

12 September, 1996

Mr S Wallis
Chairman
Financial Systems Inquiry
Treasury Building
Parkes Place
PARKES ACT 2600

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Dear Stan

I have eschewed submitting a large, formal submission to your Committee of Inquiry in favour of the attachment to this letter setting out Advance Bank's views on those issues it feels strongly about.

Advance Bank is a member of the Australian Bankers Association and contributed to the Association's submission to the Committee of Inquiry. As in any industry submission there may not always be consensus and Advance Bank, while supporting the broad thrust of the Association's submission, should not be taken to agree with each and every conclusion reached or recommendation made in that submission. The Association's submission does, however, provide a review of the broad development of the financial services sector and a discussion of the rationale for government intervention and the criteria which should be applied to it which enables us to state our position on some key issues quite simply.

Consumer demand, technology and competition are all heralding a period of change in financial services. While it is inevitable that the period of change for banks will be uncomfortable, Advance Bank is determined to remain a leader of change and to continue to be a significant and successful financial institution. We would be happy to assist the Committee in providing further information, in responding to issues papers or in meeting with members to discuss particular points as the Committee requires.

Yours faithfully

J M Thame
Managing Director

**Advance Bank Australia Limited's Views on Issues
before the Financial System Inquiry**

Introduction

In many ways the history of Advance Bank is a history of the deregulation of the Australian financial system in the wake of the tabling in Parliament of the final Report of the Committee of Inquiry into the Australian Financial System (the "Campbell Committee") on 17 November 1981. The changes in Australia's financial system wrought by that Inquiry led to the decision of our predecessor, the N.S.W. Building Society, to be the first building society in the world to demutualise, convert to bank status and list on the stock exchange along with a concomitant expansion in the range of products offered to our customers. Pre-existing subsidiaries, like Advance Asset Management Limited, and subsequently established subsidiaries, including Advance Life and mortgage insurer Home Owners Mortgage Equity Limited, together with the Bank's Financial Planning Service have given the Group experience under all the current regulatory institutions with responsibilities for aspects of financial services.

Choice, Quality & Cost of Financial Services

We would contend that even the briefest of reviews of history leads to the conclusion that deregulation played a key role in enhancing the efficiency of the financial system and expanded the choice, improved the quality and lowered the real cost of financial services to the consumers and other users who are customers of this Bank. We would be happy to provide information to support this contention should the Committee have an interest. We have not done so in this submission, realising that the Committee would be inundated if all participants in the system sought to demonstrate how their own activities contributed in this way. Some areas where we would claim particular expertise in this regard are mobile lending and telephone, Internet and PC banking.

Advance Bank is a firm proponent of the philosophy of user pays. Whilst in the past, banks were able and indeed encouraged to subsidise some loss making services from more profitable services, the fall in the proportion of deposits in relatively low yielding accounts along with increased competition for deposits and loans from deregulation, disintermediation and deconstruction and developments such as the "deeming" rules for pensioners, all have reduced the income available to banks to provide services to depositors and transactors. Cross-subsidisation is no longer appropriate or sustainable in this climate and moves towards more equitable prices for bank services have begun in earnest. Advance Bank does not apologise for seeking to maintain profitability through this action. It is applied in the context of a commitment to fair and honest dealing with all those who apply the same standards.

We continue to believe that the end result of these changes will be an outcome which will be fairer to all - depositors, borrowers and shareholders. Given the competitive sensitivity of price and cost strategies, we could only make further information available in this regard on a confidential basis. We await the Committee's advice in this regard.

Factors Driving Change in Financial Services

Throughout the developed world, banking is experiencing an accelerating revolution. That revolution is being driven by:-

- the capacity and wish of customers to bank electronically - and not through branches. More than 60% of all personal banking transactions are conducted outside banks' branch networks;
- the development of a wide range of new competitors who, understandably, only compete for the most attractive parts of banks' business - and who have the advantage of not being compelled to provide equity capital to support their lending;
- the internationalisation of all forms of capital flows; and
- the continuing decline in the share of savings held by banks - due in part, to the incentives to save through superannuation and banks' exclusion, pending retirement savings accounts, from competing for such savings.

We would suggest, other things remaining the same, the strategic responses will include:-

- a reduction in the number and style of bank branches, and perhaps, joint bank service networks;
- attention to computer and customer information systems, and other elements of information technology;
- continuing review and revision of bank fees so as to eliminate gradually cross-subsidisation, which is presently unfair to many customer groups and no longer affordable to banks;
- intensive efforts to further and sharply reduce operating costs;
- strong emphasis upon service quality for loyal customers; and
- very active management of the capital base and of all the sources of bank funding.

Regulatory Arrangements

As with the Campbell Committee before it, the Committee has to judge whether the changes in the financial system that have occurred and are in prospect have produced an imbalance in the benefits and burdens of the current structure of regulation so as to create an unlevel playing field which could produce perverse outcomes. The foundations of government intervention in the market place are, of course, the existence of externalities or market failures with, in the particular case of financial markets, the primary causes of such failures being imperfect information or knowledge (sometimes described as asymmetric information) or inadequate competition.

Depositor Protection

Advance Bank contends that the information problem remains, particularly in the case of older customers who provide the bulk of banks' term deposits, but also in respect of insurance and superannuation due to their complexity and duration. It is not so long ago that the Reserve Bank needed to issue a statement of support for a bank to cut off an incipient run based on rumour on the back of regional building society difficulties. More generally, market research has consistently shown that the majority of customers regard banks as special and choice of bank is still predominantly based on convenience with little or no thought to differences in perceived credit standing. Vague notions of government support still abound, seemingly reflecting the long discarded (mandatory) lender of last resort facilities with the Reserve Bank of Australia more than the express depositor protection provisions of the Banking Act.

Against this background Advance Bank suggests that what is required in respect of prudential supervision is fine tuning rather than fundamental change. We are reinforced in this view by our perceptions of the need to remain consistent with the Basle Concordat and the resulting Bank for International Settlements prudential standards. Whilst not operating outside of Australia, even we benefit from the reciprocal recognition the Concordat provides in our foreign exchange activities and in our international fund raising activities.

Regulatory Form

The fine tuning we see as necessary is principally centred around the level of capital required and the risk weights applying to the various asset classes. If the capital requirements are set too high there will inevitably be a relative decline in the regulated institutions competing with unregulated competitors which are not burdened with such requirements. We believe the risk weights being applied need to reflect more closely the underlying economic risks, particularly measured on a portfolio basis, and should not be varied for monetary policy purposes as has been the case with the higher risk weight for loans secured by residential property with a loan to valuation ratio in excess of 80%.

Other areas impinging on banks' competitiveness are prime assets requirements, which in our view should be truly liquids accessible in time of need and not a required minimum holding; and, non-callable deposits, which in our view should not carry a penal interest rate so as to harm banks' competitive position as was so eloquently argued by the Campbell Committee.

In respect of the latter I hasten to add, Advance Bank has no difficulty with meeting a charge more accurately reflecting the direct costs of supervision, but the current discount to the Treasury Note rate is too heavy an impost and will lead over time to a decline in banks relative to other lenders not so encumbered.

Much media and academic attention has been directed as to whether financial services should be regulated on an institutional or product basis. We would agree with the Governor of the Reserve Bank that it is institutions, rather than products, that fail. Therefore we would see prudential regulation inevitably continuing on an institutional basis for entities that participate directly in the payments system, are entitled to accept deposits without a prospectus or underwrite insurance risk and superannuation.

As an entity which has chosen to change its institutional status once already in its history, Advance Bank does not see such an institutional base in any way dulling innovativeness or efficiency. Indeed we would reserve the right of some future date if circumstances were seen to warrant it, eg. for electronic prospectuses to be ubiquitous and generally acceptable to depositors, to cede our banking authority and go forward with a different status. In short the systems dynamism can be retained by a judicious setting of entry and exit levels.

With the emergence of financial services conglomerates there has also been an increasing amount of discussion about whether institutional specialisation should be retained. Advance Bank is firmly of the view that the different "promises" made by banks, life offices, funds managers, etc. cannot cohabit in the same institution. They are inherently different in nature and need and it is difficult to conceive how the winding up of an entity having made a mix of such promises would be managed. Advance Bank feels its depositors should retain first call on the Bank's assets, a position that can only be maintained by specialisation within corporate entities, with "firewalls" between associates offering different promises within a conglomerate.

Further Advance Bank in its operation of life insurance, funds management and mortgage insurance subsidiaries has not felt hampered by the institutional basis of authorisation and supervision and, apart from the frequent changes in superannuation and life insurance, has not had to bear inordinate costs as a result.

Supervisory Authorities

The existence of conglomerates clearly poses problems for the regulators. Advance Bank's view is that a lead regulator system would prove more practical; and, that the lead regulator wherever the conglomerate includes a bank should be the central bank.

This reflects our view that the alternative of a mega regulator would have potential to blur risk differentials and so harm the efficient operation of the financial system. There are clear information advantages in combining monetary policy and supervision of the central deposit taking institutions in one entity. Most importantly, in the event of a run, it is the central bank which needs to form the view as to whether it is unfounded or whether it has potential systemic impact and, if so, whether liquidity and other support needs to be supplied to the bank(s) involved in order to stem that run.

Similarly, if confidence in the banking system is to be maintained, in those cases where a bank within a conglomerate becomes unable to meet its commitments or is threatened by the decline of associates, the central bank should continue to have responsibility to take control of the bank within the conglomerate.

Consumer & Investor Protection

Information and bargaining power asymmetries also underlie much regulation which is generic across financial products - ranging from prospectus requirements applying to other than authorised (and supervised) deposit takers and insurers through to the "truth in lending" style provisions of the Trade Practices and Fair Trading Acts and the specifically consumer oriented Consumer Credit Code. Advance Bank supports the intent of this type of regulation but our experiences suggest refinement is necessary, eg.:-

- the continued dual regulation of financial planners/investment advisers by the Insurance and Superannuation Commission, through product specific requirements, and the Australian Securities Commission ("ASC") appears inefficient and annoying. The ASC model would be preferred.
- the necessary disclosures in prospectuses and written advice from financial planners has become too complex so customers and clients have at best a doubtful understanding of the disclaimers, etc. The plain English style of many new style insurance policies have much to commend themselves in this respect.
- the costs of implementing the Consumer Credit Code are largely sunk and, although one may doubt whether consumers will ever get benefits commensurate with these costs it is probably too late and too expensive for a radical change at this late stage. In keeping with the objectives of this legislation however there should be amendment to:-
 - restore self rectification of disclosure errors
 - clarify of some definitions to maximise the certainty of contract
 - preclude the possibility of unjust enrichment under termination of a tied contract
 - clarify that the linked credit provider provisions apply only where the link is directly related with the consumer's approach to the supplier

- ensure that securitisation structures obtain no advantages over other intermediaries who remain between consumers and third parties involved in their transactions
- eliminate a number of uncertainties created in the way the Code is drafted. We would be pleased to provide further detail if this would assist the Committee.

A major step forward in this regard would be to move to a single, national consumer authority which emphasises a "truth in lending" disclosure type regime as distinct from highly prescriptive legislation which, in its complexity, perhaps hinders competition by introducing a new source of scale economies - compliance. We doubt that the selling of financial services in the broad is so different that an industry specialist is required and suggest this role should be filled by the ACCC.

Investors should continue to be protected by the ASC in its implementation of the Corporations and Securities Laws with which we have experienced few problems other than the dual regulation of investment advisers and the indirect mandating of accounting standards which seem ill-suited to the practical running of our business, as in the case of the standard in respect of goodwill.

Constraints on Technology and Competition

As a leader in Internet, telephone and PC banking in the Australian financial markets, Advance Bank is vitally concerned with a number of legal requirements which significantly restrict or prevent our expansion in the electronic delivery of products and services. The range of federal, state and territory legislation needs to adopt a uniform approach to permit technological innovation in areas such as:-

- digital/electronic signatures to overcome the present need for customers to physically sign documents and/or visit bank premises
- electronic provision of notices
- tendering electronic evidence; and
- the use of storage and transmission of customer data.

Above all, a national approach is necessary if there is ever to be a truly national market for financial services. The current inability to get legal clarity on aspects of these essential features of electronic commerce is a significant inhibitor to this Bank driving home its current lead over the competition in Internet banking.

In a similar vein of catching up to financial market developments, particularly with the Real Time Gross Settlement system going live shortly, legislative backing for contractual netting warrants early implementation to restore certainty that receivers and liquidators cannot "cherry pick" among financial transactions based on positive mark to market and attempt to repudiate those with negative mark to market.

Competition Policy

The public debate seeking to influence the Committee's views on competition policy as it applies to financial services is obviously laden with vested interest.

We are sceptical of the "national champion" argument in financial services due to the relative scale of the Australian economy and currency. These make it unlikely that an Australian Bank could maintain a position of world significance in the face of the breakdown of old barriers to interstate banking in the USA and the aggregation and harmonisation in Europe. The limits on generating franking credits in Australia would see any bank maintaining world significance inevitably transform and migrate to have capital in foreign currencies and/or an overseas money centre headquarters, so as to lose its characterisation as "Australian".

Nevertheless, Advance Bank is of the view that there is nothing particular about financial services which warrants special treatment in this area. In short, the policy that is applied to this industry should be the same as that applied to others.

I should note that this view has been formed with our perspective of the Treasurer's veto of bank mergers and acquisitions contained in the Banking Act as having a significant public interest aspect for which it should be retained. Beyond this, we feel that the definition of the market to which the ACCC applies the policy can be established on an empirical basis, looking at how banks market themselves and interact with their customers, albeit subject to change due, in particular, to gradually increasing penetration of technological innovations to permit "anywhere/anytime" banking.

Summary and Conclusions

1. Deregulation has played a key role in enhancing the efficiency of the financial system and expanded the choice, improved the quality and lowered the real cost of financial services to the consumers and other users who are customers of this Bank.
2. Cross-subsidisation in financial services is no longer appropriate or sustainable. The end result of the changes as user pays is implemented will be an outcome which will be fairer to all - depositors, borrowers and shareholders.
3. Against the background of continuing information asymmetries, Advance Bank suggests that what is required in respect of prudential supervision is fine tuning rather than fundamental change. We are reinforced in this view by our perceptions of the need to remain consistent with the Basle Concordat and the resulting Bank for International Settlements prudential standards.

4. The fine tuning we see is necessary is principally centred around the level of capital required and the risk weights applying to the various asset classes. Other areas impinging on banks' competitiveness are prime assets requirements, which in our view should be truly liquids and not a required minimum holding; and, non-callable deposits, which in our view should not carry a penal interest rate.
5. We would see prudential regulation inevitably continuing on an institutional basis for entities that participate directly in the payments system, are entitled to accept deposits without a prospectus or underwrite insurance risk and superannuation.
6. Advance Bank's view is that a lead regulator system would prove more practical; and, that the lead regulator wherever the conglomerate includes a bank should be the central bank.
7. Advance Bank supports the intent of consumer and investor protection regulation but our experiences suggest refinement is necessary so that the costs are more commensurate with the benefits to consumers and investors. A major step forward in this regard would be to move to a single, national consumer authority and suggest this role should be filled by the ACCC. Investors should continue to be protected by the ASC in its implementation of the Corporations and Securities Laws.
8. The range of federal, state and territory legislation needs to adopt uniform approach to permit technological innovation in areas such as:-
 - digital/electronic signatures to overcome the present need for customers to physically sign documents and/or visit bank premises
 - electronic provision of notices
 - tendering electronic evidence; and
 - the use of storage and transmission of customer data.
9. Legislative backing for contractual netting warrants early implementation to restore certainty that receivers and liquidators cannot "cherry pick" among financial transactions.
10. Advance Bank is of the view that there is nothing particular about financial services which warrants special treatment in the area of competition policy. In short, the policy should be applied to this industry as it is to others. This view has been formed with our perspective of the Treasurer's veto of bank mergers and acquisitions contained in the Banking Act as having a significant public interest aspect for which it should be retained. Beyond this, we feel that the definition of the market to which the ACCC applies the policy can be established on an empirical basis.