3.1 Corporate Finance

Corporate finance is a business area in which investment banks have particular specialist skills and are market leaders. The investment banks have been particularly innovative and have developed a comparative advantage over other financial institutions. This business forms the core of investment bank operations. It extends well beyond credit intermediation, to cover a broad range of both advisory and financing services and services a range of corporate and government clients. The nature of this business requires the banks to work closely with their clients in developing solutions to meet their specific needs.

Investment banks are an important source of finance to the corporate sector, through loan facilities that are tailored to individual corporate needs and as holders of securities issued by companies. As shown above on tables 2 and 3 above, their asset base is substantial and the bulk of this is accounted for by lending to the corporate sector. In addition, investment banks facilitate the raising of debt and equity finance by companies through the capital markets.

On the advisory side, the banks provide a range of technical and financial expertise, covering banking, accounting, taxation, law, engineering and business consulting, amongst other things. Through a combination of these services, they contribute to their clients' business development. For example, investment banks provide strategic advice to bidders and targets involved in mergers and acquisitions, formulate restructuring plans for business, assist in liability management, design equity and debt financing programmes, undertake risk assessments and evaluate project and infrastructure developments, amongst other things. The advisory business is often combined with direct and indirect financing of the underlying projects. There are important synergies across banks' business areas and units in this regard; stockbroking subsidiaries, capital markets divisions and corporate advisory divisions can all be involved in a single piece of business. In many instances these synergies extend to inclusion of the foreign parent of the investment bank, especially in organising finance and the placement of securities.

Project finance has traditionally been a significant part of investment banks' business, reflecting the importance of the resource sector to the economy. This market was an entry point to banking for many of the original merchant banks in the 1960s and 1970s and the current set of investment banks have built on their experience over the years. The primary commodities

sector is central to the economy, accounting for 60% of merchandise exports, and investment banks fulfil a vital role by servicing their financing and risk management needs both at home and abroad. Investment banks offer a range of specialised services; for example, they provide a comprehensive range of risk management services including the design of sophisticated hedging programmes and the provision of instruments like commodity swaps and options. The competitiveness of Australian banks in commodity hedging (especially bullion) is illustrated by their relatively high share (8%) of global trading in OTC commodity derivatives in 1995.¹² As in other areas of their corporate business, the investment banks utilise their foreign parent organisation to provide banking services to the resources companies, wherever they operate. In addition, they link local producers to the global commodity and capital markets.

Investment banks play a special role by servicing the banking needs of subsidiaries of foreign multinational companies that locate in Australia. This builds on established relationships between the parent entities and is part of the banks' global services. This depth of understanding reduces problems for establishing local operations for these entities, especially as they are less well known to the domestic trading banks. The investment banks usually have a more thorough understanding of parent companies' domestic conditions (for example, taxation) that shape multinational overseas business. Foreign direct investment in Australia rose from 17% in terms of GDP in 1980 (\$21 billion) to 28% in 1995 (\$125 billion). The rapid growth of foreign direct investment (in the region and globally, as well as in Australia) has increased the value of the investment banks in this regard. These links afford a useful tool in attracting foreign multinational operations, including regional headquarters, to Australia.

Table 5. Market Leaders in the Syndicated Loan Market 1995-96

Bank	Issues	Amount (\$US mn)	Market share
Westpac Banking Corporation	13	3,033	16.3
The Chase Manhattan Bank	13	2,563	12.1
Citibank	2	2,003	10.8
Bank of America	5	1,956	10.5
Commonwealth Bank of Australia	6	1,924	10.4
ABN AMRO	4	1,519	8.2
National Australia Bank	4	893	4.8
JP Morgan	2	750	4.0
Natwest Markets	2	730	3.9
UBS	2	714	3.8

Notes: *IFR Securities Data*, reported in the *Australian Financial Review*, 19 August 1996.

The market for corporate finance is very competitive, reflecting the range of banks (trading and investment, domestic and foreign) that participate in the market. To illustrate this, tables 5 and 6 present an overview of the main players in the syndicated loan and eurobond markets. Pricing in the market is very tight, driven by competition between the trading and investment banks and bond market, as an alternative source of finance. Individual investment banks typically tend to have specialist expertise in particular industries or with particular client types, so naturally a significant part of their business is concentrated there. In this regard, investment banks are able to draw upon, and feed into, their parent bank's international network on all aspects of corporate financing activity. This generates overseas business for the Australian entity, as well as competing for business here.

¹² Australia accounted for 3% and 1% of global transactions in OTC foreign exchange and interest rate derivatives, respectively. The Bank for International Settlements co-ordinated a central bank survey of foreign exchange and derivatives trading in April 1995, from which these figures are derived.

Table 6. Market Leaders in \$A Eurobond Issues 1994-95

Bank	Rank	Amount (\$US mn)
Hambros Bank	1	2,450
Nomura Group	2	2,155
Barclays Bank	3	1,189
Daiwa Securities	4	626
Nikko Securities	5	496
Deutsche Bank	6	361
Swiss Bank Corporation	7	314
Commonwealth Bank of Australia	8	307
ABN AMRO	9	246
Merrill Lynch	10	240
Yamachi Securities	11	186
New Japan Securities	12	120
Macquarie Bank	13	113
Hong Kong & Shanghai Banking Group	14	69
Dresdner	15	57

Notes: *IFR Securities Data*, reported in the *Australian Financial Review*, 3 August 1995.

◇ *Infrastructure Financing - A Short Case-Study of Investment Bank Innovation*

Private infrastructure finance is of more recent origin and is now a vital part of investment banks' business and an important means through which they contribute to economic development. The term infrastructure, as generally understood, covers the capital required to produce economic services from public utilities (like electricity, gas, telecommunications and water), public works (like roads, bridges and dams) and other transport facilities (like urban transit, seaports and airports). Good infrastructure provides key economic services efficiently, improves the economy's competitiveness, generates high productivity and supports strong economic growth. Private sector financing of infrastructure has the potential to lift both the *quantity* and the *quality* of infrastructure investment.

Private sector finance of infrastructure expanded rapidly over the past decade and this trend is expected to continue. Investment banks have been vital facilitators in this process by offering a range of services that includes project evaluation and design, arrangement and placement of securities, loan finance, the application of banks' specialist skills to facilitate development of new projects and improve their efficiency. For example, all of the bank advisers to the bidders for the \$2 billion sale of Yallourn power station in Victoria were foreign owned investment banks.¹³ In doing so, they provide considerable innovation in the organisation and provision of finance to meet specific problems encountered by promoters of private sector infrastructure projects.

Private sector involvement in the provision of infrastructure facilities and services emerged in the late-1980s, when State governments introduced formal procedures and controls on this activity. The Federal government introduced tax benefits for private financing of infrastructure through bond issues in 1992, though in late 1995 their application to road financing was terminated. The market was concentrated in New South Wales until 1994, when a range of

¹³ This was the first privatisation of a power generator in Victoria. The advisers included Bain & Co., County NatWest, JP Morgan, Salomon Brothers, SBC Warburg, UBS and Schroders. Reported in the *Australian Financial Review*, 11 December 1995.

private infrastructure projects across a variety of States (notably Victoria) was initiated. Projects were of substantial size and a large body of expertise has been developed over this period. The Economic Planning Advisory Commission (EPAC) *Private Infrastructure Task Force Report* in 1995 noted that private sector infrastructure accounts for 10 per cent of Australia's economic infrastructure and its share of *new* infrastructure investment is around 20 per cent.

Table 7. Examples of Private Infrastructure Investment

	Project	Cost \$ million
Roads	Sydney Harbour tunnel	750
	M5, M4 and M2 Motorways and Westernlink	over 1,000
	Southern and Western bypass, Melbourne	1,400
Rail	Pymont/Ultimo Light Rail, Sydney	60
	Airport rail link, Sydney	640
Water and Waste	Yan Yean Water Treatment Plant, Melbourne	35
	Macarthur Water Filtration Plant, Sydney	135
	Blue Mountains Sewerage Scheme, NSW	100
Electricity	Loy Yang Power Station, Victoria	1,400
	Yallourn	2,000
	Northern Power projects	40
Health	St Vincent's Hospital (Victoria) re-development	150
Corrective services	Junee Correctional Centre	50

Examples of private sector infrastructure projects undertaken in Australia are given in table 7. They cover the broad spectrum of infrastructure, including social infrastructure like hospitals and prisons, as well as transport, power and communications projects. Build-own-operate-transfer arrangements are the standard arrangement. The process of increasing private sector participation in infrastructure has not been without difficulty. Not all planned private sector infrastructure projects eventuated and practical problems like a lack of clearly defined government objectives and expensive tendering processes that vary across States emerged.

New participants entered the private infrastructure financing market as the supply of projects expanded and competition reduced profit margins. Australian investment banks are world leaders in some areas; for example, the world's first successful underwriting and placement of equity for a road project was built into the M2 Tollway financing structure. Banks are also heavily involved in raising debt through the bond market and take on some debt exposure themselves. Indeed, the maturity of bank debt available to finance infrastructure has lengthened as the market matured.

Private sector involvement in infrastructure development would not have evolved in the absence of investment banks advisory skills. These were embodied in strategic analysis, evaluation and financial modelling of projects, as well as tariff design, tax planning and liaison with the authorities. Infrastructure financing is a mixture of economic, legal, accounting, tax, engineering, mathematical and banking skills. Investment banks have placed considerable resources into the development of project finance teams that meet these criteria to a high standard.

A considerable pool of infrastructure projects suitable for private sector participation remains. In the future, banks are likely to increase all aspects of their involvement in infrastructure

financing. The role of other financial institutions and markets will continue to develop too. For example, superannuation funds, the natural source for long term funds, are entering the market and are likely emerge as important investors in the market. Investment banks have established infrastructure investment funds to meet their needs and promoted development of the market.¹⁴ Another example, is the potential for the bond market to provide a greater amount of infrastructure funds at longer maturities. This will depend partly on the Government's desire to promote the market's development, through both technical adjustments and policy measures.

3.3.2 Capital Markets

Investment banks are major players in both the primary and secondary domestic markets for debt and equity securities and have been an important impetus to market development. Primary market corporate business originates in part from corporate finance business, though banks operate in a variety of capacities in capital market issues; for example, as lead arrangers or as regular members of a tender panel. Again, synergies between stockbroking and international associates is important here. Capital markets business also covers short and long term debt issues by State and Federal governments. Investment banks are also active traders in the secondary markets for debt and equity securities.

On the other side of the intermediation coin, investment banks provide a range of investment services. This ranges from investment advice and other services provided by the bank itself, to funds management through associated entities. This category of business has increased strongly in recent years, but is not uniformly undertaken to a significant degree by all investment banks.

3.3.3 Risk Management

Derivatives now have a central place in financial activity. They include exchange traded instruments, like futures and options traded on the Sydney Futures Exchange and the Australian Stock Exchange, and instruments traded over-the-counter (OTC), like swaps, floating rate agreements (FRAs), options and exotics. The most actively traded derivatives are based on interest rates, foreign exchange, equity and commodities (like gold and wheat).

Investment banks provide a broad range of customised OTC derivatives to their corporate and government clients, as well as to other financial sector institutions. These mainly cover exchange rate, interest rate and equity exposures. In addition, as mentioned above, the banks play an important role in management of commodity risk. In some cases, these instruments are used to improve the quality of corporate financing arrangements; for example, a project loan may be linked with a commodity swap to reduce uncertainty of cashflows. Investment banks also participate, directly and indirectly, in the exchange traded derivatives markets, as traders, brokers, advisers and investment managers.

3.3.4 Transactions and Payments Services

¹⁴ For example, AIDC launched an Australian infrastructure growth fund marketed jointly with Commonwealth Funds Management to large superannuation funds in the first half of 1996. Similar investment opportunities have been offered by other investment banks.

Investment banks provide a range of specialist services that facilitate economic and financial transactions, including foreign exchange payments and custodial services. A recent survey by the Australian Society of Corporate Treasurers and KPMG found that foreign banks account for close to 25% of the corporate electronic banking market and provide a range of services, like currency transactions, payments processing, account information retrieval and trade documentation. Amongst the leading foreign banks were Citibank, Bank of America, ABN Amro, Chase Manhattan, Lloyds and the Hong Kong Bank. Table 8 provide an outline of some Australian dollar payments facilities offered by their payments packages. Similar facilities are available for foreign exchange. All products can facilitate intercompany payment transfers.

Table 8 **Electronic Banking Leading Providers**
Australian Dollar Payments Capability

		Form of Payment		Cheque outsourcing	Payment types			
		electronic	cheque		bulk	individual	same day	future dated
ABN Amro	Pay station	✓	✓			✓	✓	✓
ANZ	Online/Envoy	✓			✓	✓	✓	✓
Bank of America	WANDA	✓	✓	✓	✓	✓	✓	✓
CBA	DIAMMOND	✓			✓	✓	✓	✓
Chase	Chase Insight	✓	✓	✓	✓	✓	✓	✓
Citibank	Citibanking	✓	✓	✓	✓	✓	✓	✓
GE Information	EPAY	✓			✓	✓	✓	✓
Hong Kong Bank	Hexagon	✓	✓	✓	✓	✓	✓	✓
Lloyds Bank	DirectLink	✓			✓	✓	✓	✓
NAB	Flexilink	✓			✓	✓	✓	✓
St George	EBS	✓	✓	✓	✓	✓	✓	✓
Westpac	Deskbank	✓	✓	✓	✓	✓	✓	✓

Source: Electronic Banking Towards 2000, ASCT and KPMG, (advance copy, September 1996).

Investment banks as a group are not major players in the domestic retail payments system. There are some exceptions, notably Citibank which has a well targeted retail base. There are several reasons for this. Merchant banks are not permitted to hold ESA accounts at the Reserve Bank, while foreign bank branches are not permitted to take retail deposits. Most importantly, the large trading banks have a significant comparative advantage over investment banks in clearing and settling domestic payments, by virtue of their traditional position, large retail business (and related scale factors) and control of the institutional settlement systems.

3.3.5 International Banking and Offshore Banking Units

Australian licensed banks (and authorised foreign exchange dealers) can operate offshore banking units (OBUs) that benefit from concessionary tax rate of 10% on their profits from offshore banking. This regime was introduced in 1992, in response to industry submissions, and the OBU sector has gained a viable foothold and is still developing. Business conducted by OBUs is tightly defined according to the counterparty, which must be a non-resident and currency, which in some instances must be non-Australian dollar.¹⁵ The investment banks are leaders in the development of the OBU sector.

The investment banks service overseas entities, as well as the domestic economy, through a variety of mechanisms, in addition to pure off shore banking activities. Some banks serve as a

¹⁵ OBUs can trade in foreign exchange with residents, as long as Australian dollars are not involved.

centre of excellence within their parent bank's global and regional network and take a lead in the parent banks activities in specified areas; for example, in infrastructure and resource financing, commodities trading and funds management. Other banks service their parent entity more substantially by operating as regional headquarters and other less so by contributing as a normal foreign subsidiary or branch. This business contributes to the economy through foreign earnings, employment and other means and has great potential for the future. This issue is taken up in section 4.

3.3.6 Retail Banking

It has been noted that investment banks generally do not participate in retail banking. On the liabilities side, this is partly a consequence of regulation; the Reserve Bank does not permit foreign bank branches to accept initial deposits of less than \$250,000. This restriction is based on the Bank's responsibility to protect depositors under the Banking Act (Division 2) and its difficulty in properly supervising branches of foreign banks (great reliance is placed on home country supervisors) and managing their affairs in the event of a problem. A solution for foreign banks is to retain a capitalised subsidiary to undertake retail business along side the branch. To date, only one bank (Citibank) has elected to do this. Merchant banks must issue a prospectus to support deposits being raised from the public, except for selected money market deposits whose character is of a wholesale market nature.¹⁶

On the assets side, trading banks have had a significant comparative advantage over investment banks in the provision of medium and small business finance and personal loans. Extensive branch networks and strong customer relationships forged through the provision of payments services provided the trading banks with a deep reach into this market. This is now changing with the emergence of mortgage originators, many of which are linked to investment banks.¹⁷ This trend appears likely to spread across other categories of banking, like securitisation of loans to small and medium size business.

3.3.7 Summary

In summary, investment banks contribute to financial sector and economic performance in all of the key functional areas; savings, credit intermediation, liquidity management, payments and risk management. However, the orientation of their business is quite different from that of the trading banks and other financial institutions. Their core client base is the corporate and government sectors. Nevertheless, retail consumers and small business have also benefited directly and indirectly from the operations of investment banks. These aspects are discussed in the following section.

¹⁶ The exemption is given in the ASC Class Order 853.

¹⁷ Investment banks do not provide mortgage finance from their balance sheet, but rather facilitate the link between borrowers and investors, through trust arrangements (though they do hold mortgage security bonds).

4. An Evaluation of Financial Sector Deregulation

The primary objective of financial sector deregulation was to improve the efficiency of the financial sector and through this to lift economic performance. In the 1970s, the financial sector was subject to a high level of control by the authorities, which was perceived to be the cause of several operational deficiencies. The financial sector was not free to function in important areas; notably, it could not independently set either the price or volume of credit in the economy. Retail interest rates were tightly regulated and yields on government securities were largely controlled and quite insensitive to market forces. Bank lending was subject to various credit guidelines and controls and was constrained by banks' resource base. In particular, bank allocation of credit between government and the private sector was heavily constrained; that is, banks were inhibited from their vital *capital allocation* function in the economy. The relative importance of banks in the financial sector was in a long term decline and non-bank financial institutions like building societies, merchant banks and finance companies, that operated outside of government regulation, proliferated.

This formed the backdrop to the Campbell Inquiry in 1981 and determined the key issue which the Inquiry had to address; regulation versus deregulation of the financial sector. A consensus emerged in the financial community that deregulation was the appropriate, indeed essential, course of action. The substance of the Inquiry's recommendations were adopted by government over the following decade and the financial sector has since literally been transformed. Investment banks were important innovators in this change, taking a direct role in the financial sector, and influencing the shape and behaviour of other financial institutions. The transformation was not easy and had significant associated costs, for both institutions (including investment banks) and the economy. However, the net impact was unambiguously beneficial. This is discussed below in more detail.

It is emphasised that financial deregulation was not the only factor in this regard, but it was a vital catalyst. Globalisation and technology were important too and it can reasonably be argued that these factors would have inevitably caused financial deregulation, though most certainly in a less organised and ordered fashion. In short, external forces would have forced the Government's hand on deregulation and the contribution of the Campbell Inquiry was that it made way for a managed response that was least disruptive. The current Inquiry has a somewhat similar, if more explicit brief, to place the financial sector in the best possible position to take advantage of the ongoing impact of these factors.

While the Campbell Inquiry represents a critical point in financial deregulation, and was the major advance since the war, the process of deregulation had in fact been evolving slowly over the previous decades. There has been a long term shift in common intellectual thinking and the philosophical approach to government policy in favour of market driven solutions. The current Inquiry is part of this continuum. The Inquiry's focus on efficient and effective competition in the financial sector, as a means to develop the sector and improve its economic contribution, is significant in this regard.

It is clear that financial deregulation took place in a climate of ongoing change. Therefore, in assessing the contribution of the financial sector, it is important to measure the current sector against that which existed in the 1980s, but also to consider where it might have ended in the absence of a managed programme of financial deregulation.

4.1 Macroeconomic Evidence on the Effects of Financial Deregulation

There is debate in the economics profession about the contribution of financial sector deregulation to economic performance. The balance of evidences favours a positive impact from deregulation, mainly by lifting the quality of investment, rather than by increasing the quantity of investment and saving. However, this evidence is largely based on developing country experience and on countries that moved from a small, government controlled and highly inefficient financial sector to one in which market forces have much greater sway. Thus, it provides only modest guidance for a review of Australian experience, as the financial sector here was sizeable and comparatively well developed prior to deregulation in the 1980s. Nevertheless, the underlying principles established in the debate provide a useful framework from which to work. Standard economic growth models suggest that economic growth is:

- Negatively related to financial transactions costs;
- Positively related to capital productivity; and,
- Positively related to the level of investment and the savings rate.

These propositions are all quite intuitive. Lower financial transaction costs reduce the amount of resources absorbed by the financial sector in performing its payments, intermediation and risk management functions. A higher level of investment (and savings to finance it) will increase output, as will better quality investment. A liberalised financial sector can lift performance under each of these headings. Competition between financial institutions lowers bank margins and fees and market determined interest rates properly reflect economic conditions and expectations, so that capital is more accurately priced. The latter ensures that savers are rewarded and that a proper benchmark cost for project investments is imposed. Thus, both the quantity of saving and investment should rise. The nature of financial deregulation in developed countries is such that there is a strong expectation that the macroeconomic influence will be most felt through investment productivity.

This suggests a rather simple test of the contribution of financial sector deregulation since the Campbell Inquiry. In practice, it is not so for several reasons. Firstly, financial sector deregulation was accompanied by a range of other policy measures like tariff reduction and microeconomic reform. Unfortunately, it is impossible to satisfactorily discriminate between the impact of different policy measures in empirical studies, so the specific impact of financial sector deregulation on savings, investment and economic growth is ambiguous. Analysis of this type is further complicated by the existence of short and long term policy effects and the difficulty is separating the impact of cyclical and secular developments in economic studies. Secondly, the complex operations of an advanced financial sector (like Australia's) and the nature of its interaction with the real economy is not sufficiently well understood and is not captured in formal economic models that are used to estimate the impact of financial sector development.

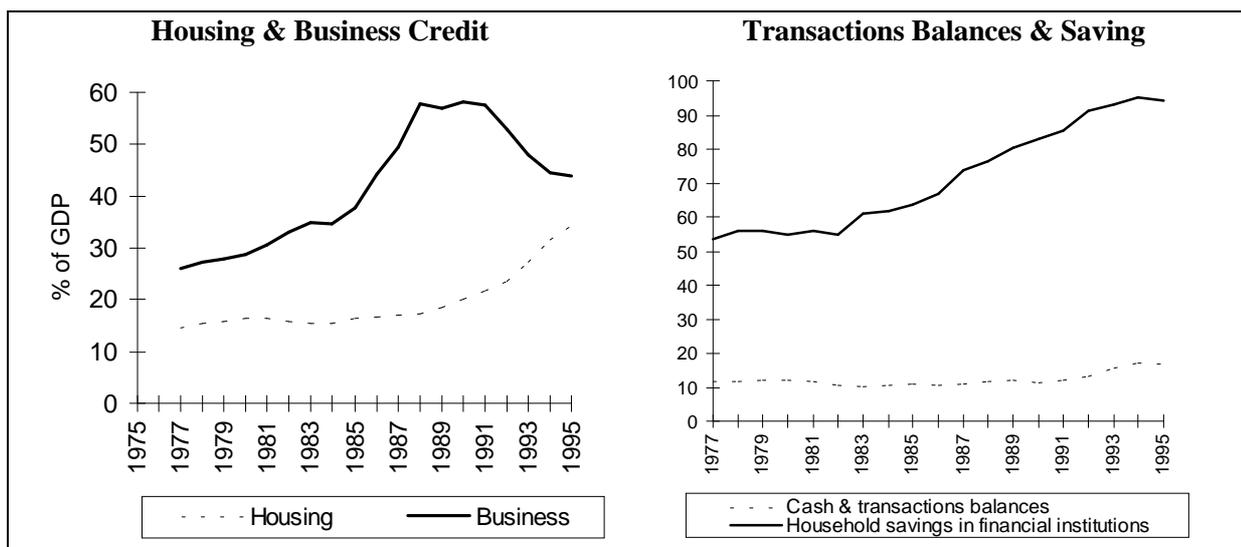
In view of this, it is necessary to evaluate the success of financial sector deregulation by reference to a range of intermediate benchmarks, selected to proxy the underlying economic impact. For example, if it can be shown that interest rates more accurately reflect economic conditions post-deregulation, this is taken as an unambiguously good outcome for the economy. This is an intermediate benchmark because the more accurate financial prices improve economic decision making (especially regarding saving and investment) and through this lift economic performance. Section 4.2 provides evidence across an important cross section of such indicators. This evidence suggests that financial sector deregulation had a

significant positive economic outcome. Further, the microeconomic evidence suggests that investment banks played an important role in delivering the benefits

Before moving to consider this micro-evidence, it is useful to briefly review the evolution of some key economic aggregates since the early 1980s. It follows from the above discussion that the direct impact of financial sector deregulation cannot be precisely identified. However, it should be possible to detect any extraordinarily beneficial or calamitous effects and the value of the analysis is limited to these parameters.

To set the scene, consider broad financial sector trends. The first point to note is that the financial sector ‘deepened’ following deregulation. That is household financial savings and credit to the private sector expanded in terms of GDP, as shown on figure 2. It is noteworthy that transactions balances (cash and current account balances) were broadly stable in terms of GDP. This suggests that the deepening that took place was related to credit intermediation and savings functions of financial institutions, rather than to their role in the payments system. The conclusion from this short analysis of balance sheet data is that the financial sector has taken up a much more important place in economic activity. Data on off-balance sheet risk management activity, proxied by derivatives, strongly support this conclusion.

Figure 2. Broad Financial Sector Developments - Credit & Saving



Data source: Foster & Stewart (1996), Occasional Paper no. 8, *Australian Economic Statistics*, Reserve Bank of Australia.

A second important development is that interest rates moved from being negative in real terms in the 1970s to being substantially positive in the 1980s and 1990s. This primarily reflects two factors; firstly, the upward adjustment in interest rates when that inevitably occurs when they are liberalised and, secondly, a return to lower inflation in the 1980s. Negative real interest rates for any sustained period do not make economic sense, as money has a positive time value. Therefore, it appears that the financial sector began to more accurately price capital post-deregulation. This is taken up in more detail in section 4.2.

Economic Growth

The evidence on economic growth is ambiguous. There is no evidence that financial sector deregulation either boosted economic growth, or reduced it, by a substantial amount. Therefore, it is unlikely that it had a significant impact on unemployment (which appears to have had a secular upward rise).

The rapid expansion of private sector credit from the mid-1980s did fuel the asset price inflation, which later caused problems for banks through bad loans and probably deepened the economic downturn at the start of the 1990s. This may be viewed as a problem of transition to the deregulated environment, similar to that experienced in many other industrial countries - in many cases with much more damaging consequences.¹⁸ Bankers had to develop new skills and expertise, as those that they carried from the 1970s are now inadequate.¹⁹ Policy makers initially did not adapt well to the changes either and reacted too meekly to the asset price spiral.²⁰ Given the initial boost to economic growth in which financial sector deregulation played some part, it is difficult to determine the net impact of financial sector deregulation.

On the other hand, benefits from financial sector deregulation, like wider product range, economic returns on savings and a better defined cost of capital, amongst other things, should be continued into the long run. There have been important gains in productivity in some areas, though how much of this can be attributed to a more efficient financial sector is uncertain, especially as financial deregulation was accompanied by a series of other micro-reforms.

Savings

The national savings rate was inadequate to service the economy's growth needs. A consequence of this was a sharp expansion in the national foreign debt during the 1980s. Financial deregulation did not solve the problem which had been building since the 1970s, but neither did it accentuate it.

International studies suggest that financial sector deregulation will only have a marginal direct impact on saving, if any at all. With deregulation, households receive positive real returns on their bank investment but are at the same time released from credit restrictions. These factors tend to offset each other. A variety of other factors come into play, including the age profile of society and its financial culture. Although savings may not have increased with financial deregulation, national welfare has risen as consumer choice and lifestyle flexibility were greatly enhanced.

¹⁸ See Bank for International Settlements Annual Report 1992 for some discussion of international experience.

¹⁹ Concepts like asset liability management and risk adjusted return on capital were central to operating successfully in the new environment.

²⁰ For example, see CMBF number 7, *Conference on Financial Stability*, Centre for Studies in Money Banking and Finance, Macquarie University.

4.2 Micro-evidence on the Effects of Financial Deregulation

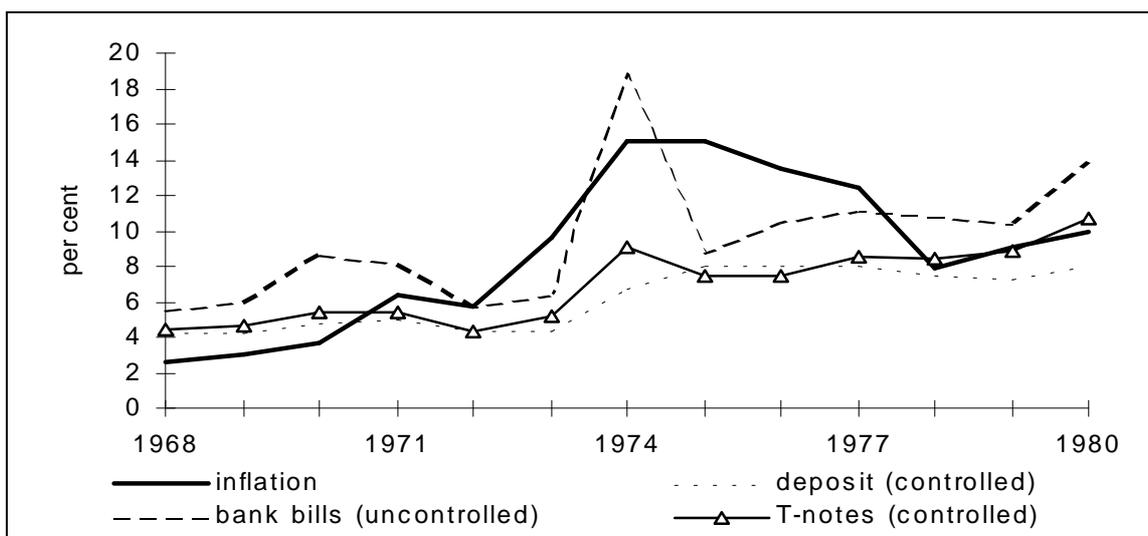
Analysis of the micro-evidence provides a more focused examination of the benefits (and costs) of financial deregulation, with more certain results. This covers key aspects of the financial sector's operations, identified by the Campbell Inquiry as requiring reform. This compensates for the difficulty in forming a view at the macroeconomic level and enables a firm judgement to be made on the net benefit delivered by financial sector deregulation. Attempts to evaluate financial sector deregulation usually tend to focus on too narrow an area, especially interest rate margins and similar consumer issues. This is too narrow a perspective on financial activity and the effect of financial deregulation to permit an acceptable economic judgement on its merit. Proper account must be taken of both financial institutions and financial markets and of the breadth of their respective services.

The approach here is to first examine the impact of financial deregulation on price signalling, transactions costs and product range, all of which have been identified as primary mechanisms through which financial sector deregulation can lift economic performance. This analysis embraces several important underlying issues, most notably competition. This is followed by an assessment of the effect of deregulation on the government bond, equity and derivatives markets and the consequences for the financial sector and economic efficiency. There is a tendency to overlook the contribution of these markets in an effort to assess the direct implications of deregulation for retail consumers. This misses an important part of the financial sector, that contributes directly and indirectly to consumer welfare. An advantage of this approach is that it also facilitates a closer look at the role of investment banks.

4.2.1 Interest Rates

Both retail and wholesale consumers of financial products benefited significantly from financial sector deregulation, because it produced market determined interest rates that much better reflected economic conditions than did controlled rates prior to reform.

Figure 3. Interest Rates in Australia Pre-Deregulation



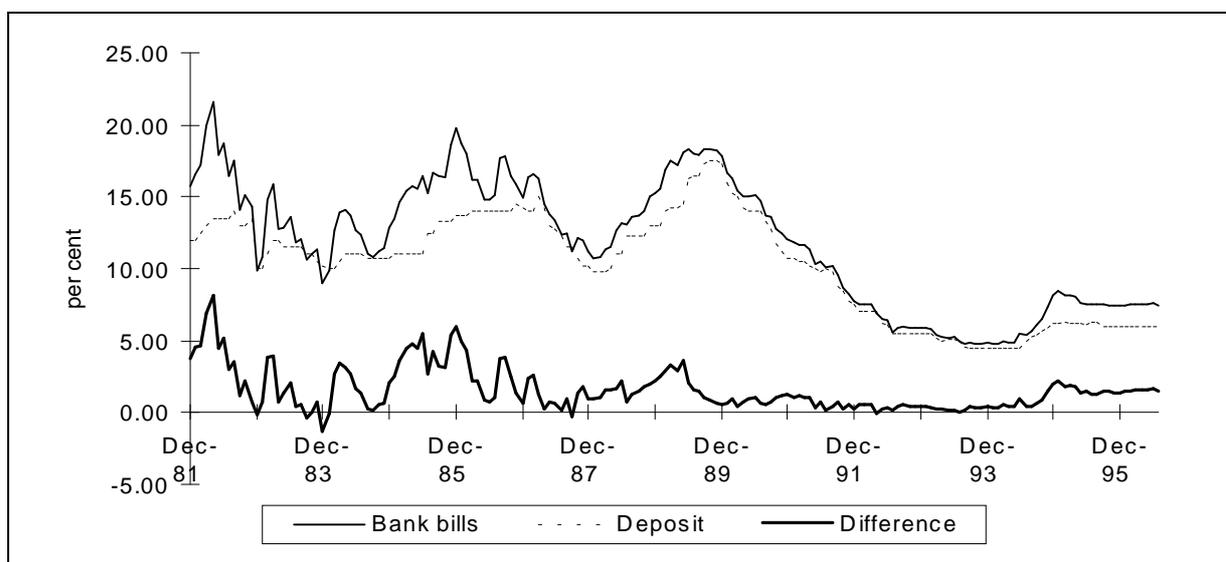
Note: Three month maturity investments; data are from Foster and Stewart (1996).

Consistent and accurate pricing of financial instruments are vital outputs from an efficient financial sector. Accurate interest rates reflect economic conditions and are particularly

important because of their pervasive impact on economic activity. An efficient financial sector produces positive real interest rates that reflect peoples' positive rate of time preference and growth opportunities in an economy. Negative real interest rates are usually a pernicious outcome of excessive financial regulation. In addition to being positive in real terms, interest rates should be sufficiently flexible to reflect changing economic expectations and conditions. For example, nominal interest rates should alter to reflect changes in expected inflation or, in other words, real interest rates should remain constant, other things being equal.²¹ Thus, both the level and flexibility of interest rates matters.

Interest rates in Australia in the 1970s, prior to deregulation, failed both these tests. They were significantly negative for sustained periods, which is in part a manifestation of their inflexibility at the time. This is illustrated in figure 3, which demonstrates that market determined bank bill interest rates much better reflected the upturn in inflation in the mid-1970s than did the controlled interest rates. In other words, the economic information content of market determined bank bill interest rates was much greater than the controlled rates, despite the general distortion caused by excessive financial regulation.

Figure 4. Interest Rates in Australia Post-Deregulation



Note: 90 day bills and three month term deposit interest rates; data are from RBA *Bulletin* databank.

Both wholesale money market interest rates and bank retail interest rates better track changes in inflation since controls were removed as a part of the deregulation process.²² Retail deposit interest rates had most ground to make up and recorded the most marked improvement, as illustrated on figure 4. This reflects two factors; the final removal of interest rate ceilings and greater competition in the financial sector. Cartel arrangements can preserve high interest margins and limit competition. Therefore, deregulation may not translate into efficiency gains provided by market determined interest rates that properly reflect economic conditions, unless the competition in the market is sufficient to push the market towards its true equilibrium. A

²¹ This is a little more complex than is presented here. For example, a significant rise/fall in inflation may change economic growth opportunities and therefore cause a change in the underlying real interest rate. This does not materially affect the analysis here.

²² The movement towards market determined interest rates was entrenched prior to the Campbell Inquiry, with significant easing of controls in the previous decade.

variety of factors came together to heighten competition in the market for deposits and improve interest rate signalling.

1. Competition between trading banks intensified, as they consolidated and prepared to take advantage of new funding opportunities and defend their existing deposit base.
2. Money market instruments provided competition for bank deposits, directly through CDs and bank bills and indirectly through cash management trusts (introduced by investment banks) that emerged in 1980.²³ Note the decline in the margin between bank bill and deposit rates on figure 4.
3. Investment banks indirectly increased competition in the market for retail deposits. Even where direct competition is difficult, contestable markets theory applies to place a limit on the difference between wholesale and retail interest rates. Stephen Grenville describes the process, thus:

“The prospect of licensing new foreign banks (even before this was formally done in 1985) forced banks to turn from asset management towards liability management, competing vigorously for deposits. The foreign banks, if they wished to break into the retail market, had no option but to bid up interest rates offered on those deposits which had previously paid below-market rates, and the existing banks responded defensively”²⁴

4. Money market interest rates benchmark for retail interest rates. Competition is important in this regard, but there are a variety of reasons for this. Money market participants are efficient at collecting, analysing and absorbing new information flows that affect interest rates, given their communications and analytical resources. They benefit from scale factors, cross market linkages and lower information asymmetry. This means that it is efficient for retail markets to follow the lead provided by the wholesale market. This is re-enforced by banks’ use of the money market as a source of banks’ marginal funds, which means that changes in market interest rates are passed on to loan customers to maintain profitability.

The speed at which retail deposit rates moved in response to changes in money market rates increased sharply after de-regulation. Thus, retail rates not only adjusted more substantially to money market interest rates but did so considerably faster than in the past. This also has important implications for the operation of monetary policy, by speeding policy transmission mechanisms. Indeed, a major benefit from financial deregulation, and the related development of the money, government bond and foreign exchange markets, is that it provided a means to implement monetary policy effectively through open market operations. Monetary operations are now more subtle, flexible and accurate. The benefits from this have not been quantified but are quite substantial in economic terms.

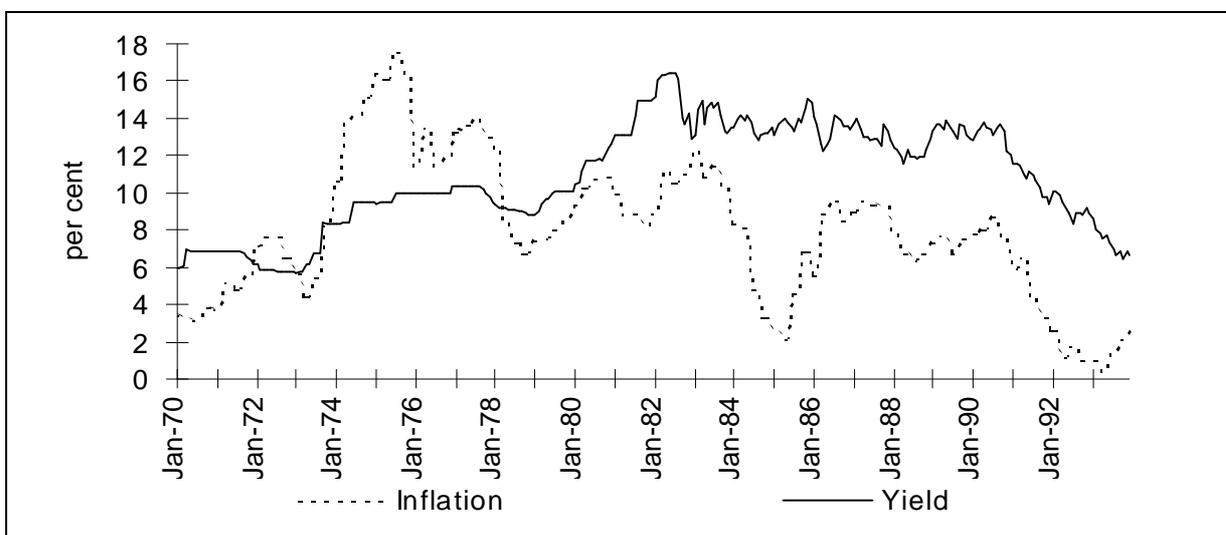
²³ The competitive edge provided by efficient money markets to a liberalised financial system is manifest on a number of fronts. By offering investors a market determined rate of return, it places a minimum to bank deposit rates, taking account of transaction costs that are affected by scale considerations. Similarly, bank loan interest rates are kept competitive. The market provides direct access to finance for large companies with a strong credit rating, at below retail costs. Thus, credit is allocated at a cost that better reflects debtor risk. Further, other financial instruments, like bonds and shares, are priced to take account of returns available from the money market.

²⁴ Stephen Grenville in “The Evolution of Financial Deregulation”, in *The Deregulation of Financial Intermediaries*, pages 3-35, Reserve Bank of Australia (1991).

While the link between the wholesale and retail markets was forged, another significant development occurred; Australia's economic integration with the global economy tightened considerably. This was in part a response to deregulation which opened the financial sector to much greater international influence, but other domestic and external pressures were pushing the sector in this direction anyway. As a consequence of this, domestic interest rates are now much more susceptible to changes in international economic conditions. Empirical evidence strongly suggests that domestic money market interest rates more closely follow international interest rates since deregulation than they did in the preceding decade. It can be concluded that money market interest rates in Australia are more accurate post-deregulation because they better reflect domestic and international economic conditions.

Government bond yields suffered a similar fate to retail interest rates prior to full liberalisation of the market, as illustrated on figure 5. This chart also vividly demonstrates the different character of financial price behaviour, once a market is liberalised. Staccato movements in yields in the controlled market are replaced by continuous yield movements in response to new information flows in the liberalised markets. In addition, yields were largely impervious to changes in inflation in the 1970s but show greater sensitivity post-deregulation. Not surprisingly, empirical analysis finds that the term structure of interest rates implied in the government bond market has much greater economic content now than it did before liberalisation. This is reflected in its much enhanced value as a predictor of economic growth and inflation. Economic benefit to this is increased by the use of market yields as a benchmark for setting interest rates that apply to other products, including retail loans and deposits.

Figure 5. Government Bond Market Yields and Inflation



Note: Data sourced from RBA *Bulletin* database.

Leaving aside arguments about the precise level of real interest rates, which cannot be unconditionally resolved, it is clear that the financial sector performed better post-deregulation on two important fronts:

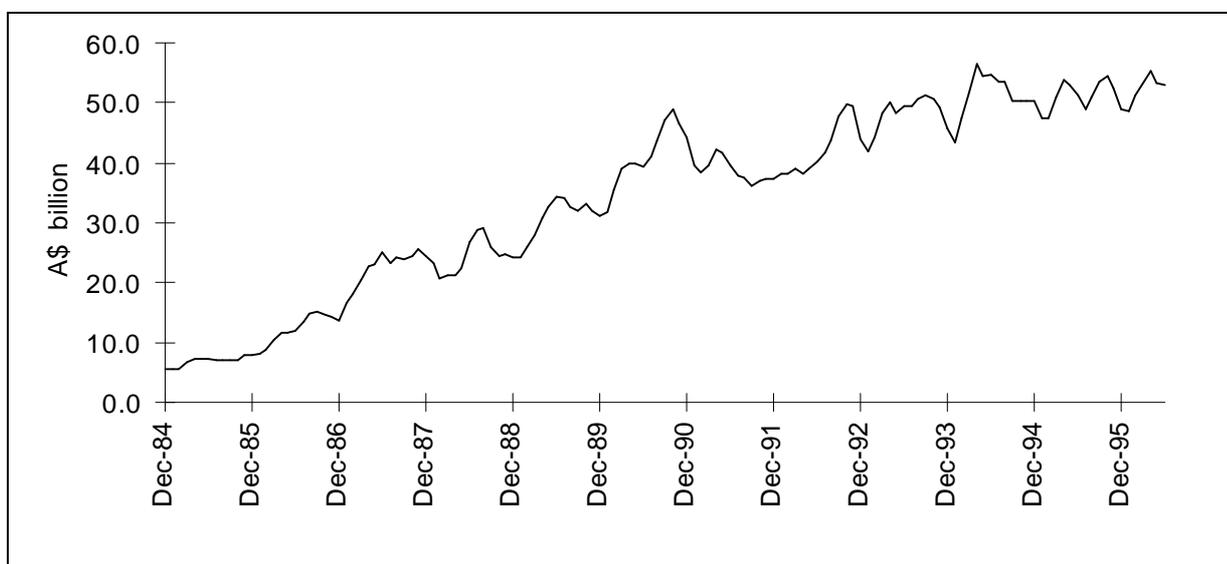
- The markets provide interest rates that are much more meaningful in an economic sense;
- Interest rates flexibly absorb new information; that is, they get to the right level faster.

Further, it is clear that investment banks contributed greatly to this process, both directly and indirectly. They heightened competition in the retail and wholesale deposit markets and participated as major players in the money and bond markets and lifted their efficiency.

4.2.2 Exchange Rates

Exchange rate determination is not discussed in detail here, but some important aspects should be noted. The floating of the exchange rate in 1983 marked a critical point in financial sector deregulation. In effect, the government's hand was forced by the market, through the pressure of foreign capital flows. The float had two important advantages; firstly, it allowed the market to determine the exchange rate, subject to management of transitory pressures by the Reserve Bank and, secondly, it improved the operation of monetary policy. Growth in the market's turnover took off following the float, as shown in figure 6. The market is deep enough to generate continuous market prices that reflect economic conditions and to be suitable for discreet policy related transactions.

Figure 6. Total Foreign Exchange Turnover - Australia



Note: Three month moving average. Swap component in aggregate data prior to 1990 is estimated. Original data are from the Reserve Bank's *Bulletin* database.

The float was consistent with the market orientated philosophy of government policy and acknowledged the market's ability to better determine the exchange rate level, or at least the authorities inability to stand in the market's way. On occasions the market exchange rate can diverge from the level warranted by the economic conditions, but over time it produces the right outcome. In contrast, the managed exchange rate regimes led to occasional build-ups of pressure, often driven by speculative flows based on expectation that became self fulfilling. As with interest rates, staccato changes in the exchange rate that were managed by the authorities, were replaced by continuous adjustment of the exchange rate to reflect new market information. The change in policy increased short term exchange rate volatility, but the market developed a range of new instruments (notably derivatives) to manage this risk.

The second advantage was that it allowed the Reserve Bank to implement monetary policy with a freer hand and with greater potency. With its exchange rate obligation removed, the Bank could manage foreign liquidity in accordance with its monetary policy objectives, rather than these being subservient to a primary exchange rate target.

4.2.3 Range of Products and Services:

Both wholesale and retail consumers benefited from an increase in the *range* and *quality* of financial services available at competitive prices. Greater competition in the financial sector generated a fundamental re-assessment of customer needs and related services and supported an upsurge in innovation. Product and service cross-subsidies were scrutinised in an effort to better define product costs and exploit areas of comparative advantage. The outcome of this was a vast array of new products that better and more cost effectively meet retail and corporate needs. These are separately considered below.

New Wholesale Market Products

Competition for corporate business intensified in the mid-1980s, when foreign banks were granted full banking licences. These investment banks introduced a range of new skills and adapted products from their home markets. Particular banks established specialised services and developed niche market products that filled market gaps left by the major trading banks. The trading banks themselves were committed to innovation and developed new products to service their corporate clients. By the mid-1990s, a broad range of new payments, financing, investment and risk management facilities were offered to corporates, through banks and the financial markets. Taken together, they offered many new opportunities and much greater flexibility to companies' in managing the full range of their financial affairs. The following are some illustrative examples;

◇ *Payments*

Electronic commerce offers a range of new payments facilities to banks' corporate clients, as outlined in section 3.3.4. An example of a recent innovation is the application of EDI (electronic data interchange) to financial payments. Financial EDI operates like an electronic cheque and allows a bank client to transfer funds directly to its counterparty's through the exchange of information through computers. There are many advantages to this including faster settlement, more efficient operations, greater accuracy and better cash management. There many other systems being developed to facilitate payments, not all of which are organised by banks or based on bank facilities. Foreign banks are especially active in the corporate electronic banking market and have developed PC based packages that assist in cash management and provide a range of other financial processing services.

◇ *Financing*

New financing instruments are available through both banks and the financial markets. Banks have developed an impressive range of new financing products; for example, specialist research and development loan syndication packages, operational leasing products and mechanisms to securitise company receipts. These satisfy financing requirements not previously met and/or provide more effective solutions to existing financial problems.

Financial markets have become more important as securitisation of loans previously taken from banks increased. For example, a commercial paper market has emerged to provide high quality companies with access to short term credit at a lower cost than bank facilities. The cost of commercial paper better reflects the high credit standing of these companies and the issue terms represent more accurate pricing of credit.

By applying innovation to traditional bank products and combining them with financial market instruments (especially derivatives) banks have been able to substantially improve the quality of loan products available to their corporate clients. Financial markets are better able to split risks like exchange rate, interest rate and commodity price risk than they were in the past and have adapted these techniques to match the financing profile that best meets their client needs. Innovation is ongoing and new products, like credit swaps, continue to emerge.

Another important aspect of corporate financing that warrants mention is significant borrowing on international capital markets, like the Euromarkets that emerged in the 1970s and 1980s. The Euromarkets and US capital markets are now an important source for corporate finance and the cross currency swaps market facilitates the transfer of funds raised into Australian dollars.

◇ *Risk Management*

Two events increased the need for more active risk management by corporates (and others). Financial deregulation brought about an increase in the volatility of nominal interest rates and exchange rates. In addition, more general deregulation across the economy, coupled with a related expansion of international trade and capital flows, meant that corporates faced a broader range of interest rate and exchange rate exposures, that were also significantly larger. In other words, both the variability of financial prices and the size of corporate balance sheets and cash flows exposed to these price movements rose. Financial innovation provided solutions to the resultant risk management problems.

The financial sector responded by improving the risk management capability of traditional products; for example, capped loans, more flexible debt raising and roll-over facilities were developed. In addition, a broad range of derivatives products was developed, including highly standardised exchange traded futures and options and customised OTC products, like FRA's, swaps and options, that are designed to meet specific customer needs. The splitting of risk through derivatives gave rise to an enormous range of new products; for example, a commodity swap can eliminate price risk for a mineral producer, or an interest rate option can protect a construction project from interest rate rises that would otherwise terminate it.

Innovation in risk management has not been restricted to product development. Indeed, in recent years much greater emphasis has been placed on development of more accurate derivatives pricing mechanisms and better risk management systems. This was in part a response to bank management concern about internal control of risk, after a series of high profile losses were reported. Banks use their research and development in this area to enhance the range of services available to clients. This ranges from computer software to price risk and determine exposures, to information systems designed to improve decision making.

Real innovation should not be confused with product differentiation through marketing. Both occur to a significant extent, but the former is most important from a finance industry development perspective. Innovation in risk management products has provided substantial real gains in the latter sense. These translate into real competitive advantages for Australian industry competing overseas, because these companies can better manage their risk than their competitors. For example, Korean manufacturers cannot hedge their currency risk, because they have neither the products required to do so, or the necessary risk management skills to effectively utilise them. In contrast, Australian manufacturers have a broad range of exchange

rate products to hedge their cash flows and borrowings. This does not eliminate the competitive impact of long term movements in exchange rates, but it does smooth out the impact of short term transitory movements and provides time to develop a strategic response to the changing environment.

New Retail Market Products

As well as providing greater access to personal finance, the financial sector has developed an enormous range of new products to the benefit of retail consumers.²⁵ This has enhanced both the choice of products available in all aspects of banking and the greatly improved quality of many of these services. Banks offered consumers new types of products, like EFTPOS and mortgage offset accounts, and better access to existing products, for example, through ATMs, telephone banking and emerging internet banking. More intensive competition (both between banks and within the financial sector more generally), technological development and innovation were the key factors driving these changes.

Non-bank financial institutions (some of which are associated with banks) also greatly expanded the range of products available to retail consumers. The key development on the investments side was the rapid expansion of superannuation funds and unit trust funds, especially since the mid-1980s. Household savings were increasingly directed more towards these outlets and household assets held by life insurance companies and superannuation funds rose from 21% in terms of GDP in 1980 to 56% in 1995. The main change on the liability side was the overhaul of the home finance market, with home loan originators capturing a significant share of the market in recent years.

Investment banks contributed by stimulating the competition that drove these initiatives, even though they directly provide services in only quite limited areas of retail banking. For example, Hill Samuel (now Macquarie Bank) established the first cash management trust in 1980 and Citibank introduced the cash management account to Australia in 1986 (the major banks did not offer these accounts until at least two years later). The investment banks have continued to selectively pioneer new retail products, like capped loan mortgages and direct payments systems. The major direct contribution by the investment banks in recent years has been in the funds management and home mortgage financing fields.

◇ Home Mortgage Finance - Securitisation

Financial sector deregulation led to a major shake up in the home financing market, that was manifest in the introduction of new lenders and new products, especially in the 1990s. The securitisation of home mortgages was the most important development in this regard. Investment banks (and their associates) were the key players behind these developments, which have delivered a wider range of better quality loans and lower interest rates to home borrowers. Table 9 provides an outline of the leading players in the market in April 1996.

Table 9. Market Leaders in Securitisation

Originator/Manager	Investment bank	Bonds sold (\$ million)
---------------------------	------------------------	--------------------------------

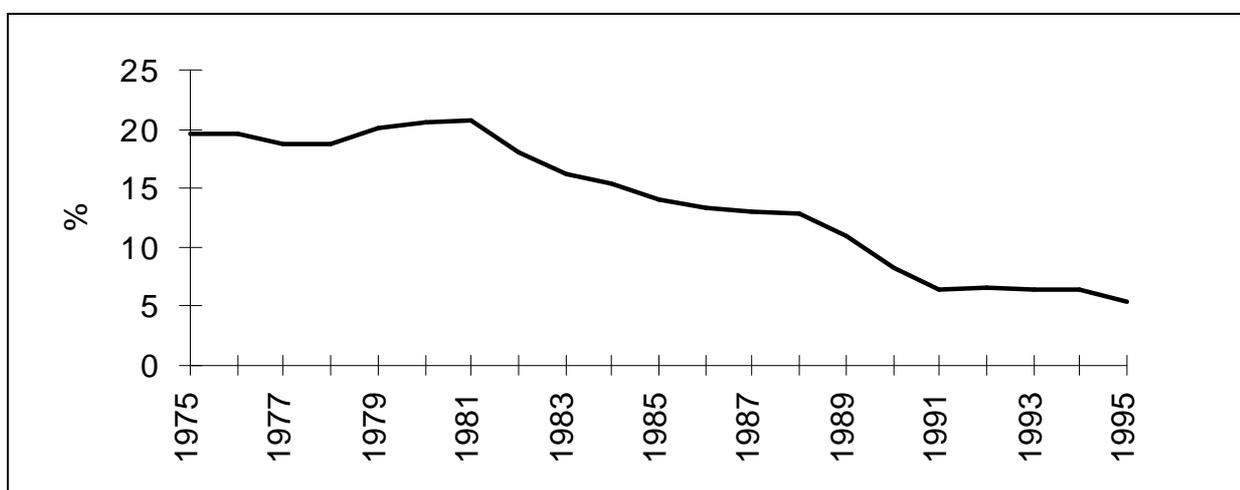
²⁵ The Australian Bankers Association submission to the Parliamentary Inquiry into the Australian Banking Industry (December) gives a detailed list of products developed between the early 1980s and 1990. Innovations since then include new credit cards, new direct payments facilities, smart cards and internet banking.

PUMA Management	Macquarie Bank	2,200
Mortgage Power & SAM Trusts	Citibank	1,200
Interstar	Private group	600
Rams	BT Australia/Private group	600
Waratah	(Trading bank - Westpac)	440
AMS	SBC	350

Information sourced from the *Australian Financial Review*, 23 April 1996.

Banks and building societies had a comparative advantage in the provision of home finance, because they had large branch networks and could fund home loans off a cheap retail deposit base, that was not available to investment banks and other financial institutions. A combination of greater competition that increased banks average cost of funds and lower inflation carved away this advantage. Cheap funding available to banks through non-interest bearing accounts declined sharply (see figure 7) and low inflation reduced banks' benefit from non-interest bearing accounts. Meanwhile, rates paid on interest bearing deposits were bid-up.

Figure 7. All Banks: Non-interest Bearing Deposits as a Percentage of Total Deposits



Data sourced from Foster and Stewart (1996).

This created an opening that was filled by mortgage originators; specialist institutions that market housing loans that are funded by security issues to the wholesale market (investors are mainly life offices and superannuation funds). The mortgage originators do not hold loans on their balance sheet but rather act like a sophisticated broker between the home loan borrower and the professional market investor. The originators identify and assess suitable borrowers and aggregate the resulting loans and package them in a manner that facilitates their issue as mortgage backed securities. This usually involves some form of trust arrangement. The originator, like a broker, does not bear the risk of the loans and therefore does not attract a prudential capital charge for them. The risk is absorbed by the investors in the securities and the mortgage insurers. The absence of a capital charge and cheaper origination fees (direct from consumers rather than through a branch network) provides a competitive opportunity for mortgage managers.

The home mortgage originators rapidly gained market share and accounted for around 4% of the housing finance market (or \$7 billion) in early 1996, compared with only 1% three years

ago.²⁶ House loan approvals data in mid-1996 show that other lenders (largely mortgage managers) hold 12% of the new loan market, which suggests that this trend will continue into the near future, at least. Home mortgage securitisation is much longer established in the US and originators account for a much greater share of the market. There are around 100 home mortgage originators, but the market is dominated by a small number of originators that are part of investment bank groups. This illustrates investment banks' capacity to innovate and increase competition to the benefit of retail consumers, despite their non-participation in the direct provision of consumer loans from their balance sheet.

There is strong evidence that the advent of mortgage originators has benefited consumers:

- Between mid-1994 and mid-1996 official cash rates were increased by 2.75 percentage points but banks standard variable rate home loan rate rose by only one percentage point.
- Consumer choice has been greatly expanded as banks introduced a range of new housing finance facilities, like 'no frills' mortgages, new fixed interest packages and 'honeymoon' in an effort to compete with mortgage originators;²⁷
- The abolition of mortgage stamp duty on re-financing by the NSW government from end-June 1996 further increased competition, by opening up the market for existing mortgages to much greater competition. Subsequently, the average interest rates on standard variable home loans charged by the major banks was reduced by 0.75%;
- Refinancing of home loans rose from 8% of home loan approvals in mid-1991 to 28% in mid-1996.

The Reserve Bank of Australia calculated effective interest rates to enable a proper comparison of the cost of home finance. Mortgage managers provided cheaper finance for all the categories of finance examined (see table 10).

Table 10. Effective Average Rates on Owner-Occupied Housing Loans

Loan type	Banks		Mortgage Managers	
	Advertised	Effective	Advertised	Effective
Standard variable-rate loan	9.9/10.5	10.4/11.1	9.2	9.7
Honeymoon loan	7.9	10.3	-	-
Basic loan	9.0	9.6	9.0	9.5
3-year fixed loan	9.6	10.6	9.9	10.1

Information sourced from the Reserve Bank of Australia *Bulletin* (June 1996, page 5)

Finally, it should be noted that mortgage securitised bonds enhance the investment product range by providing long term investment opportunities to superannuation funds, not otherwise available. This has additional merit in view of the likely reduction in the Commonwealth government's domestic debt portfolio over coming years.²⁸ This also has the beneficial effect of introducing new funds to the housing market.

²⁶ The home mortgage securities emerged through the State-sponsored home purchase assistance programmes, like FANMAC Ltd in New South Wales. These are of a different character to commercial loan originators.

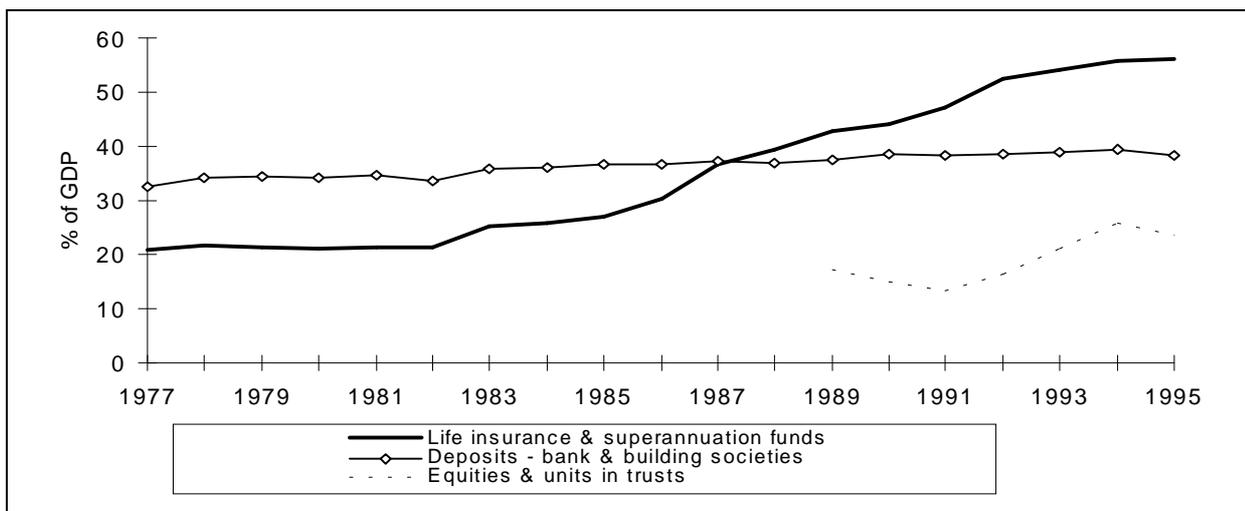
²⁷ Bob Joss of Westpac noted in his talk at the Australian Banking and Finance/Siemens-Nixdorf lecture series talk in July 1996 that in 1980 there were 26 different types of mortgages and now there are over 1,800.

²⁸ The nature of the problem was explored by the market at the end of the 1980s, when a shortage of top quality liquid paper was anticipated, following a series of Commonwealth government budget surpluses. In the event, large Commonwealth government budget deficits from the early 1990's necessitated the issuance of stock and the problem was avoided.

◇ *Funds Management*

The funds management industry has grown strongly since the mid-1980s and now has a much more important profile in the financial sector and the broader economy. Figure 8 shows that (gross) financial assets held by the household sector have increased and shifted away from deposits towards investments with market linked returns. This is an outcome of a combination of several factors including greater superannuation saving (stimulated in part by government policy), competition by unit funds for business traditionally held by banks, and effective marketing of their services by fund managers.

Figure 8. Household Saving - Sectoral Trends

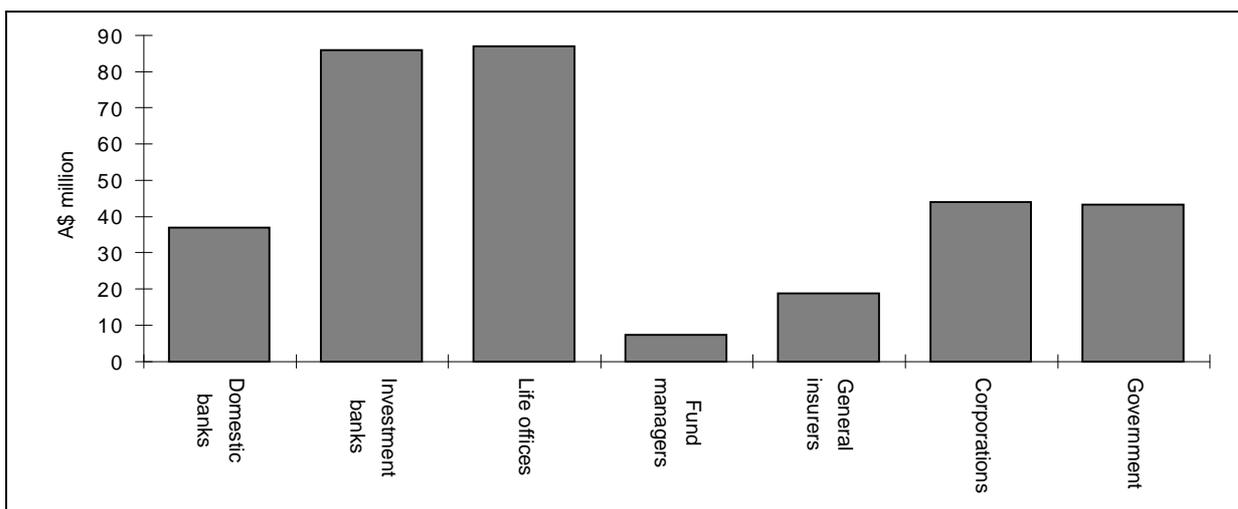


Data sourced from Foster and Stewart (1996).

The introduction of cash management trusts in the early 1980s was an important step in the development of the sector. A vast range of unit trust investment and superannuation facilities are now available and offer retail (and wholesale) investors the opportunity to invest in property, cash, fixed interest, equities, infrastructure debt, small business and commodities, amongst other things. These unit funds provide the retail investor with efficient access markets both at home and overseas.

Investment managers had a total of \$323 billion (71 per cent, in terms of GDP) under management at end-1995, of which \$8.6 billion was raised offshore and managed locally. Concentration in the market is low, with the top ten managers accounting for 56% of the market. Figure 9 provides an overview of the distribution of business between different categories of managers. Investment banks, through their funds management subsidiaries, account for a major slice of the market. Traditional players, like AMP, have been challenged by new entrants like BT Australia and Macquarie Bank, who are now amongst the market leaders. A broad range of investment banks are active in the market (six of the top twenty funds managers are owned by IBSA members). This has stiffened competition and broadened the range of options available to investors.

Figure 9. Institutional Share of the Funds Management Market at End-1995



Based on data provided by AIMA.

The ‘export’ of domestic funds management skills through the management of foreign investors’ funds through local fund managers is a growing source of income for these entities and the country. Australia has several advantages in this regard, including a strong skills base, a well developed financial culture and sophisticated local markets. There is great potential to expand this business, if a more committed approach is taken by government to selling Australia as an international financial centre.

Summary

Consumers not only have a wider choice of financial institutions but also have a substantially improved range and quality of financial products and services available to them since deregulation. Further, the general public are now much more sophisticated consumers of financial products than they were in the early 1980s. They are more demanding and better able to recognise and use new products.

Increased competition has required banks to re-examine cross-subsidisation and re-price some products. This leads to some confusion about the precise benefit to consumers, as some individuals gain and others lose in this regard. As a matter of economic efficiency, it is better that products are priced and the cross-subsidies are made transparent. This leads to a more optimal allocation of bank costs and services that ultimately is to the benefit of all consumers.

4.2.4 Transactions Costs

A reduction of financial transactions costs is a direct mechanism through which it is unanimously agreed that financial development, stimulated by deregulation, can improve economic performance. In simple terms, less resources are required to do the same job, or a better quality job is done for the same expenditure of resources. There is strong evidence that deregulation has delivered in this respect. There are several aspects to financial transactions costs that must be considered in making an assessment, including bank interest rate margins, direct fees and charges and indirect benefits.

◇ Bank Interest Rate Margins

The evolution of bank interest rate margins dominates much of the debate about transactions costs. They have been the subject of considerable research and analysis, and are likely to be a

significant part of other submissions to the Inquiry.²⁹ Therefore, it is not proposed to repeat the exercise here but rather to note some relevant points.

- Bank interest rate margins are not a perfect, or even necessarily good, guide to the cost of financial transactions for consumers, especially if they are not based on some form of average weighted interest rate;³⁰ bank fees, the effects of cross-subsidisation and quality of service must be taken into account to assess the latter, and this is quite a subjective matter.
- The evidence on net interest margins (the difference between average interest paid and average interest received) is that consumers benefited from a fall in interest rate margins from just over 5 percentage points in 1980, to 3.8 percentage points in March 1996.³¹ A further narrowing of spreads is expected, as the impact of the mid-year cut in housing loan rates feeds through into the average spread.
- Bank profitability and efficiency indicators are useful supplementary information in any assessment of the change in the cost of quality adjusted financial services. Various efficiency measures, like operational expense ratios, point to a significant improvement in banks' operational efficiency since deregulation.

The substance of the above comments suggests that bank customers have benefited from lower transaction costs since deregulation. Various factors were at play in determining this outcome but there is no doubt that greater competition, prompted by deregulation, made a significant contribution.

◇ *Financial Markets Transactions Costs*

The costs of transacting on financial markets have declined substantially since deregulation. Most participants in the financial markets are professional players (including large corporates), so the gain from lower transactions costs is passed on to consumers through lower fees and better returns. Retail investors do participate in some markets, or segments of markets (notably the equity market).

The overall cost of executing a transaction is the sum of commissions (often implicit in the bid-offer spread) and the price impact of the trade.³² Commission costs are readily observable, however, the price impact cost - the difference between the transacted price and the price that

²⁹ For example, see Reserve Bank of Australia, *The Deregulation of Financial Intermediaries* (1991), the proceedings of the Martin Review reported in *A Pocket Full of Change - Banking and Deregulation* (1991) and Professor Tom Valentine's "Bank Interest Rate Margins", Working Paper No. 22, School of Economics and Finance, University of Technology Sydney (1992).

³⁰ Interest rate margins at the optimal level provide for the efficient provision of financial services at a profit level that provides for a stable banking system. For example, negative interest rate margins have been recorded on occasions in some developing countries, in which cases the financial system has dreadfully failed its price signalling function (inevitably due to government intervention) and is inherently unstable.

³¹ These data refer to the major banks' interest rate spreads. See Reserve Bank of Australia *Annual Report 1996*, (page 40).

³² The price impact of a transaction is the amount by which a security price moves solely as a consequence of that transaction having taken place. For example, a bank may purchase \$100 million of bonds at the market price of 100, but have to pay 101 to purchase a second \$100 million tranche; the first deal having moved the market price. Thus, the price at which \$200 million is dealt is not the initial quoted market price of 100, but that *plus* the price impact, or 100.5 in total.

would have been in the absence of the trade - is unobservable, but can be large in thin markets. A measure of transaction costs is:

$$\text{Transaction cost} = 1/2 \text{ bid-offer spread} \textit{ plus price impact.}$$

Price impact is negatively related to market liquidity. Thus, a reasonable indication of market trading costs may be gained by looking at both the bid-offer spread and market liquidity. Efficient markets should have low bid-offer spreads and high liquidity. There is a strong correlation between turnover and the size of bid-offer spreads; the two are in many ways a composite measure of the efficiency of a market's information dissemination systems, regulations and technical operations.

Table 11. Financial Market Transaction Costs

	Bid-offer spread		Turnover (% of GDP)	
	1980	1995	1980	1995
Government bond market	25 bps	3 bps	9	325
Money market - bank bills	10-15 bps	3 bps	23	56
Foreign exchange	no change		200 (estd.)	2,815
	Commission		Turnover (% of GDP)*	
	1980	1995	1980	1995
Equity market				
- Professional deal	0.7	0.2-0.4	6	26
- Retail deal	2.6	1.0-2.0	-	-

Note: Turnover data are for the financial year and cover the physical markets only. * Both retail and wholesale. Spread and commission data are illustrative, as amounts vary by deal characteristic and market volatility at the time of the deal.

As shown on table 11, changes to both elements in the financial costs equation point to a substantial reduction in transaction costs on financial markets since deregulation. Direct charges in the form of bid-offer spreads and commissions declined, and turnover of financial markets, which is inversely related to the indirect price impact cost, rose sharply. The decline in trading costs is understated by this analysis as it does not take account of the impact of trade in related derivatives.

Derivatives reduce the direct cost of trading benchmark financial instruments (government bonds, bank bills, leading listed equity stock, etc) by lowering spreads and generating liquidity. Other financial instruments benefit indirectly too; for example swaps are a means to trade illiquid bonds, without suffering the usual high price impact of such trading. Derivatives are perhaps of most benefit in portfolio management trading, like short-term timing and asset allocation trades. Used in this manner, they can substantially reduce the transactions costs of portfolio or index trading - often by a factor of *ten* or more.³³

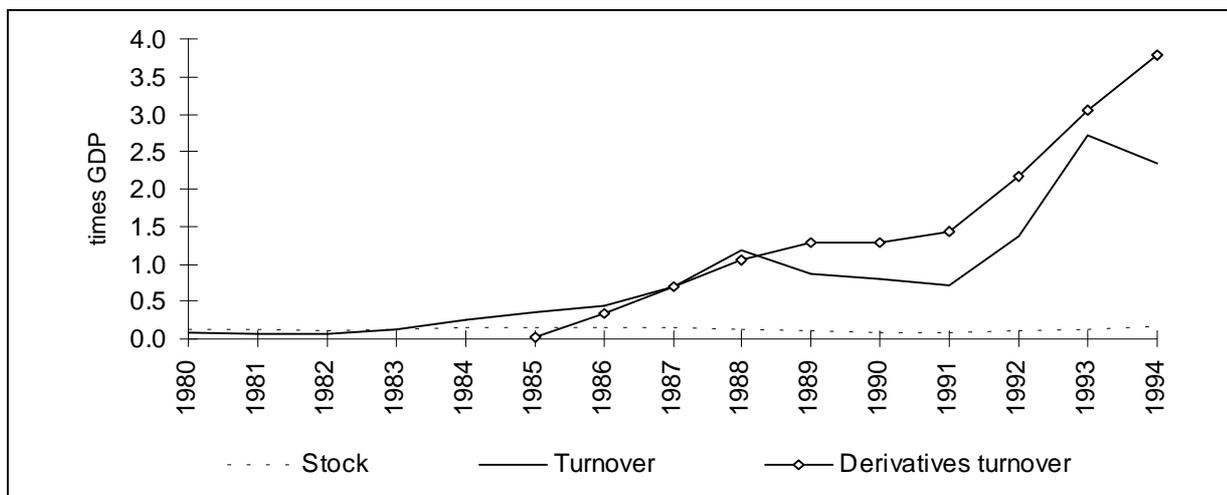
This is a rather cursory look at one aspect of financial market transactions costs but it suffices to make clear that financial transactions costs on the professional markets declined. This had indirect benefits to retail consumers, through lower fees and better quality management of their intermediated assets.

³³In a study of the equity market transactions costs in the USA, Japan and the UK, Gary Gastineau (*A Framework for the Analysis of Portfolio Execution Costs - Stocks versus Derivatives*, Salomon Brothers, 1991) finds that round trip transactions costs for a US\$50 million Japanese equity portfolio are 3.12% in the physical market, 0.23% using stock index futures and 0.16% using stock index options. In Australia, similar exercises show that share price index and individual share futures contracts, traded on the Sydney Futures Exchanges, afford substantially lower transactions costs to tactical portfolio traders and to small investors.

4.2.5 Government Bond Market Deregulation

The market for Federal and State government bonds has been transformed over the last fifteen years. The market prices more accurately (as outlined above), provides greater liquidity (see figure 10), has lower transactions costs (outlined above), is technically better organised and more efficient and better facilitates risk management. These gains were derived from a move to full market pricing in the primary market, the elimination of 'captive' market controls (like the '30/20 rule abolished in 1984), the application of technology and market making by key traders, including the investment banks. This has made a positive contribution to the operation of the financial sector and the economy.

Figure 10. Features of the Commonwealth Government Bond Market



Notes: Repos account for just under half the physical market turnover. Derivatives are futures and options on government bonds traded on the Sydney Futures Exchange.

The technical operation of both the Commonwealth and State government bond markets have been dramatically improved. Debt management has been improved through a series of measures, including a shortening of maturities, improved transparency, shorter tender periods and better focused issues.³⁴ For example, the Commonwealth Treasury ensures that sufficient 'hot stock' bonds are available to support market liquidity, which also meets the needs of the bond futures market.³⁵ The latter has underpinned development of the bond market, by providing an effective means of hedging. State governments established central borrowing authorities to handle the borrowing of state agencies and local government authorities on a centralised and better ordered basis. The rationalisation of debt issues, together with the introduction of market makers, has provided ongoing benchmark prices and a valuable piece of infrastructure for derivatives.

Against this background, institutions' willingness to trade in State and Commonwealth government bonds increased markedly, all of which has enhanced liquidity and significantly

³⁴ The separation of debt management and monetary policy achieved in the early 1980s was an important first step, which benefited both the operation of monetary policy and stimulated better debt management.

³⁵ Improvement to Commonwealth debt management has occurred at the procedural level for bond issues and through the application of more sophisticated techniques for managing the portfolio in the long term. Both have generated significant savings for taxpayers. Treasury has used both JP Morgan and UBS as advisors on debt management.

lowered the cost of servicing government debt. The annual interest savings to taxpayers has not been estimated, but is almost certainly measured in hundreds of millions of dollars. All banks participate in the government bond market to some degree and most are active traders. The foreign banks are particularly well represented as market makers in the fixed interest markets. For example, they dominate the top ten market makers for NSW government benchmark bonds issue by T Corp, as shown on table 12.

Table 12. Top Ten Market Makers in T-Corp Benchmark Series Bonds 1995/96

Rank	Institution
1.	SBC Warburg Australia Ltd.
2.	Bain Capital Markets Ltd.
3.	NatWest Markets Australia Ltd.
4.	Bankers Trust Australia Ltd.
5.	BZW Australia Ltd.
6.	CS First Boston Australia Ltd.
7.	HSBC Markets
8.	Westpac Banking Corporation
9.	National Australia Bank Ltd.
10.	Morgan Guaranty Trust Company of New York

Source: NSW TCorp.

Efficient government bond markets improve economic performance in several ways. Firstly, they allow governments to raise large amounts of finance without resorting to captive market controls that distort interest rate signals. Secondly, government bond yields reflect economic and financial conditions, accurately signal the aggregate cost of debt finance and fairly compensate savers. Related to this, the 'risk free' status of government bonds and the depth of their secondary market make them a valuable pricing benchmark for corporate bonds and bank loans. An advantage of the government bond market, in this respect, is its low level of information asymmetry, because information on economic conditions and policy considerations that drive the market is widely available. Other benefits of efficient government bond markets include low transactions costs for investment and risk management, a broader range of investment and risk management products and a means for the monetary authority to implement open market operations. The market in Australia operates efficiently in all these respects now, but would have failed prior to deregulation.

Finally, discipline is an important benefit from an efficient market. The central role of government in the economy makes disciplined policy making by it an important input to economic growth. Captive market and other regulations reduce (if not eliminate) government's sensitivity to market discipline and prevent the market from signalling the true cost of capital in the economy. Deregulation of the market opens the government to greater market discipline.

Government borrowing on international capital markets is transparently subject to market discipline, through debt ratings by the major ratings agencies, Moodys and Standard & Poors. Market sanctions, in the form of higher debt servicing costs and possibly restricted market access, are imposed on governments that embark on irresponsible economic policies. This disciplining force also exists on the domestic market. Disciplinary measures feed into the economy through benchmarking and other relationships. Two important consequences follow. Firstly, the government must either increase taxes, cut expenditure, or increase borrowing to pay the higher debt servicing cost. The first two are not politically palatable and the latter

exacerbates the problem. Secondly, political pressure on the government from voters paying higher mortgage and business loan interest rates intensify pressure on it to rectify policy. This creates a healthy tension between the government and the markets, which opens out and improves the quality of economic debate.

More critical and better informed evaluation of government spending, tax raising and financial management generally leads to better economic policy making and an improved economic performance. The policy credibility premium offered by the market is a strong incentive for government to maintain responsible policies. Of course, a deregulated bond market is not a panacea for poor policy making and it may not halt a government's imprudence, especially if an election is in the offing. Nevertheless, greater market discipline on government should be marked on the scorecard for deregulation as a worthwhile benefit from deregulation.

4.2.6 Equity Market Development

Trading of company shares on the stock exchange is one of the oldest organised features of the financial system and the fundamentals have changed little over time. However, the technical operation of the market has improved greatly since the Campbell Inquiry and the market now better serves the economy. This is a consequence of several factors including deregulation of brokerage commissions, the formation of the Australian Stock Exchange as a national exchange, development of the financial sector (as a user of the market), technological development, globalisation and privatisation.

The main economic contribution of the equity market can be summarised under four headings;

1. Mobilising of capital for listed companies,
2. Sharing and management of risk,
3. Information collection, assessment and signalling, and
4. Privatisation.

Equity markets provide a valuable outlet for individuals' savings, directly and indirectly, through financial institutions and trusts. By aggregation of savings, large amounts of funds are mobilised for investment, while the liquidity of shares in effect transforms the maturity spectrum of investments. Thus, equity markets broaden the range of investment products for investors, most notably by offering full participation rights in projects, and enable more precise construction of investment portfolios.

The equity market is a valuable way to trade business risk; companies sell shares in their business on the primary market and investors can later trade these shares on the secondary market. Equity derivatives (exchange based and over-the-counter) increase flexibility and substantially lower the cost of managing risk from share price movements, both idiosyncratic and aggregate. Active equity markets lower liquidity risk by facilitating trading at a low transaction cost (net of the price impact of a trade).

The equity market collects and assimilates information, including expectations. At the macroeconomic level, movements in the share price index are used as a lead indicator of economic growth. At the microeconomic level, the market generates information that reduces information asymmetry between companies and their investors and creditors. Relative share price movements also reflect the market's evaluation of company's prospects and serve as a discipline on management. Other benefits include attraction of foreign investment and, of

particular importance in recent years, a reduction of government's role in the economy through privatisation.

Table 13. Features of the Equity Market

		1980	1985	1990	1995
(% GDP)	Capitalisation	35	33	44	66
(% GDP)	Physical Turnover	5.5	7.2	15.5	25.9
(% GDP)	Futures Turnover	0	8.0	13.3	24.4
	Liquidity (physical)	0.16	0.22	0.35	0.39
	Liquidity (including futures)	0.16	0.46	0.65	0.76

Data sourced from Foster and Stewart (1996).

It is best to use a range of indicators to help gauge the performance of the equity market since the early 1980s from a macroeconomic perspective. Both market capitalisation and turnover have increased significantly in terms of GDP. Market capitalisation, turnover and liquidity all increased significantly, as shown on table 13. Transactions costs declined through lower commissions, derivatives and better liquidity. Product range increased through the listing of new companies, unit trusts, derivatives and overseas companies. Market pricing and discipline are subjective and there is insufficient time in the preparation of this submission to go into the issue. The spectre of the 1987 crash in share prices remains to be fully explained but industry has learned from the experience, especially in terms of risk assessment and management.

Table 14. New Equity Raisings - Leading Stockbrokers in 1995/96

Rank	Stockbroker	Market share (%)
1.	Potter/SBC Warburg	15.5
2.	Were	11.7
3.	McIntosh	10.6
4.	County Natwest	7.6
5.	CS First Boston	5.4
6.	Salomon Brothers	5.4
7.	Macquarie Bank	5.3
8.	Bankers Trust Australia	3.2
9.	Ord Minnett/Paterson	2.5
10.	Pru Bache	2.1

Source: Australian Equities Market, reported in the *Australian Financial Review*, 28 August 1996.

Perhaps the best guide to the economic contribution of the equity market is its success in raising new capital for listed companies. The market has improved considerably by this measure over the past decade. New equity issues were consistently modest, at less than 2% in term of GDP, until the mid-1980s. However, this ratio lifted markedly to an average of 3.6% between 1986 and 1994. New issues accounted for almost 80% of the rise in market capitalisation over this period, after allowing for economic growth.³⁶

Privatisation of state-owned enterprises account for a significant element of the new issues. Benefits from privatisation include a diminished role for government and greater market discipline from previously state owned companies, that bring efficiency gains. Together with

³⁶ This is a much higher ratio than that recorded for most other markets in the region, which are much more speculative (see Lynch, 1995).

deregulation, it can increase competition within an economy and has other benefits, like removal of enterprise financing constraints and a widening of capital markets. Each case must be considered on its merits but it can be stated unambiguously that the option afforded to government by privatisation is of material economic value.

Table 15. Investment Bank Participation in Privatisation - Three Examples

GIO Australia (June 1992) <i>Financial adviser to Government</i> BT Australia Ltd	Qantas (June 1995) <i>Financial adviser to Government</i> Bain Capital Markets Limited <i>Financial adviser to Qantas</i> Baring Brothers Burrows & Co Ltd	Commonwealth Bank (May 1996 share offer) <i>Business adviser to Government</i> Bain & Co Corp. Finance Ltd <i>Global co-ordinator</i> JB Were & Son
<i>Underwriters</i> County Natwest Securities Bain Capital Markets Limited Potter Warburg Capital Markets Ltd.	<i>Joint lead managers</i> McIntosh Corporate Ltd Potter Warburg Capital Markets	<i>Joint lead managers</i> County Natwest Securities CS First Boston Salomon Brothers Inc JB Were & Son
<i>Retail brokers</i> include: BOS Stockbroking Hambros Equities Ltd Macquarie Equities Ltd. James Capel Australia Ltd	<i>Domestic co-lead managers and international co-managers</i> BZW Australia Ltd Ord Minnett Corp. Services Ltd JB Were Corp. Services Ltd ANZ McCaughan Corporate and Financial Services Ltd	<i>Domestic co-lead managers</i> Macquarie Underwriting Ltd McIntosh Corporate Ltd Ord Minnett Corp. Finance Ltd
<i>International selling group members</i> include: ABN-Amro Bank NV Credit Suisse First Boston James Capel Australia Ltd	<i>International co-lead managers</i> McIntosh Securities Inc Salomon Brothers Inc SG Warburg Securities	<i>International co-lead managers</i> ABN AMRO Hoare Govett Ltd Cazenove & Co Daiwa Securities Australia Ltd

Investment banks have a central place in the equity market, directly through stockbroking subsidiaries and indirectly through their corporate finance, trading and funds management operations. Of the top ten stockbrokers, six are owned by foreign investment banks. In particular, there are valuable synergies that can be utilised in the corporate advisory and funding areas. Table 15 details the participation of investment banks in the privatisation of the Commonwealth Bank, Qantas and GIO privatisations. Legal advisers and accounting firms, registrars and trustees were other prominent participants. Their involvement covers a broad range of activities associated with listing and includes providing financial and strategic advice to Government (and the listing entities), underwriting, domestic and international distribution of the securities.

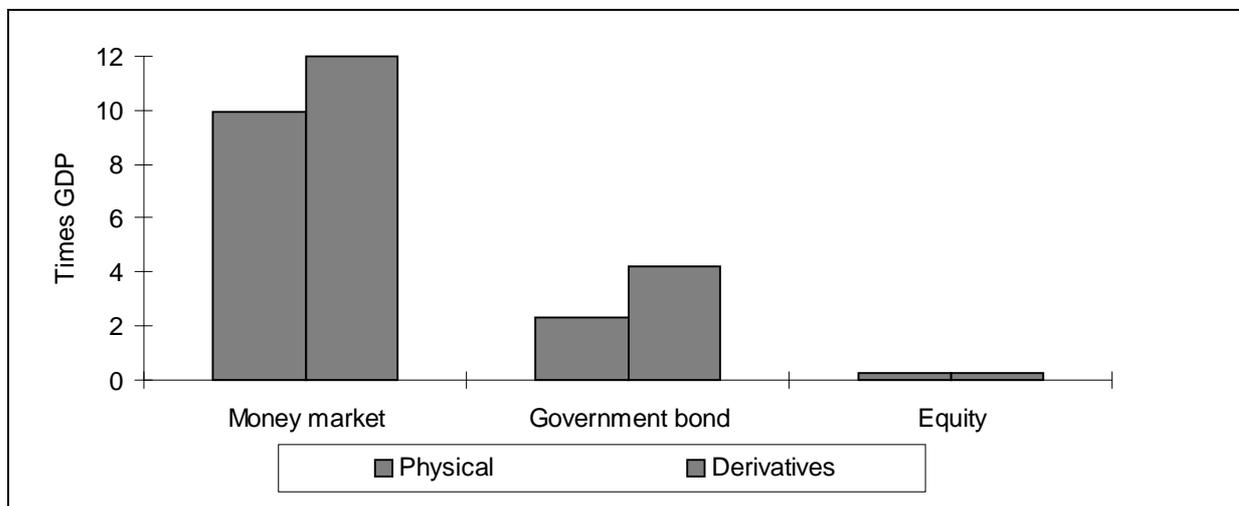
4.2.7 A New Market - Derivatives

Derivatives emerged to become a conspicuous feature of the financial sector since deregulation, with turnover frequently at higher levels than that in the underlying market (see figure 11). They make a valuable contribution to the efficient operation of both the financial sector and the wider economy.³⁷ Investment banks are the key providers in the market. The

³⁷ Non-financial derivatives are widely used in the economy; for example, rent escalation clauses give lessors the option to raise rent in a given set of circumstances and mining licenses give the holder the option to produce mineral resources, or not.

role played by derivatives is frequently misunderstood or understated. It is important to an evaluation of financial deregulation that the economic function of derivatives is placed in proper perspective. Risk management and derivatives are not synonymous, but derivatives are used to trade risk and are an essential tool for effective risk management.

Figure 11. Turnover on Derivatives and Underlying Physical Markets in 1994



Notes: Data cover both exchange traded and OTC derivatives, except for equities (futures only), and the underlying physical market. Money market physical turnover is estimated (see Lynch, 1995, *Links between Asia-Pacific Financial Sector Development and Economic Performance*, PhD thesis, Macquarie University).

Origin of Financial Derivatives

Four interrelated factors combined to stimulate more active risk management and the development of derivatives. Derivatives reduced the cost of economic and financial sector deregulation, by allowing entities to efficiently manage the resulting risks. An appreciation of these factors helps understand the character of derivatives and their economic contribution.

1. Financial sector deregulation included the abolition of controls on interest rates and liberalisation of the exchange rate. These prices became more volatile in nominal terms. There was greater integration with international markets, where both exchange rates and interest rates volatility had risen markedly in the aftermath of the break-up of the Bretton Woods agreement. Meanwhile, the financial sector deepened and cross border financial flows increased dramatically, so the amount exposed to this volatility rose. Development of the money, foreign exchange, bond and equity markets provided essential infrastructure for derivatives.
2. The philosophy of government policy shifted towards a much less interventionist approach and an opening up of economy to international competition, including trade and investment. Attendant with this was a widening of exposures to be managed.
3. Technological advances in communications and computing were applied by financial institutions to improve information flows, lift trading efficiency, reduce transaction costs, develop new products and design new trading techniques. For example, computer software has been developed to price complex financial instruments and their speed of execution facilitates more active trading. Other problems, like ongoing accurate measurement of

exposures, have been transformed. There have also been significant theoretical advances in areas like the pricing of derivatives.

4. The process of financial innovation provides new products that can lessen the impact of constraints on financial activity. Product innovation was an important input to the development of the derivatives. It was applied to both products and to risk management systems. This utilised technological developments and foreign banks drew on their parent banks' expertise, though Australia's markets are well developed in international terms and highly innovative in their own right.

Products

A wide variety of derivatives are traded both on the organised exchanges and OTC markets.³⁸ Exchange traded derivatives have standardised terms, guaranteed settlement arrangements exist, and novation occurs. These characteristics help generate market liquidity. OTC derivatives are more flexible and can be customised to meet specific transactor needs, though at the cost of higher counterparty and operational risks and lower liquidity. Legal risks on OTC markets are usually reduced by the use of ISDA or similar standardised documentation.³⁹ Similar derivatives frequently trade along side each other in the OTC and exchange traded markets. Indeed, the markets are frequently interdependent; for example FRA traders use bank bill futures as a means to hedge positions and manage their market risk.

Table 16. Trading of OTC Derivative Products by Counterparty - 1995

Interest Rate Products	Turnover \$ billion	In-house %	Banks %	Government %	Corporate & other %
FRA's	1,025	28	52	10	10
Interest rate swaps	248	51	32	8	10
Cross currency swaps	69	40	25	18	17
Interest rate options	35	-----13-----		-----87-----	
Cap/floors	25	26	8	13	53
Foreign Exchange Products		Domestic Dealers %	Overseas Banks %	Corporate & other %	
Outright forwards	472	10	20	71	
Swaps	6,656	33	41	26	
Options	141	15	57	28	

Source: Data are derived from the *1995 Australian Financial Markets Report*, AFMA, Sydney (1995) and the Reserve Bank's *Bulletin*. These data are consistent with those compiled by a Reserve Bank of Australia's in a survey of foreign exchange and derivatives activity in April 1995.

The principal traders of derivatives are financial institutions themselves and governments and the corporate sector are the end-users; see table 16 for the OTC market. User surveys consistently show that larger companies are more active users of derivatives. The strength of the investment banks in the derivatives market is indicated by the number of banks that responded to the AFMA survey last year (see table 17) and also by the range of derivative instruments in which they recorded significant business. This reflects in part the specialist skills of investment banks and is an expression of their innovative character. The range of market participants, together with the depth of the individual markets, demonstrate the highly competitive nature of the derivatives market.

³⁸ Derivatives are traded on both the Sydney Futures Exchange and the Australian Stock Exchange.

³⁹ ISDA stands for the International Swaps and Derivatives Association.

Table 17. Participants in the Derivatives Market in 1995

Organisation	SWAPS	FRA's	Currency Options	Interest rate options
Advance Bank	✓	✓		✓
ANZ	✓	✓	✓	✓
Australian Gilt Securities				✓
Bain & Company				✓
Bank of America	✓	✓		
Bank of Melbourne	✓			✓
Bankers Trust	✓	✓	✓	✓
BNP		✓		
BZW		✓		✓
Challenge Bank	✓			
Chase Manhattan Bank	✓			✓
Chemical	✓	✓		
Citibank	✓	✓	✓	✓
Commonwealth Bank of Australia	✓	✓	✓	✓
CS First Boston				✓
Deutsche Bank	✓	✓		
First Chicago	✓			
Hambros		✓		
Hong Kong/Midland Bank	✓	✓	✓	✓
IBJ	✓			
JP Morgan	✓	✓		✓
Lloyds	✓	✓	✓	
Macquarie Bank	✓	✓	✓	✓
Merrill Lynch	✓			✓
National Australia Bank	✓	✓	✓	✓
NatWest	✓	✓		✓
Potter Warburg				✓
Rothschild				✓
SBC	✓			✓
Schroders	✓	✓		
Societe Generale	✓	✓		
St George	✓	✓		✓
State Bank of New South Wales	✓	✓	✓	✓
Toronto Dominion		✓		
UBS	✓			
Westpac	✓	✓	✓	✓

Note: These institutions participated in the 1995 AFMA survey of OTC markets.

Benefits

As discussed, derivatives lower transactions costs, especially for portfolio trading. This is an important benefit but there are other reasons underpinning their success. Derivatives facilitate risk trading by splitting synthesised risks, which allows risk to be transferred to those entities most willing to hold it at the market price. A simple example is an importer with future foreign exchange expenses, who buys foreign exchange on the forward market from an exporter who has future foreign exchange receipts. In doing so, both eliminate their exposure to unfavourable exchange rate movements and benefit from greater certainty, at the cost of foregoing potential benefits from favourable movements.

Derivatives assist entities by promoting better identification of risk and more accurate pricing of risk, as well as improving their ability to hedge and manage risk. These attributes are especially important to banks, given the range of financial risks that they face. Derivatives also enable banks to offer customers a wider range of products; for example, banks can more readily design financial packages to meet corporates' specific needs and offer a wider range of retail mortgage facilities to home purchasers.

An additional benefit from hedging is that it allows companies to concentrate on their core business activity, where their comparative advantage lies, and provides their investors with the business exposure that they presumably desire. For example, a widget manufacturer that hedges its foreign exchange exposure can concentrate on making widgets (where it has a comparative advantage) and avoid currency speculation (where it has a comparative disadvantage). However, a passive (do nothing) approach to risk management must not be confused with a conservative risk taking strategy. If an exposure exists, *not* actively hedging it is equivalent to speculation.

In addition to providing risk management facilities, derivatives can reduce company cost of funds. This is more complicated than sometimes portrayed. Derivatives are of no benefit if the apparent reduction in the cost of finance is offset by a less transparent economic cost. On the other hand, a company that issues short term debt and swaps it for long term fixed rate finance reduces its exposure to interest rate changes, without having to pay the standard long term debt premium. This is because it is kept on a financial discipline 'leash' by its short term debt holder. Thus, derivatives have an inherent value for companies and their creditors. In practice, transaction costs and other distortionary factors also create opportunities to lower funding costs using derivatives.

Costs

Derivatives have limitations in risk management. While hedging can reduce the covariance of a company's income stream with variables like the exchange rate, it cannot eliminate long run exposures to them. However, hedging may give more time to adjust to new circumstances, which can have significant benefits if adjustment costs are high (for example, if capital stock is made obsolete). The optimal time profile of hedging minimises adjustment costs to transitory shocks, while also facilitating adjustment to long term change. Derivatives are not the only tool in the risk management kit, but they are the most important one.

It must be remembered that while derivatives offer benefits to companies, their inherent risks pose serious problems for company management. Proficient hedging reduces the likelihood of bankruptcy, but deficient hedging can quickly cause bankruptcy. Management procedures and

controls, operations, external factors and systemic risk are areas where serious problems can occur. The leveraged nature of derivatives creates a particularly difficult incentive structure to manage and there is potential for small problems to quickly get out of control. Entities that use derivatives must bear the cost of implementing safety controls in their use.

Finally, there is an issue of systemic risk in the financial sector. It is not certain that derivatives increase the risk of systemic instability in the financial sector; in some instances they can reduce it. However, it is a matter of regulatory oversight and is a necessary additional cost to the operation of the financial system. Minimisation of this cost is an issue for regulatory review.

Macroeconomic Considerations

Some macroeconomic benefits from derivatives are simply those of individual companies written large. For example, hedging can lengthen the life of capital and reduce the effective rate of depreciation of the economy's capital stock. Similarly, the facility to reduce investment risk may increase investment at the aggregate level. However, other economic benefits are less obvious from the impact of derivatives at the company level.

Derivatives play a valuable role by facilitating trading of risk, principally market risk. This sets a benchmark price for risk and increases transparency of financial costs. A positive externality arising from this is more accurate project appraisal, for example, through greater awareness of embedded options. In a free market, risk gravitates towards those most willing to hold it at the market price and distribution of risk within the economy improves.

Another benefit from hedging, from an economic development perspective, is a reduction in contingent resources held as a precaution against market risk. Funds released improve aggregate investment returns, in much the same way as does the provision of liquidity by financial intermediaries. Derivatives can also lower transaction costs and ultimately the cost of capital, by reducing the illiquidity premium associated with securities.

Summary

Derivatives are playing a useful if, complex role in the economy. At the individual entity level, they provide significant advantages if used astutely, but pose dangers if not properly understood. At the macroeconomic level, there are both direct and indirect benefits and some potential risks. Financial deregulation brought forward the development of active derivatives markets, but this was inevitable as the economy cannot be insulated from global events. On balance, there is compelling evidence that the development of derivatives since deregulation has provided a significant net benefit to the economy, not least by enhancing the competitiveness of Australian firms.

4.3 International Trade in Financial Services

There are three aspects to international trade in financial services and, thus, to Australia's potential as an international financial centre. Australia can serve as;

1. A base from which to sell financial products in the region and global markets;
2. A base from which to undertake an entity's regional business; that is, provide a base for the regional headquarters (RHQ) of financial institutions and multinational companies;

3. A base from which to undertake specific aspects of an entity's business; that is to serve as a global or regional centre of excellence, rather than as a centre for the entities' entire operations.

It is useful to examine these in a little more detail to help differentiate their respective lines of business. In the first instance, Australian financial institutions sell their services to non-residents, including the regional headquarters of companies based elsewhere. For example, a resources company based in Singapore may purchase bullion derivatives from an Australian based bank. In the second case, the regional headquarters purchase financial services locally that they would otherwise source elsewhere in the region if they were based there. For example, a global gold producer that bases its treasury operations here will tend to rely on local banks to service their financial needs, including bullion derivatives. In the third case, international banks and multinational companies establish a local entity to undertake business in Australia and subsequently use the specialised skill base that it develops here to service its regional and global clients. For example, Australia has a large resources sector and some international banks use their Australian operations as a base from which to provide commodity products and services to their global and international clientele.

In other words, the Australian financial sector can sell its products overseas to non-resident institutions and companies from here, or attract those entities to locate here to purchase them. This also highlights the fact that Australian companies can purchase their financial services abroad, almost as easily as they can here. For example, Australian resource companies are drawn towards listing on the Vancouver stock exchange, banks conduct significant foreign exchange operations in Singapore and investors invest in funds managed in Hong Kong. Therefore, it is vital to maintain the competitiveness of the financial sector.

The opening of the financial services market to international competition in this manner has occurred since financial deregulation but is not entirely attributable to it. Technological advancement in telecommunications and information processing and increased integration of goods and capital markets were important too. The globalisation of financial markets is both an opportunity for new business and a threat to existing business. How the financial sector fares depends on the performance of its component institutions and on government commitment to development of the sector. These issues are taken up in Part 3. Australian based banks have taken the opportunities presented to expand their international operations. For the moment, consider some aspects of this business to illustrate the issues at stake.

◇ *Selling Infrastructure Financing Skills Overseas*

Australian trading and investment banks are significant players in private sector infrastructure development in the Asia-Pacific region, which brings foreign income into the economy. The expertise and experience developed here since the late 1980s provides them with an important competitive advantage in infrastructure financing. Some of this talent is being drawn away by overseas banks, from whom there is a strong demand for Australian corporate finance executives with experience in this area.

There is a variety of networking mechanisms, bank and customer driven, that facilitate investment bank infrastructure finance operations in the region. Most foreign owned investment bank operations are tightly integrated with those of their parent in the region. This includes banks like Indosuez, Societe Generale and Schrodgers, amongst others. They link in with parent bank domestic and regional operations (often in Hong Kong or Singapore), which

control most of the bank's business in the region. The regional infrastructure finance operations of their Australian based operations are nonetheless quite significant. This is often built upon specialist skills in infrastructure acquired in Australia and existing banking relationships with Australian companies, like BHP and Telstra, that are promoting infrastructure projects in the region.

Some banks base their main regional infrastructure finance operations in Australia; for example, the Chase Manhattan Bank, recognising the value of its local expertise, bases its energy infrastructure operations in Australia. Building on its extensive domestic experience, the Australian owned Macquarie Bank has established itself as a leader in the region's infrastructure finance market. It has offices in several Asia-Pacific countries that assist its regional operations. In another variant, Hambros Australia formed a joint venture with CITIC Australia to undertake investment banking operations in East Asia, especially China.

The list of Asia-Pacific countries in which Australian banks have participated in infrastructure financing is extensive. It includes China, Hong Kong, India, Indonesia, Laos, Macau, Malaysia, Pakistan, the Philippines, Vietnam and Thailand, amongst others. Examples of infrastructure projects in which Australian banks have participated are;

- US\$2.4 billion power station in Indonesia
- US\$300m tollway in China
- US\$170m airport in Macau
- US\$90m power station in the Philippines
- US\$92m hydro-power facility in Pakistan.

The range of products and services provided by the banks to private infrastructure promoters in the region are similar to those provided here. They include;

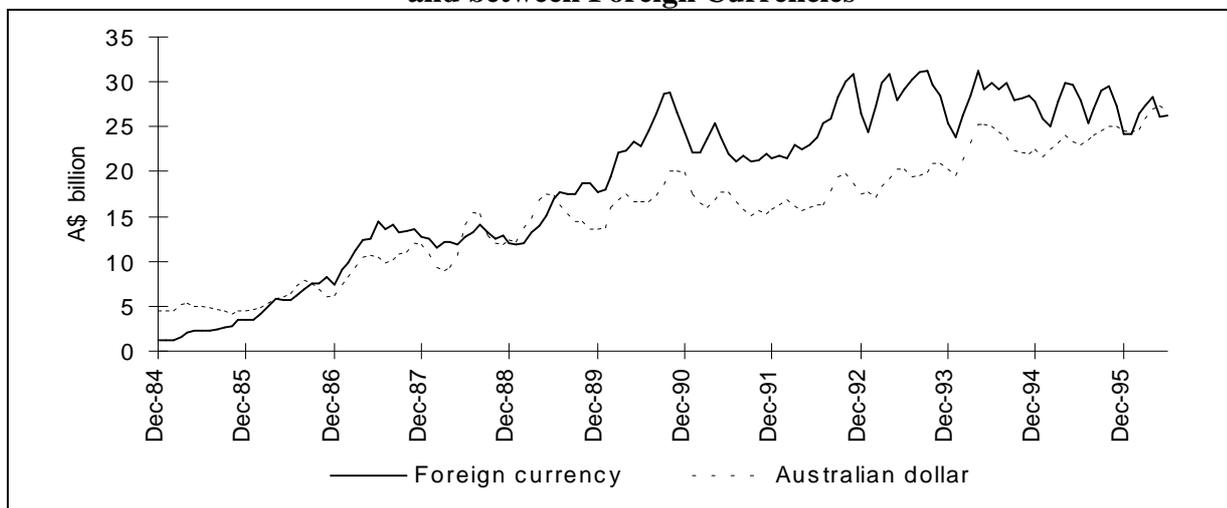
- Assessment and allocation of project risk
- Preparation and co-ordination of expert reports
- Advice on project financial structuring, including off-balance sheet items
- Design of tariff structure
- Modelling project financial flows
- Arrangement of domestic debt and equity finance
- Arrangement of international debt and equity finance
- Underwriting project finance
- Provision of debt finance
- Liaison with government and other bodies
- Supplier of finance for capital goods and liaison with export credit agencies

Australian based investment banks participate mainly as advisers in regional infrastructure projects. They are active in debt arrangement and placement (both locally and overseas) but, as a rule, participate to a quite limited extent in direct finance. This reflects the nature of their relative expertise (and its good transportability), the size of the projects involved and the character of preferred financial structures. Thus, fee based activities rather than interest earning lending, are most important for the banks. This naturally affects their risk exposures and is reflected in comments below. These comments are neither bank nor country specific and, as such, are quite generalised but do establish some key principles.

◇ *Foreign Exchange Trading*

Trading on the Australian foreign exchange market grew rapidly after the float of the dollar in 1983. It is notable that trading in both Australian dollars and third currencies expanded rapidly, as shown on figure 12. The entry of foreign banks in the mid-1980s was a significant factor in the market's growth and remain key participants in the market, as shown table 18. In the 1990s, most of the continued growth has been in Australian dollar trading.

Figure 12. Foreign Exchange Turnover against the Australian Dollar and between Foreign Currencies



Note: Three month moving average. Swap component in data prior to 1990 is estimated. Primary data are from the Reserve Bank's *Bulletin* database.

Table 18. Foreign exchange Market Leaders AUD/USD Spot Transactions (Second half of 1995)

First ten (alphabetical order)	ANZ Banking Group Bankers Trust Australia Citibank Commonwealth Bank of Australia Lloyds Bank NZA Macquarie Bank Midland bank Morgan Guaranty Trust Company of New York National Australia Bank Westpac Banking Corporation
Second ten (alphabetical order)	Bank of America Bank of Western Australia Barclays bank The Chase Manhattan Bank Deutsche bank Dresdner Bank The First national bank of Chicago Banque Indosuez Societe Generale State Bank of New South Wales

Source: Material provided by the Reserve Bank to IBSA.

Turnover is influenced by short term shifts in currency volatility and a range of other structural factors, including increased international economic integration and capital transactions. Australia's time-zone spans New York and Tokyo and attracts international business by linking the two larger markets. This is reflected in the mix of business; Australian dollar transactions account for only around half of total turnover and around 40% of business is conducted with foreign banks. In Singapore, the strongest regional competitor for international business, local currency trades account for less than 5% of the market.

According to the Bank for International Settlements co-ordinated survey of foreign exchange turnover in April 1995, 60% of global trading in Australian dollars takes place overseas; mainly in the UK (20%), USA (14%), Singapore (8%), Hong Kong (7%) and Japan (6%). Not all local currency business is likely to take place in Australia due to time-zone difference, the location of traders and the international spread of entities with a financial interest in Australia. However, it is indicative of competition that local traders face. Indeed, it is a matter of some concern that Australia is finding it difficult to retain its share of the regional foreign exchange business. Singapore has steadily pulled away from Australia as a centre for trading foreign exchange since the early 1980s.⁴⁰ This trend has continued despite the OBU tax regime introduced in 1992, probably because Singapore has established advantage through critical mass. Part 3 outlines further measures that need to be taken to shore up Australia's claim to be an international financial centre.

◇ *Regional Headquarters - Recent Developments*

There has been some success in developing Australia as an international financial centre and location for regional headquarters. An RHQ is a holding company for a multinational group's operations in a geographical region providing high level management and treasury services to group members in the region. An RHQ can also be any group entity that provides a service (such as marketing or data processing) to other members of the group in the region. RHQs, by definition cover a range of possibilities from a single functional regional support centre to an RHQ which is an interposed holding company between the foreign parent and regional subsidiaries, and in addition to high level management, will provide a wide range of support services to those subsidiaries, including for example, marketing, treasury, research and development, finance and accounting etc.

Regional operations established in Australia to date demonstrate the substantial economic returns that can be achieved, in terms of employment and income, from attracting international operations here. In 1995, a number of financial institutions established regional operations in Australia.⁴¹ State Street Bank & Trust Company announced that it would locate its Asia Pacific RHQ in Sydney to undertake its regional custody operations (300 jobs). Low labour and office accommodation costs, high quality of living, and good technological infrastructure were reported as attractions of Sydney. The Bankers Trust Group established its regional headquarters for custody operations in Sydney (300 jobs) and announced the transfer of its international funds management operations to its Australian subsidiary. Credit Suisse selected Melbourne as the site for its regional precious metal operations. Other notable success in

⁴⁰ Comparison of Reserve Bank of Australia and Monetary Authority of Singapore local foreign exchange turnover data confirms this. In the mid-1980s turnover in Australia and Singapore average daily turnover was around US\$5 billion and US\$10 billion, respectively. In April 1995, this was US\$40 billion and US\$105 billion, respectively.

⁴¹ John Masters provides information on this in *Australia as a Regional Finance Services Centre*, Journal of Applied Finance and Investment, March/April 1996. This article is a good review of the issues involved.

attracting RHQs include American Express (700 jobs), attracted in part by Sydney's multicultural base, and Capital Finance, a Bank of Scotland subsidiary (450 jobs).

These operations supplement existing regional operations and centres of excellence. However, the trend is not one way.⁴² For example, in April 1996, Banque Indosuez announced that it was scaling back its Australian dealing room activities, as part of its a strategy to build its Asia-Pacific business. Dealing activities are being transferred to its three regional hubs; Singapore, Hong Kong and Tokyo; Australian dollar and derivatives trading is being moved to Singapore. The Australian subsidiary intends to concentrate on core corporate finance business and will target cross border operations in Asia, as well as local business. Not all regional business may be moved to one location. For example, Bank of America has centralised its financial institution credit analysis in Sydney but its Asia wholesale group headquarters is located in Hong Kong. Thus, it is evident that the market for attracting international banking business is very competitive. As international centralisation continues, Australia must ensure that it captures its share.

In sum, today's financial sector is markedly different to that which existed pre-deregulation. It is now an international market, with significant potential to attract foreign earnings and employment to Australia. Developments since the Campbell Inquiry are largely about the integration of the domestic banking and financial markets to produce an efficient national financial sector. A vital outcome of the current Inquiry must be competitive placement of the financial sector, such that it thrives in the integrated international market, to the benefit of the country.

5. Concluding Comments

The financial sector provides a range of vital services, including payments, savings/credit intermediation, liquidity management and risk management, without which the economy would not function efficiently. The financial sector has developed considerably since deregulation; financial assets and liabilities increased, the range of products traded expanded and the quality of financial services improved. Since deregulation financial markets (money, equity, bond, foreign exchange and derivatives) have increased in importance, as has the role of investment banks as key participants in these markets.

What has all of this meant for consumers of financial services ? A range of indicators suggest that deregulation has markedly improved the performance of the financial sector, such that it now better meets the needs of consumers and has lifted economic performance. For example, the market now emits sensible interest rate signals that properly reflect economic conditions. This is critical to economic performance. Investors and borrowers have a wider choice of institutions to purchase from, transactions costs have declined and a wider range of better quality products are on offer. Retail consumers have better market access; for example, retail deposits offer market related returns that were previously the preserve of large investors. Therefore, the sector is more equitable in its operation. Other advances include sophisticated risk management instruments and services. The effect of these improvements has been to give the Australian business sector a competitive advantage. Investment banks, which are largely foreign banks, played a vital role in this respect by stiffening competition in the wholesale and retail markets for financial products and services and by taking advantage of foreign financial and other resources.

⁴² Comments are drawn from information releases and on media reports.

Deregulation of the financial sector lifted economic performance in other respects too. Some important aspects in this regard are;

- Financial prices with much greater economic intent, upon which to base commercial decisions;
- Operation of a flexible, market orientated monetary policy, (facilitated by developed money and foreign exchange markets), in preference to the old system of controls;
- Greater financial discipline, including on 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 Committee.

The financial sector must build from its current position. This means that further efficiency gains must be achieved and the sector's international competitiveness enhanced and improved. A number of issues have emerged in the stocktake analysis here. Firstly, strong competition in the financial sector is the best way to ensure that further gains are achieved. In this regard, the competitive role of investment banks has added great value to the sectors output and current blockages to this, like interest withholding tax on branch overseas funding, should be removed. Secondly, the finance sector is a national industry competing in a global market; there must be a policy commitment to ensure that the industry succeeds. Thirdly, regulation of the industry must be co-ordinated and flexible enough to respond efficiently to future developments, many of which are as yet unknown. Appropriate responses to these issues will be vital to ensuring the ongoing success of the financial sector, to the benefit of its users and the economy more generally.

