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Abbreviations

ACCC	Australian Competition and Consumer Commission
AFIC	Australian Financial Institutions Commission
APCA	Australian Payments Clearing Association
ASC	Australian Securities Commission
ATMs	Automated Teller Machines
BAD	Bank Accounts Debits Tax
CFS	Council of Financial Supervisors
DTI(s)	Deposit Taking Institution(s)
EEC	European Economic Community
EFT	Electronic Funds Transfer
EFTPOS	Electronic Funds Transfer at Point of Sale
ELSS	Emergency Liquidity Support Scheme
FI Scheme	Financial Institutions Scheme
FID	Financial Institutions Duty
GDP	Gross Domestic Product
IATA	Insurance Acquisitions and Takeovers Act
ISC	Insurance and Superannuation Commission
MINFIN	Ministerial Council for Financial Institutions
PN	Prudential Note
RBA	Reserve Bank of Australia
RSAs	Retirement Savings Accounts
RWA	Risk-Weighted Assets
SGC	Superannuation Guarantee Charge
SIS Act	Superannuation Industry Supervision Act
SSA	State Supervisory Authority
SSPs	Special Services Providers

Preface

This submission to the Wallis Inquiry has been prepared by Credit Union Services Corporation (Australia) Ltd (CUSCAL). The contents of the submission may be copied, or reproduced in any form, by the Wallis Inquiry's Secretariat for the purpose of public circulation. The contents of the submission should not be reproduced for other purposes without CUSCAL's permission.

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Executive summary

Section 2 — The Australian credit union industry

Australian credit unions are significant participants in the retail banking market. There are 285 credit unions in Australia with $15 billion in assets and nearly three-and-a-half million members. In addition to providing a full range of retail banking services, credit unions have been at the leading edge of innovative development in technology, including the introduction of ATMs and EFTPOS to Australia and the trial of stored value cards.

The distinguishing feature of credit unions is that they operate as mutual organisations, observing the principle 'one member-one vote'. Internationally, the co-operative banking sector is highly developed, with a market share of around 20% in Europe, and similar market share in Canada.

In Australia, collective endeavour is a feature of the credit union industry, taking its form through the Credit Union Services Corporation (CUSCAL) which was established in 1992. CUSCAL is the author of this submission.

Section 3 — The FI Scheme

Since 1992, credit unions and building societies have been regulated under the Financial Institutions Scheme (FI Scheme). The Australian Financial Institutions Commission (AFIC) sets standards while State Supervisory Authorities (SSAs) have supervisory responsibilities in each State and Territory.

The Scheme aims "*... to protect and promote the financial integrity and the efficiency of the State-based financial institutions system; and to protect the interests of depositors....*"

The FI Scheme has provided a useful regulatory framework which has lifted credit unions and building societies to very high levels of prudential standards and assisted credit union access to the payments system.

However, credit unions now believe that these principal benefits are behind us and are unlikely to be matched by comparable achievements ahead.

- The FI Scheme fails its own first test of achievement, which is uniformity Australia-wide in regulating and supervising credit unions.

- Credit unions are disadvantaged because the content of the FI Scheme is not competitively neutral.

- The legislative requirements and prudential standards imposed on credit unions differ significantly, to the competitive disadvantage of credit unions, from those imposed on banks by the RBA.

- The processes within the FI Scheme have proven to be incapable of achieving internal uniformity or resolving many of these content issues, still less resolving them in a timely fashion that responds to market change.

- These 'process' problems will never be fixed and therefore the content issues never resolved, within the framework of a State-based system of regulation and supervision.

The FI Scheme should be abolished and replaced by a national system of regulation which would recognise the national market in which credit unions now operate and which is competitively neutral.

Section 4 — The post Campbell/Martin regulatory environment

The objectives of financial market regulation are:

- to maintain the stability of the financial system and promote consumer confidence in that system;

- to protect consumers by ensuring that they are provided with sufficient information to make informed decisions; and

- to prevent the abuse of market power.

Similarity in the aims of the Campbell (1981), Martin (1984) and Wallis (1996) Inquiries suggests that the policy objectives underlying regulation of the financial system have changed little in the last fifteen years. Each of these Inquiries has been set the task of reforming the means of achieving these objectives in a way that promotes efficiency, competitiveness, flexibility, fairness and stability. The need for such periodic review confirms that best practice changes over time: regulatory structures should ideally respond to changes in financial markets, in products and institutions, and in consumer behaviour.

The regulatory approach favoured by the Campbell and Martin Reports gave priority to the objective of systemic stability, and in particular to the prudential supervision of banks. The resultant system provided:

- a system of regulation that is primarily determined on the basis of institution, rather than function;

- a special and preferential regulatory regime for banks;

- privileged access by banks to activities such as cheque issuing and direct access to the payments system;

- a sub-optimal framework of State-based regulation for credit unions and building societies; and

- different regulatory treatment of identical products offered by DTIs.

The priority given this objective of systemic stability has limited other potential gains from competition and efficiency.

Section 5 — Assessment of the existing regulatory environment

The current regulatory arrangements retain the essential features advocated by Campbell and Martin, in particular the important distinction between banks and non-banks, and between DTIs and non-DTIs.

In CUSCAL's view the current regulatory arrangements are seriously deficient and will become more so in the future.

Current regulation is impeding competition and efficiency, and does not have the capacity to respond to technological development and the increasing globalisation of financial markets.

In the period since the Campbell Report, there has been an expansion of regulators with overlapping responsibilities such as the various DTI supervisors; and an extension of consumer regulation such as consumer credit and privacy law.

Consequently, similar products receive different regulation. For instance, non-bank DTI products receive substantially more intrusive prudential regulation than banks. DTIs' deposits are much more intrusively regulated than the deposits now being offered by non-DTIs (such as AMP's Guaranteed Income Plan, or Solicitors' Investment Schemes). By the same token non-bank DTIs' securitisation programs are much more circumscribed by regulation than those of non-DTI competitors.

Institutional regulation gives preferential treatment to some institutions while penalising others. DTIs face multiple regulators and prohibitions when seeking to access the superannuation market directly. On the other hand, they face much heavier prudential regulation of their savings vehicles than do superannuation funds, which are now arguably at least as important a 'safe haven' in the ordinary savings of Australians.

Finally the lack of a national, competitively neutral regulatory framework impedes realisation of the benefits of new technology such as expanded consumer access to financial services and greater competition through reduced barriers to entry.

Section 6 — An alternative regulatory framework

In order to redress these undesirable features of the current regulatory structure, we recommend that it be rebuilt, from the ground up, by identifying the types of financial functions which require regulation; by identifying appropriate regulatory intervention for each; and by aligning that intervention with a single regulator and a single regulatory objective.

We propose five major categories of financial activity on which to base regulation: savings instruments, risk management, lending, payment services and financial advice.

The nature of regulation will be specific to each function, and ought to apply equally and consistently to all providers, irrespective of institutional character.

The appropriate mix of prudential and consumer protection regulation for each function is determined by the nature of the liability borne by the institution and the financial sophistication of the investor.

We recommend that there be a substantial rationalisation and consolidation of existing regulators such that there is a single national regulator for each major regulatory objective and type of regulation.

Accordingly there should be a single, national, prudential regulator built around the RBA, parts of the ISC and AFIC/SSAs. We see little difficulty with the responsibility for monetary policy remaining with the new prudential regulator. The prudential regulator would be responsible for the stability and integrity of the financial system and supervising orderly entry and exit from the financial system.

There should be a single financial consumer protection regulator assuming the consumer protection responsibilities of the ISC, the ASC and some State-based responsibilities such as consumer credit and privacy. The consumer protection regulator would be responsible for consumer protection measures, including adequate disclosure for consumers, fair conduct in the market towards them, and the oversight of dispute resolution mechanisms. An agreement between the consumer protection regulator and the ACCC would give responsibility for consumer protection in the finance industry to the specialist regulator. Consumers would still be able to seek redress under Part V of the TPA, but the ACCC itself would not pursue actions in the industry.

There should be a single national competition regulator, the ACCC. There should be no finance sector specific competition rules other than the generic provisions of the TPA. The ACCC would be responsible for preventing abuse of market power and promoting competition. The ACCC could also assume responsibility for other regulation which provides for market participation. Thus those provisions of the Corporations Law providing for companies' formation and governance, creditors' entitlements and winding-up, could be administered by the ACCC.
In this way, a reduced number of regulators would be given single, clear regulatory objectives for an institutionally neutral regulatory system.

Section 7 — The new regulatory framework and credit unions

The three activities which are characteristic of retail banking are capital-guaranteed investments, the provision of payment services and the provision of loans. The first two of these require some prudential regulation, while the third does not.

With regard to the traditional instruments of regulation in these areas (capital and liquidity requirements, depositor protection, ownership controls, supervision arrangements and disclosure rules), there is substantial scope to reduce the intensity of existing controls. These include easing ownership requirements and easing liquidity controls.

Some changes are also necessary to achieve institutional neutrality for mutual retail banking institutions, for instance in the areas of access to capital, liquidity management and supervision.

In still other areas, new forms of regulation may be necessary, such as operational standards for payment services.

Section 8 — Incorporation of credit unions

A fully national system of financial regulation will mean that all financial institutions should be regulated nationally, including their formation, governance and winding-up. Accordingly, we recommend that institutional incorporation and governance be regulated under the Corporations Law.

In the case of credit unions, the Commonwealth is able to regulate these matters using the banking power or the financial corporations power. To prevent consumers being mislead, we recommend that the Corporations Law provide that a company cannot use ‘credit union’ as a trading name unless it is mutual in structure.

We also recommend that the successor to the Banking Act Cth 1959 provide that an institution cannot use the names bank, building society or credit union unless licensed to do so by the prudential regulator.

Summary

The regulatory framework proposed in this submission has several advantages over the current system. It provides clear lines of responsibility for regulators. It provides for fewer regulators. It is more likely to achieve institutional neutrality. It will ensure that similar products are regulated similarly and it will be flexible.
The new system would involve substantial legislative change, and major administrative change. The establishment of a new system would need to go hand in hand with close consultation with industry and consumers, as well as between regulators and governments. The Inquiry’s recommendations should therefore include procedures that might be taken up by Government in developing the substantive recommendations, including provision for industry and consumer consultation.

1. Recommendations

We make the following recommendations.

1.1 Broad regulatory framework

1. A major overhaul of the current regulatory arrangements should be undertaken to promote a competitive and efficient financial system, while maintaining systemic stability and appropriate protection for consumers.

2. Similar financial service functions should attract similar regulation regardless of the institutional status of the service provider.

3. The objectives of regulation should be to:

   - maintain the stability of the financial system and promote consumer confidence in that system;

   - protect consumers by ensuring they are provided with sufficient information to enable them to make informed decisions; and

   - prevent the abuse of market power and promote fair market conduct.

4. The three primary types of regulatory intervention should be:

   a) prudential regulation which focuses on the entire balance sheet activity of entities performing functions which pose a potential threat to the maintenance of systemic stability;

   b) disclosure regulation which aims to facilitate informed decision-making by consumers and shareholders; and

   c) competition regulation which aims to foster a competitive market-place, promote fair market conduct and prevent the abuse of market power.

5. Whatever the form that the regulation takes it ought to:

   - apply equally and consistently to those engaged in similar activities, regardless of their particular institutional status;

   - be administered in the most efficient manner possible; and

- involve the minimum degree of intrusion necessary for its objectives to be achieved.

1.2 Administration of regulation

6. A new prudential regulator should be built around the RBA, with the RBA continuing to combine its regulatory and monetary policy responsibilities.

7. The new prudential regulator should supervise all entities providing capital-guaranteed investments, payment services or some risk management products. These entities will include banks, credit unions, building societies and some insurance companies, with the appropriate regime of regulation and supervision for these institutions to be determined on the basis of the actual activities performed by them.

8. A new consumer protection regulator should draw together the consumer protection functions of the ASC and the ISC and the finance sector specific functions of the ACCC, the Privacy Commission and Consumer Affairs agencies.

9. The ACCC and the new consumer regulator should reach agreement that the latter has responsibility for consumer protection in the finance industry. Part V of the TPA would still be available for individual consumers seeking redress but the new consumer regulator would assume responsibility for specialist statutes and Codes of Conduct.

10. The new consumer protection regulator should perform all three categories of consumer protection regulation namely:

    - appropriate disclosure provisions;

    - the setting of and compliance with minimum standards of expertise; and

    - the establishment of dispute resolution mechanisms.

11. The ACCC should retain its existing responsibilities under Part IV of the Trade Practices Act in relation to the abuse of market power and should be the sole arbiter of merger proposals between institutions of any type.

12. The ACCC should assume responsibility for regulation of companies.

13. The various finance sector-specific restrictions on merger activity should be repealed, including repeal of the Banks (Shareholdings) Act.

1.3 Credit union regulation and the FI Scheme

14. The FI Scheme should be repealed and responsibility for credit union regulation and supervision should be assumed by a national regulator; this change would involve repeal of the FI Legislation and amendments to the Banking Act and Corporations Law.

15. If this reform is not supported then the Commonwealth Government should provide for the national regulation of credit unions in specific legislation, which it could enact under the banking power.

16. Mutually structured entities such as credit unions should not be discriminated against under the new regulatory and supervisory arrangements. Institutional neutrality should be a key feature of the new system.

1.4 State-based regulation

17. The regulatory environment for financial intermediaries should reflect the fact that the market for financial services is now undeniably national and increasingly international and should therefore be established under Commonwealth legislation and national regulators.

18. Consideration should be given to replacing State-based legislation for privacy and consumer credit with Commonwealth legislation.

1.5 Intensity of regulation relating to functions that are most important to credit unions

In additional to the above recommendations, the following principles should apply when determining the intensity of regulation relating to the functions set out below.

Capital-guaranteed investments

19. Any entity which provides capital-guaranteed investments should be subject to prudential regulation and be supervised by the national prudential regulator.

20. The regime of prudential regulation applying to capital-guaranteed investments should include the following features:

    - capital requirements which are consistent with those established by the Bank for International Settlements (BIS);

- scope for credit unions to access non-voting capital from sources other than retained earnings;
- the new liquidity requirements would be reduced with no Non-Callable Deposits (NCD), no Emergency Liquidity Support Scheme (ELSS) and no prescribed operational liquidity ratio;
- liquidity requirements to be set through a prescribed Prime Assets Ratio (PAR) or Prime Liquid Assets (PLA) ratio, which should be set at the same level for all institutions offering these products, with a discretion for the supervisor to raise or lower the level as appropriate given the liquidity risk faced by the institution;
- consideration of the emerging risk management techniques and the associated need to keep the levels of liquidity controls under constant review;
- no implicit or explicit guarantee (by governments or the national prudential regulator) of deposits or institutions;
- no statutory contingency fund or ‘deposit insurance’ scheme;
- the possible extension of a statutory depositor priority to all institutions offering capital-guaranteed investments;
- no restriction on the asset composition of the entity’s balance sheet other than large exposure limits; and
- application of prudential requirements (and supervision) to the entire balance sheet of any entity providing capital-guaranteed investments.

Payment services

21. Any entity which provides payment services involving both the transfer of value and potential settlement risk should be subject to prudential regulation and be supervised by the national prudential regulator.

22. The regime of prudential regulation applying to payment services which involve potential settlement risk should include all of the features outlined above for capital-guaranteed products plus the following additional features:

    - objective entry criteria which do not require entities providing payment service to adopt any particular institutional status; and

- a requirement for entities providing payment services to satisfy objective standards regarding operational capacity, in addition to balance sheet prudential requirements.

23. The regime of prudential regulation applying to payment services which do not involve any settlement risk should be based on the entity's ability to satisfy objective standards regarding operational capacity as referred to in paragraph 22 above.

24. In addition to prudential regulation, payment services should continue to have existing disclosure and fair conduct rules applied to all entities that provide such services; these rules include the EFT Code of Conduct and the Credit Union Code of Conduct, which should be applied equally to all institutions which provide these services.

Lending functions

25. Lending functions should not involve prudential regulation, since there is unlikely to be systemic risk flowing from the default of borrowers on their loans.

26. Regulation relating to lending functions should focus on disclosure and fair conduct rules, with the intensity of such regulation varying according to whether the loans involve retail or commercial transactions.

Incorporation of credit unions

27. Credit unions should be incorporated under the Corporations Law.

28. The Corporations Law should ensure that the term 'credit union' may be used only by a mutually structured entity.

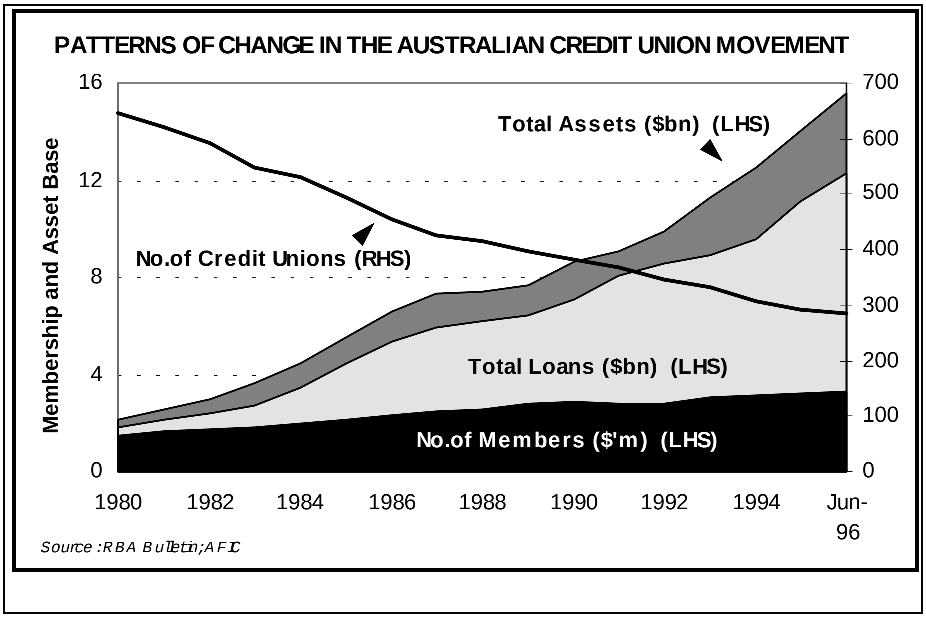
2. Credit unions and co-operative financial institutions — background

2.1 Credit unions in Australia

Australian credit unions are significant participants in the retail banking market. There are 285 credit unions in Australia with $15 billion in assets and nearly three-and-a-half million members. One in five adults has all, or part, of their financial requirements met by credit unions.

Since the 1980s, the number of credit unions has steadily declined with many smaller credit unions merging to form fewer, but larger and stronger credit unions. At the same time, membership of credit unions has increased steadily and been accompanied by growth in their assets and loans as indicated in Figure 1.

Figure 1



The services and products provided by credit unions include:

- cheque accounts with almost 35 million cheques processed each year;
- savings accounts;
- investment accounts — credit unions are estimated to be the second largest holder of term deposits;

- various loan products — credit unions are estimated to be the largest provider of personal loans;
- managed funds — providing products which are utilised by 33,000 members and growing;
- direct entry services — credit unions process almost $14.6 billion of direct entry debits and credits each year; and
- electronic transaction services — credit unions offer access to around 4,000 ATMs which process over 16 million transactions each year.

The credit union industry has also been at the leading edge of innovative developments in technology. Some of these initiatives are:

- The first ATM in Australia was installed in a Queensland credit union in 1977.
- The first pilot EFTPOS facility in Australia was conducted by a credit union in 1981.
- The world's first inter-continental cash withdrawal was made from a credit union ATM in Sydney in 1984.
- Credit union cards were able to access the EFTPOS system from 1985.
- Credit unions participated in the first trial of disposable stored value cards (SVC) in 1995.
- Credit unions participated in a trial of re-loadable SVCs and developed the first Code of Conduct for re-loadable SVCs in 1996.

The distinguishing feature of credit unions is that they operate as mutual organisations, observing the cardinal mutual principle of 'one member-one vote', irrespective of the size of individual shareholding, deposits or loans. Unlike all other financial institutions, except for some building societies, credit unions are wholly owned by their members. Both the mutuality principle and associated co-operative structure are central to defining the identity of credit unions here and overseas.

2.2 The international co-operative banking sector

Australian credit unions are established within a world wide movement of co-operative banking which is particularly strong throughout Europe and north America.

The co-operative banking sector in Europe is highly developed and its position has strengthened further over the last decade. Major co-operative banks have an average market share of around 20% in the national retail banking markets of France, Germany, the Netherlands, Belgium, Austria and Italy.

In Canada and the USA co-operative banking is an integral part of the financial services industry. In the USA, there are just over 12,000 credit unions with over 70 million members and combined assets of more than $US 300 billion. In Canada, more than one in three Canadians are members of either the 968 credit unions or of the 1,480 *caisses populaires* which are mutual organisations providing retail banking services to francophone Canadians.

A common feature of co-operative banking in all nations has been the formation of central organisations to provide the benefits of aggregation to member bodies. Thus treasury investment, liquidity management, payments system access, development funding and loan syndication are commonly found among the central banking services provided by credit unions to credit unions via their central organisations. In addition to service provision some of these central organisations also discharge supervisory functions within the official regulatory system. Central bodies in this category, including the Desjardins Group (the confederation of caisses populaires in Canada) and the Rabobank Group in the Netherlands, are typically responsible for ensuring aggregated or collective compliance by all members with capital and liquidity prudential standards, and are able to support system stability through systems of interlocking guarantees.

In Europe, national co-operative banking movements are formally associated through membership of the Unico Group, which has 39,000 affiliate bank branches in member countries. Membership includes France (Credit Agricole), Germany (DG Bank), the Netherlands (Rabobank), Austria (RZB Osterreich), Italy (ICCREA of Italy), Belgium (CERA Bank) Sweden (Foreningsbanken) and Finland (Okobank).

Similar forms of association and central service provision unite the credit union movements of many non-European nations. Eighty-seven nations, representing 88 million credit union members, are affiliated internationally via the World Council of Credit Unions.

This ubiquitous feature of co-operative banking, both intra and internationally, is collective endeavour, through which individual co-operatives co-operate together to give the industry a collective strength that is greater than the sum of its individual parts. By building critical mass and reducing unit cost, credit unions achieve business outcomes together that would be beyond the reach of individual units, or achievable by them only at prohibitive cost.

2.3 *Collective endeavour in Australia*

In Australia this universal tradition of collective endeavour is highly developed. Credit Union Services Corporation (Australia) Limited (CUSCAL) is the premier central organisation providing services to member credit unions. Its role as central banker to members is formally recognised in the FI Scheme provisions for the formation, registration and regulation of Special Services Providers (SSPs). CUSCAL is a member of the Australian Payments Clearing Association, a Principal Member of VISA International and holds an exchange settlement account with the RBA. The range of services CUSCAL provides to credit unions includes:

- Treasury
- Chequing (member and corporate)
- Business and Marketing supplies
- Collections
- Corporate lending
- Funds Management
- Information Technology
- Insurance
- Loan Securities
- Network Services
- Staff recruitment
- Retail Banking
    - Redicard
    - Network Redicard
    - VISA Debit card
    - VISA Credit card
    - VISA Fraud Pool
    - Reditellers
    - Rediteller Management Services
    - Direct Entry
    - Travellers Cheques and Overseas Drafts
    - Mortgage Breaker
- Securitisation
- Staff Training
- Compliance Advice
- Economic and Market Research
- Government and Public Representation

2.4 Summary

Australian credit unions provide a full range of retail banking services through a broad network of branches across the country. They are innovative service deliverers which have led the way in the development of several non-traditional banking methods. Australian credit unions are part of a much larger world-wide industry which is particularly strong in Europe and north America. The key distinguishing features of credit unions that set them apart from their competitors are their mutuality and the principle of collective endeavour whereby individual credit unions assist each other and in so doing strengthen their own position. In Australia the collective endeavour principle is embodied in CUSCAL — the author of this submission.

3. The Financial Institutions Scheme

3.1 Introduction and summary

This Section of our submission explains the Credit Union Movement's assessment of the Financial Institutions (FI) Scheme.

Credit unions are in no doubt as to whether the FI Scheme should be retained or disbanded. Overwhelmingly their opinion is that it should go, for reasons that are directly relevant to the Inquiry's third term of reference, namely, reasons of efficiency, cost effectiveness, adaptability, flexibility, responsiveness, consistency within the Scheme across State borders and consistency with the regulatory framework applying to competitors providing similar products, services and functions. The picture that emerges from their observations is of a regulatory/supervisory regime that is:

- too prescriptive;
- inflexible in its use of supervisory discretions;
- intrusive, restrictive and paternalistic in its supervisory style;
- inconsistent as between States in standards interpretation and supervisory approach;
- slow to respond to market change; and
- inefficient, especially due to replication of functions and personnel, both Boards and staff, in most States.

Many of these observations have already been documented at length in independent reports on the FI Scheme. Richard Beetham, former ISC Commissioner, First Assistant Secretary of Financial Institutions Division in Treasury and Member of the Martin Review Committee observed:

"... the concept of both AFIC and SSAs forming part of one co-operative supervisory structure in pursuit of the same objectives is not proving in practice to be conducive to uniform supervision or cost efficiency. The major problems arise in such areas as:

- *differences in interpretation of the standards among States;*
- *differences in approach to supervision;*
- *inconsistencies in administrative practices; and most notably*

- *duplication of functions and diseconomies of scale.*"[1]

Michael Waterhouse, Senior Adviser to the Campbell Committee, assessed the Scheme's operations against the benchmark principles of prudential regulation established by the Campbell Committee, the Council of Financial Supervisors and the FI Scheme's own codified Statement of Principles. He found that its prudential standards were inexplicably higher than those for banks, that it was relatively inflexible, highly prescriptive, lacked consistency with its own Statement of Principles and lacked national consistency in its approach to prudential supervision.[2]

The common theme in these published commentaries and credit unions' concerns is inconsistency — inconsistency among the States in their interpretation and application of what is supposed to be a "uniform" Scheme, and inconsistency as between FI Scheme standards and those applied to banks by the RBA. Our submission traces the source of this non-uniformity and competitive non-neutrality within the Scheme and concludes that the FI Scheme is incapable of eliminating these features of its character. More particularly, our case against the FI Scheme is as follows.

- The FI Scheme fails its own first test of achievement, which is uniformity Australia-wide in regulating and supervising credit unions.

- Credit unions are disadvantaged because the content of the FI Scheme is not competitively neutral. That is, the legislative requirements and prudential standards imposed on credit unions differ significantly, to the competitive disadvantage of credit unions, from those imposed on banks by the RBA.

- The processes within the FI Scheme have proven to be incapable of achieving internal uniformity or resolving many of these 'content' issues, still less resolving them in a timely fashion that acknowledges the pace of market change or the comparative speed of RBA/bank adaptation to change.

- We believe that these 'process' problems will never be fixed, and therefore the content issues never resolved, within the framework of a State-based system of regulation and supervision. Credit unions have come to the conclusion that a federalist system cannot be an efficient, adaptable and responsive system; that it is possible to have one system or the other, but not possible to have both.

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[1] Richard Beetham [Access Economics], "A Review of the Structure, Efficiency and Effectiveness of the Financial Institutions Scheme," December 1993, pp 4–5.
[2] Michael Waterhouse [Waterhouse Associates], *Credit Unions and the Financial Institutions Scheme* (2 vols), October 1994.

- Over time, as bank regulation continues to adapt to change and the FI Scheme remains stuck fast under the inertia of its own weight, the resultant competitive gap will widen to the point of threatening credit union survival.

For these reasons the fundamental propositions that credit unions wish to submit to the Inquiry in relation to the FI Scheme are:

- it is not uniform and is unlikely ever to be so;
- competitive neutrality is an essential benchmark standard of financial system regulation;
- the FI Scheme will not deliver competitive neutrality;
- this incapacity is not remedial within the limits of a State-based Scheme; and
- reform of the FI Scheme is not therefore a feasible option.

3.1.1 **Origins, objectives and achievements of the Scheme**

Before the commencement of the FI Scheme on 1 July 1992, each State and Territory separately regulated the formation and core activities of credit unions and building societies. Regulatory approaches varied considerably among the fourteen relevant Acts of Parliament. Some States had established prudential standards and supervisory systems of a high order while others had neither. Some were excessively prescriptive and paternalistic, severely restricting credit unions' capacity to adapt to changing markets, while others permitted greater degrees of institutional latitude. Some had solvency support funds to provide added depositor protection, while others provided no form of depositor safety net. In their regulation of interstate trading, all States reflected the protectionist policy of an era in which markets were defined locally and preference was given to local institutions over interstate "foreigners." In short, the relevant laws of the eight States and Territories were very disparate, exhibiting even less uniformity or convergence than had been adopted at that time within the banking laws of the member nations of the EEC. The extremities of approach were characterised at one end by stifling over-regulation and at the other by virtual non-regulation, neither of which served the interests of the institutions, their depositors or the wider public.

After the collapse of Pyramid Building Society the Commonwealth, States and Territories agreed at the Special Premiers' Conference in October 1990 to reform the regulation and supervision of State-based financial institutions. The next Special Premiers' Conference in May

1991 endorsed a Working Group Report and associated Heads of Agreement that stamped the shape of the future FI Scheme.[3] It was decided that the primary public policy objective, *"the supervision of State-based financial institutions in the context of the stability of the financial system as a whole,"* should be achieved by establishing a co-operative scheme which ensured that:

"a) there is a system of State-based prudential supervision of permanent building societies and credit unions with national coordination of high uniform standards and practices;

b) the legislation relating to the scheme is, and continues to be, uniform throughout Australia at all times;

c) the legislation is administered on a uniform basis;

d) there are suitable industry funded national liquidity support mechanisms;

e) the States will co-operate with each other in regard to the matters to be provided in the legislation and the way in which the legislation is to be administered;

f) the legislation is capable of effective administration throughout Australia with a minimum of procedural requirements and is so administered; and

g) changes in the legislation are proposed for consideration as appropriate from time to time and amendments made when the need for reform arises."[4]

These Heads of Agreement led in November 1991 to the Financial Institutions (FI) Agreement which, together with the Financial Institutions legislation subsequently enacted by each State, regulations issued under that legislation and prudential standards issued by AFIC, constitute the legal framework of the FI Scheme. The FI Agreement specified the Ministerial and administrative bodies that would be created to operate the Scheme. It defined the legislative mechanism by which statutory uniformity would be established and maintained among the States, and it contained a schedule of core prudential standards and practices for credit unions and building societies.

[3] The Report was entitled "*Proposals for Reform of the Supervisory Structure for Non-Bank Financial Institutions*".
[4] Recital E, Financial Institutions Agreement [Schedule of AFIC Code].

"It is the objective of the States," the Agreement said, *"that the Scheme should at a minimum maintain the overall level of depositor security reflected in* [this schedule of core] *prudential standards and practices for building societies and credit unions...."*[5]

This objective was subsequently given statutory expression in the AFIC Code in these terms:

"The principal objects of the financial institutions scheme are —

(a) to protect and promote the financial integrity and the efficiency of the State-based financial institutions system; and
(b) to protect the interests of depositors."[6]

Credit unions acknowledge that the Scheme has been responsible for notable achievements, in particular:

- staunching the loss of depositor confidence, which was especially acute in both the building society sector and State of Victoria after the collapse of Pyramid;

- lifting all credit unions and building societies to very high levels of prudential standards which, in AFIC's own description are *"among the toughest for any financial institution in the world"*[7]; and

- laying the prudential foundations that were a necessary pre-requisite both to credit union access to the payments system and to the reform of trustee and related legislation that previously discriminated against credit unions.[8]

However, credit unions are mindful that these principal benefits of the Scheme are behind us and are unlikely to be matched by comparable achievements ahead.

Before documenting the other side of the Scheme's performance assessment, our submission describes the Scheme's structure and design, especially its designed management system. It is necessary to do this next in order to draw the contrast later between the Scheme's

[5] Part 3, FI Agreement [Schedule of AFIC Code].
[6] AFIC Code, s9.
[7] AFIC brochure, "*Credit Unions and the Financial Institutions Scheme*."
[8] In this same context it is notable that credit unions and building societies qualify under the Commonwealth's new policy as financial institutions able to offer RSAs, but friendly societies, which are not yet prudentially supervised, do not.

promised and actual performance.

3.2 FI Scheme design

The purpose of this Section is to establish how the Scheme was intended to operate, with particular emphasis on the management systems intended to achieve the objectives of uniformity, competitive neutrality and adaptation in a changing environment.

3.2.1 **Legislative structure**

There are sixteen statutes in the FI Scheme that fall into three categories, namely:

- two Queensland Acts —
  - AFIC Act (Qld), of which s21 is the AFIC Code
  - FI (Qld) Act, of which s30 is the FI Code;
- seven Acts of other States and Territories that apply the AFIC and FI Codes within their jurisdictions; and
- seven Acts of other States and Territories that establish State Supervisory Authorities.

In addition to these sixteen Acts, there are five Books of Prudential Standards issued by AFIC, which have the standing of ‘statutory instruments’ within the Scheme.

As measured by the number of pages of black letter law, the FI Scheme is not, therefore, a model of brevity or simplicity. In this regard it contrasts starkly with the relative succinctness of the Commonwealth’s banking legislation and RBA’s Prudential Standards. The principal sources of difference are that the FI Scheme must bind eight sovereign parliaments in legislative uniformity whereas the Commonwealth stands jurisdictionally alone, and that the content of the regulation is overly prescriptive and complex.[9]

[9] In point of fact the FI Scheme is not fully uniform. Each State wrote its own legislation establishing its own SSA, though these Acts were required to comply with the SSA elements of the FI Agreement. Even here, however, there is non-uniformity:

> “SSAs, except VicFIC, are expressed not to be subject to direction by the government or the Ministerial Council.... This lack of uniformity should be contrasted with clause 404 of the FI Agreement which ... requires ‘that the SSA should have operational independence from industry and government’.”
>
> Butterworths, *AFIC: Legislation Commentary*, pp 28, 816

Three observations arise from this (nearly) uniform, State-based approach to the Scheme legislation.

First, it should be noted that this model was not the only available legislative route, forced on the States because constitutional barriers precluded the Commonwealth's direct involvement. On the contrary, the Commonwealth has clear heads of power in relation to banking and financial corporations. Legislative complexity was chosen in preference to legislative simplicity essentially because neither the Commonwealth nor State Governments wished to change the convention under which bank and non-bank DTI regulation has been divided between the Commonwealth and States respectively.

Secondly, in terms of aligning the market with the most appropriate legislative jurisdiction it made little sense in 1992 to preserve the sovereignty of the States in this area of regulation and it makes even less sense now. The financial services market then was national, if not international in character, given the widespread use of global funding and international payments systems. It is even more so now with the development of the latest generation communication technologies and in all likelihood this trend will accelerate in the future. It is simply inappropriate in our view to maintain as primary policy makers and regulators within national and international markets, governments whose jurisdiction is defined provincially.

Thirdly, the administrative task of giving effect to a partnership agreement among eight governments was never going to be easy, especially considering that none of the partners was (or is) politically comfortable in relinquishing its legislative autonomy and would not have formed the Scheme at all had not public opinion demanded reform in the wake of the Pyramid crisis.[10] Administrative success in these circumstances would obviously rely in large measure on the management system established under the legislation being strong enough to hold the partners together in common purpose; in effect, having a centripetal management system able to counter the centrifugal tendencies of the partners.

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[10] In relation to the Uniform Credit Laws Agreement 1993, which followed introduction of the FI Scheme, Western Australia rejected the adoption of template legislation first enacted in Queensland and opted instead to enact "alternative consistent legislation." In explaining this choice the WA Minister for Health, the Hon Peter Foss, said:

> "Template legislation is anathema to the Western Australian Parliament — both Government and Opposition.... The distaste for template legislation was brought to a head with the Financial Institutions legislation in 1992. The Parliament was required to pass it without having been fully consulted or having any real opportunity to have any input to the legislation, or even to know the wording of the legislation it was adopting. With template legislation, further amendments are made by agreement between Ministers, and Parliament is not consulted at all."
>
> *Financial Review*, Letters, 4 August 1994

3.2.2 Institutional structure of the FI Scheme

The various administrative bodies created by the sixteen statutes and FI Agreement are:

MINFIN — The Council of State and Territory Ministers responsible for the Scheme legislation and for appointments to AFIC and AFIAT.

AFIC — The central, coordinating body accountable to MINFIN whose independence is guaranteed under the AFIC Code. It issues prudential standards that are binding on financial institutions and SSAs. It directly supervises SSPs and manages the statutory Emergency Liquidity Support Scheme.

SSAs — The primary functions of the eight SSAs are to ensure compliance by credit unions and building societies with the FI Code and prudential standards and to ensure that an effective system of prudential supervision is applied to them.

ICC — The Interstate Consultative Committee, comprising one representative of each SSA, is a quasi-statutory body established under the FI Agreement. It meets regularly for the exchange of information about the FI Scheme and related operations. It may make recommendations to AFIC but does not have a right to make recommendations directly to MINFIN (which is not to say that MINFIN cannot seek its advice). It may nominate two candidates for appointment to the Board of AFIC. Six of the SSAs have both a Board and management; the other two (ACT and NT) are corporations sole, having appointed a single person to be the SSA.

AFIAT — Provision is made in the AFIC Code for appointments to be made to an FI Scheme Appeals Tribunal. It is effectively a dead letter because most decisions of AFIC and SSAs that might give rise to appeal from an FI are prudential and so have been classified as non-appealable under the FI Code.

3.2.3

Scheme management — the design

In all there are twelve statutory bodies — eleven more than the number needed in a national, as distinct from federalist, Scheme and eleven more than would have been created if the Scheme had been established by reference to an optimum standard of operational efficiency.

Even so, the Scheme was designed with a management system firmly in mind, the two primary features of which were:

- allocating functions among the bodies in a way intended to avoid duplication (other than the unavoidable duplication involved in each SSA supervising credit unions and building societies domiciled in its own State); and

- establishing one body, AFIC, as both the sole source of Ministerial advice and the ultimate administrative authority within this Scheme, especially the authority needed to maintain uniformity in standards, regulatory interpretation, supervisory methods and the exercise of SSA discretions.

There is no doubt that each of these elements of Scheme management was intentionally built into the design, not least because the design team consciously set out to avoid a repetition of the recently failed Uniform Scheme for the Regulation of Companies and Securities. A major flaw of this Scheme was its failure to integrate the National Companies and Securities Commission and State Corporate Affairs Commissions into a single, cohesive management system.

Accordingly, the functions assigned to AFIC and SSAs were intended to be complementary. The former is essentially responsible for policy recommendations, standards formulation and maintenance of uniformity, the latter for implementing policy and enforcing standards among financial institutions (excluding SSPs). While it is dangerous to rely too heavily on conventional corporate models because there are nine corporates in the FI Scheme, not one, it is nevertheless plain that in functional terms this division of responsibilities between AFIC and SSAs was intended to be analogous to a national corporation, with policy formulation located centrally and the delivery of services located in the regions.

What reinforces this view is the abundant evidence in the AFIC and FI Codes of the designers' intention to lock AFIC in as the peak administrative body in the Scheme. This is not to say that the Codes authorise AFIC to intrude at will into functional responsibilities assigned discretely to SSAs, or that anybody thought effective relations among the parties could be established by relying on legislative authority or discipline rather than goodwill. It simply says that because the Scheme designers recognised that Scheme uniformity would be lost unless one body had ultimate administrative authority, they intentionally created that central authority at many points in the AFIC and FI Codes. These included:

- AFIC's responsibility to *"institute, develop and ensure the effective and efficient implementation"* of both a system of uniform prudential standards and uniform supervision of financial institutions: AFIC Code, s15(b).

- AFIC's capacity to issue standards applying to SSAs, both in relation to the practices and procedures of supervision and the administration of the Scheme: AFIC Code, s28.

- A corresponding obligation upon SSAs to comply with these standards: FI Code, s68.

- AFIC's independence from MINFIN or government direction in determining standards: AFIC Code, s18.

- AFIC's exclusive responsibility to advise MINFIN in relation to changes to the FI Scheme legislation: AFIC Code, s15(g).

- SSAs' responsibility to advise and make recommendations to AFIC: FI Code, s66.

- SSAs' responsibility to provide information and statistics to AFIC; AFIC Code, ss15(c) and 48; FI Code, s66.

- AFIC's authority to inform first the Minister, next MINFIN and ultimately the Premier of a State whose SSA fails to supply information to AFIC, or fails to observe or give effect to a standard, or fails to take action in any matter that is in AFIC's opinion adequate and appropriate: AFIC Code, Part 7.

- Limiting the role of the ICC to making recommendations or representations to AFIC: FI Agreement, Clause 601.

- AFIC's control of the Emergency Liquidity Support Schemes: AFIC Code, Part 6.

- In addition to these provisions in the FI Agreement and legislation, AFIC has issued a prudential standard that requires SSAs to refer to it all discretionary decisions before themselves exercising a discretion: PS 2.016.

- Finally, it is AFIC that represents the Scheme on the Council of Financial Supervisors.

These two design features — avoiding functional duplication and establishing a peak administrative body — were intended to produce effective Scheme management (though not efficient management due to the creation of ten statutory bodies to do a job that could be done by one). Since the tests of efficacy were themselves built into the Scheme design in the form of defined objectives and expressed principles, it is a relatively simple task, therefore, to measure the efficacy of the Scheme by assessing performance against goals and by comparing its actual and theoretical management processes. The next Section of this submission makes these measures, with particular reference to the Scheme's stated objectives of

"... legislation administered on a uniform basis ... administered with a minimum of procedural requirements ... amendments made when the need for reform arises ... and all financial institutions [competing] *on an equitable basis with each other and with other bodies in the financial system".*[11]

3.3 *Scheme management in practice*

The purposes of this Section are first, to contrast the Scheme's planned and actual achievements in relation to uniformity, competitive neutrality and progressive adaptation and second, to show that each of these departures from Scheme design has arisen because the management system does not function as planned.

3.3.1 **Maintaining uniformity**

Despite uniformity of legislation, interpretation, supervision and administration being a primary goal of the FI Agreement, and despite the numerous legislative provisions in the Codes to ensure this goal is met, there are many instances of non-uniformity as between AFIC and SSAs and among SSAs themselves. Most relate to administrative practices among SSAs, which, although irksome to credit unions directly affected, are not a major source of concern bearing on the efficacy of the FI Scheme. For example, some SSAs permit liberal rules defining eligibility for credit union membership — the "common bond" — while others are more conservative in approach. Some use their discretionary abridgment powers to relieve credit unions of compliance with administrative red tape that is not prudentially related; others insist on compliance to the last letter of regulation. When credit unions are required under the standards to "consult" their SSA before entering into

[11] Recital E, FI Agreement and AFIC Code, s10.

large exposures, most SSAs are content to review the loan application documents, give advice as they think is necessary and leave the final decision on loan funding to the credit union. This is a not uncommon situation when small credit unions are asked to fund individual mortgage loans. One SSA, however, has institutionalised the process to the extent of issuing pro forma letters of notification and intruding further into the commercial realm of deciding loan approvals.

Our submission is not concerned with these irritating but essentially minor differences in management practices in the Scheme. Of greater concern are instances of inconsistency in interpreting prudential standards or, worse, effectively substituting national standards with rules made and enforced locally. For example, AFIC's prudential note on liquidity makes it plain that operational liquidity may "*include stand-by lines of credit or overdraft facilities with other financial institutions, including SSPs*".[12] CUSCAL received written confirmation from AFIC that undrawn balances under the committed overdraft facility CUSCAL provided to credit unions qualified as operational liquidity under this prudential standard:

"We have received the draft agreements and are of the opinion that the overdraft agreement and standby facility agreement should allow such facilities to be counted as operational liquidity in the books of societies."[13]

VicFIC declined to accept AFIC's determination of what constituted compliance with AFIC's own standard. Instead, it took the view that:

"... [the facility documentation does] *not appear to enable the undrawn amount of these facilities to be treated as operational liquidity for the purpose of meeting the minimum liquidity requirements...."*[14]

The disagreement was resolved only by CUSCAL amending the facility documentation, previously approved by AFIC, to accommodate VicFIC's concerns.

The high water mark of inconsistent interpretation is the 'securitisation saga', which persisted as a difference of interpretation between AFIC and SSAs for 15 months and even then remained unresolved. It was terminated rather than resolved only when CUSCAL and credit unions abandoned the product that gave rise to the stalemate between AFIC and SSAs, in the process losing both their investment in the product and the downstream commercial opportunities it would have created for credit unions.

[12] PN 4.120.
[13] Correspondence, AFIC to CUSCAL, 16 September 1994.
[14] Correspondence, VicFIC to Victorian Credit Union, 25 March 1996.

In 1991 CUSCAL, via its wholly-owned subsidiary Members Mortgage Australia (MMA), established a mortgage securitization program in conjunction with Australian Mortgage Securities (AMS), a wholly-owned subsidiary of the AMP Society. For the first three years the program securitised only new mortgages as they were originated by CUSCAL's member credit unions that had elected to participate in the program. Then in 1994 MMA and AMS introduced a program enhancement under which credit unions could securitise parcels of seasoned mortgages.

Every care was taken, at considerable legal expense, to ensure that the sale documentation complied in every respect with the provisions of AFIC's Practice Note (PN) 2/93, which specified the qualifying requirements for 'clean sales' of securitised assets — that is, the conditions to be met to ensure they were sold without recourse. AFIC confirmed in writing in December 1994 that:

"AFIC is satisfied that credit unions selling assets under the [mortgage purchase deed] *will achieve a clean sale and therefore any capital obligations with respect to these assets are removed. Importantly, documents do not oblige the credit union to support either the credit worthiness of the securitised assets or the liquidity of MMA. While the new RBA C2 is yet to be finalised, it would appear that the* [mortgage purchase deed], *together with appropriate professional statements, will satisfy the new requirements."*

VicFIC objected to the program enhancement, initially on the ground that Victorian credit unions lacked the legal capacity to participate as 'sub-originator managers' — *"the FI (Victoria) Code does not endow societies with powers to enter into the MMA program."*[15] Legal advice confirming the existence of legal capacity was then sent by CUSCAL to VicFIC and apparently accepted, although the existence of adequate statutory power was not acknowledged. Instead, the response hinted that, even if not *ultra vires* the FI Code, credit union participation might still be *ultra vires* their own rules — *"... each society should satisfy itself there is nothing in its rules which would prevent it from entering into the MMA program."*

The second ground of objection did not emerge at the same time as the first, but later, when the first seemed lost. It was that the documentation would not provide a clean sale, notwithstanding AFIC's earlier pronouncement of the program's compliance with AFIC's own Practice Note. This objection was soon taken up by the ICC on behalf of all SSAs. Most of 1995 was then spent (and in retrospect, wasted)

[15] VicFIC to CUSCAL, 6 January 1995.

in exchanges between ICC and CUSCAL officials arguing this point that had already been settled authoritatively by AFIC. In all this time the enhanced securitization program remained on hold. In February 1996 CUSCAL provided the ICC with independent advice from its auditor that the sale documentation complied both with AFIC PN 2/93 and RBA C2.

In March 1996 when this second objection seemed lost the ICC raised even further concerns, which it claimed would necessitate amendments to the sale documents.

At this point CUSCAL withdrew the product, firstly because it was untenable to ask our commercial partners to continue to fund drafting amendments which both we, and they, believed were unnecessary; secondly, because the product would have no value to credit unions unless they could be assured that SSAs would accept the sale of existing mortgages under the program as clean sales no longer requiring the support of capital in their balance sheets. CUSCAL could not give that assurance because the ICC had made it plain:

"Should a society not be able to clearly demonstrate its compliance with the Standard, the relevant SSA will reserve its rights to review the documentation ***and the society's practices in detail*** *and if necessary require the holding of capital against securities* ***apparently*** *transferred to MMA as part of the securitization programme* [our emphasis]."[16]

Ironically, this cancellation meant that credit unions abandoned one of the most prudentially sound initiatives they had undertaken, one that would have improved capital ratios and made room for controlled growth, because the prudential supervisors wouldn't accept it!

For credit unions this securitization incident was a watershed in their assessment of the FI Scheme, as no doubt it was for many others when they read on the front page of the *Financial Review* that AFIC and SSAs were in open (and quoted) disagreement on a prudential matter.[17] What it demonstrated conclusively was that AFIC was either unable or unwilling to use its undoubted powers to ensure the maintenance of uniformity in the Scheme, even though it was plain that leadership and Scheme uniformity were the crucial issues at stake. In effect, the management system built into the Scheme to ensure uniformity was put under challenge and failed, or more precisely was not even used.

The costs of the delays and final abandonment of the securitization program are difficult to quantify, but would clearly include the actual cost of the investment in the system, together with the opportunity cost

[16] Correspondence, ICC to CUSCAL, 19 March 1996.
[17] *Financial Review*, 22 April 1996.

of not proceeding with it. Credit unions also face the additional cost of now not being able to compete as effectively with other loan providers.

3.3.2 Competitive neutrality

In this submission 'competitive neutrality' is given the same meaning as ascribed to it by the Campbell Committee in 1981, namely:

"competitive neutrality stresses the need for consistency in the regulatory and taxation burdens imposed on different intermediaries."[18]

This concept of equality in the regulatory burden is taken up in the Inquiry's term of reference 3(d), which requires the Inquiry to:

"make recommendations on the regulatory arrangements and other matters affecting the operation of the financial system (including prudential and other regulations made by the RBA and other bodies) as will establish a consistent regulatory framework for similar financial functions, products or services which are offered by differing types of institutions."

Competitive neutrality is also one of the foundation *Principles of Supervision* formally expressed in the AFIC Code, as follows:

"It is the intention of the Legislature of this State that the following principle should be applied in the supervision of financial institutions —

Competition should be fostered by ensuring that, to the maximum extent possible, all financial institutions compete on an equitable basis with each other and with other bodies in the financial system."[19]

For credit unions, the most relevant 'other bodies in the financial system' are banks, they being the only DTI not regulated by the FI Scheme and credit unions' biggest competitor in the deposit market (though as noted in Section 5 of this submission, finance company debentures compete in the same market for funds and more recently, life insurance companies have entered the market with pseudo term deposit products).

On the face of it this principle of supervision may appear to have been met within the FI Scheme. In the eighteen core prudential standards and practices for credit unions contained in the FI Agreement, there are

[18] Paragraph 1.24, *"Final Report of the Australian Financial System Inquiry"*, 1981.
[19] AFIC Code, s10(1)(g).

no less than eight approving references to comparable standards issued by the RBA. Similarly, AFIC's philosophy of supervision begins by stating that *"in many important respects, AFIC's approach to supervision follows the RBA's model for banking supervision."*[20] On closer inspection, however, the core standards that refer approvingly to RBA standards contain qualifications — "*... per RBA* ***with appropriate modifications*** *... a* ***similar*** *approach to that adopted by the RBA."* Likewise the caveat in AFIC's philosophy of supervision is that "*... there are none the less* ***important differences*** *between supervisory standards for banks and* [these] *standards* [for credit unions and building societies]."[21]

Indeed, there are numerous important differences. The following items are legislative requirements or prudential standards under the FI Scheme that impose more onerous obligations upon credit unions and building societies than the corresponding standards, if any, applying to banks.

- Credit unions and building societies must maintain 7% of total liabilities, excluding capital, in the form of Prime Liquid Assets: PSs 4.115 and 3.115. Under the Prime Assets Requirement, banks must maintain 6% of their Australian assets in similar form.

- Credit unions and building societies must maintain access to a further 6% of total liabilities, excluding capital, in a range of assets which will give them access to operational liquidity. Not less than 2% of this 6% must be held on balance sheet: PSs 4.1.2 and 3.1.2. Banks are not subject to any similar requirement.

- Credit unions must ensure that 60% of their total assets comprise assets derived from financial accommodation to their members for any purpose: FI Code, s113. Banks are not subject to any similar requirement.

- Building societies must ensure that at all times not less than 50% of their total assets comprise assets derived from financial accommodation to their members for the purchase of residential building or for residential development: FI Code, s112. Banks are not subject to any similar requirement.

- Credit unions must ensure that not more than 10% of their total assets comprise assets derived from loans to members for commercial purposes: FI Code, s113. Banks are not subject to

[20] PS 1.010.
[21] Ibid.

any similar requirement.

- At least 75% of a credit union's required capital must be core (Tier 1) capital; for banks and building societies the requirement is 50%: PSs 4.210 and 3.210.

- Credit unions' rules must limit membership (and thus financial services) to persons having a common bond of association: FI Code, ss131(2) and 115(5). Banks are not subject to any similar requirement.

- Credit unions and building societies may not issue a first advertisement without the written permission of their SSA. Beyond this, SSAs have wide powers to direct amendments to or withdrawal of any subsequent advertisement. There are no prescribed criteria to guide SSAs in the exercise of this discretion and decisions are not appealable under the Code: FI Code, ss106 and 107. There is no corresponding power vested in the RBA.

- Credit unions and building societies may not execute service contracts of two years duration or longer, for the provision of **any** services or products to the credit union or building society, without the prior approval of their SSA or, in the case of national contracts, the prior approval of AFIC: PSs 4.4.4 and 3.4.5. Banks are not subject to any similar requirement.

- Credit unions and building societies must fully disclose to members "material" service contracts and material variations to existing service contracts. SSAs may deem contracts and variations to be material but do not do so by reference to published standards or criteria. Instead, materiality is determined by SSAs on a case by case basis: PSs 4.4.4 and 3.4.5 *"... where a society or CUSCAL hold an approval for a service contract and a minor amendment is made, they should provide the SSA with a copy of the contract with amendments. If the SSA decides it is not material, no further approval would be required."* [22] Banks are not subject to any similar requirement.

- Credit unions and building societies may not hold a subsidiary company without the approval of SSAs. There are no prescribed criteria to guide SSAs in their exercise of this discretion: FI Code, s188. Banks are not subject to any similar

[22] Correspondence, ICC to CUSCAL, 19 August 1996.

requirement.

- Credit unions and building societies may not acquire shares, beyond a level determined by SSAs, in a corporation that provides them with financial or other services: FI Code, s199. Banks are not subject to a similar requirement.

- Credit unions may not conduct transactions in foreign currency; building societies may borrow in foreign currency subject to directions from SSAs: FI Code, s121. Banks are not subject to a similar requirement.

- Credit unions must contribute at prescribed levels (which vary from State to State) to Contingency Funds — ie, statutory solvency support and depositor protection funds. Other than in NSW, credit unions are not entitled to the earnings from these Funds: FI Code, s98. Banks and building societies are not subject to any similar requirement.

- Credit unions and building societies intending to trade interstate must first obtain a certificate from their home State SSA stating that they comply with all applicable prudential standards: FI Code, s364. Some SSAs will not issue certificates without first conducting a thorough on-site inspection. Certificates have a two month currency, so if host State registration has not been obtained in that period the certificate lapses and the process must begin again. Banks are not subject to any similar requirement.

- Credit unions and building societies intending to trade interstate must also first obtain registration in those host States as *"foreign societies"*: FI Code, s364. Banks are not subject to any similar requirement.

- A condition precedent to registration as a foreign society is the appointment of an agent in each jurisdiction: FI Code, s364. Banks (and other companies generally) are not subject to any similar requirement. Even genuinely foreign banks (those incorporated outside Australia) are required under Part 4.1 of the Corporations Law to appoint only one agent for the whole of Australia, not one for each State and Territory.

In addition to these regulatory and prudential standard inconsistencies affecting credit unions alone or affecting both credit unions and building societies, SSPs have also been marked out for differential treatment.

- Apart from a narrow, prescribed range of treasury management services (accepting deposits, investing them in liquid assets and making loans to member credit unions or building societies), SSPs may not provide **any** service without first securing AFIC's approval in writing: AFIC Code, s36(2). Banks are not subject to any similar requirement. AFIC has recommended to MINFIN that this section of the AFIC Code be amended to remove any doubt that SSPs **must** secure AFIC's approval before providing any new product or service to members. Banks are not subject to any similar requirement.

- SSPs providing treasury management or settlement services must maintain a risk-weighted capital ratio of not less than 10% or 3.5% unweighted, whichever is greater: PS 5.2.1. The only minimum figure for banks is a risk-weighted ratio of 8%. Banks are not subject to any similar requirement.

- SSPs providing treasury services cannot deal in derivatives for the purpose of hedging credit unions' risks. That is, they may not enter into transactions with credit unions and then enter into back-to-back transactions with other institutions such as banks. Thus, to the very considerable extent that credit unions' only access to the derivative market is via their SSP, this prohibition effectively excludes credit union access to the risk management products in this market: FI Code, s120 and AFIC Regulation 5 (1)(b). Banks are not subject to any similar requirement.

Each of these regulatory distinctions between credit unions and building societies on the one hand and banks on the other, or between credit unions and all other DTIs, or between SSPs and banks, represents an inconsistency in the regulatory burden imposed on different intermediaries. Each one also represents a competitive disadvantage for credit unions/SSPs *viz-a-viz* banks in the following ways:

- by imposing direct additional operating costs (eg, higher capital ratio, higher liquidity levels, compulsory contingency fund contributions); or

- by indirect, opportunity costs via quantitative and qualitative balance sheet controls (eg, commercial loan ceiling); or

- by subjecting credit unions' and SSPs' commercial judgement to the discretionary approval of regulators (eg, service contract review, SSP product and service approval and subsidiary company formation).

At the very least it must be said that it is difficult to reconcile these competitive disadvantages for credit unions with the AFIC Code's expressed support for the principle of competitive neutrality, of *"ensuring that,* ***to the maximum extent possible****, all financial institutions compete on an equitable basis with each other and with other bodies in the financial system."*[23]

The only attempt made within the Scheme to provide this reconciliation is in the formal explanation of AFIC's approach to supervision, namely:

"In many important respects, AFIC's approach to supervision follows the RBA's model for banking supervision.... There are none the less important differences between supervisory standards for banks and the standards presented in these books [of prudential standards]*. Some variations are necessitated by the legislation, others by the nature of societies* [ie, credit unions and building societies]*. In particular, the need for national uniformity through a system of State-based SSAs demands a more intensive style of supervision and a much greater level of detail in the formal standards than are required for banking supervision."*[24]

While this statement plausibly suggests that the maintenance of uniformity in a co-operative federalist scheme is reason for greater intensity of supervision and greater detail in standards, it says nothing as to why the standards themselves should be more onerous than those applying to banks — and as such a source of competitive disadvantage to credit unions — nothing, that is, except the obscure comment that discretionary differences in standards are necessitated by "*the nature of societies.*" We are not alone in failing to understand this comment. As another commentator has observed:

"... it is not clear why more detailed standards should apply. There is nothing about [credit unions'] *characteristics — their size, ownership structure or nature of operations — which appears to justify standards designed to make them safer than banks and which, in AFIC's own words are 'among the toughest for any financial institution in the world'."*[25]

Indeed, if there were to be intentional differences in the prudential standards applying to credit unions and banks, then conventional risk-return theory would suggest that banks face the tougher standards because they should present the lowest risk among all savings institutions.[26]

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[23] AFIC Code, s10(1)(g).
[24] PS 1.010.
[25] Michael Waterhouse, op. cit., Vol. 2, pp 99–100.
[26] See, for example, Paragraph 19.180, *Final Report of the Australian Financial System Inquiry*, 1981: "The Committee believes that the principles of prudential regulation applying to non-bank DTIs should generally be comparable with those applying to banks, but should be less rigorous." Also see *Report of the Martin Review Group*, p 52: "*… believing that an efficient financial system should*

It is not the differences *per se* in regulations and standards applying to credit unions and banks that is our principal concern. It is instead their effects which are:

- first, the immediate cost and thus competitive disadvantage for credit unions arising from regulations and standards inconsistently applied;

- second, the impeded capacity of credit unions to adapt as quickly as their competitors to a changing market; and

- third, that by imposing on credit unions prescriptive requirements not imposed on their competitors, many of which intrude on commercial decision-making, the FI Scheme may ultimately subvert its own goals.

In this final regard it was Waterhouse who observed in his study of the FI Scheme:

"[The more onerous prudential standards applying to credit unions] *act to prevent an acceptable degree of risk taking. Not only does this conflict with one of the more important principles in the AFIC Code, but in so doing these requirements may stifle the ability of institutions to adapt and innovate and ultimately their ability to compete equally in a rapidly changing market. In this sense the controls may sow the seeds of increased risk they are designed to reduce....*

... If credit unions (and building societies) are to respond successfully to the challenges they face over the next few years, AFIC and SSAs need to take less of a prescriptive balance sheet approach to supervision. Rather, they need to adopt a more flexible approach which reflects an understanding of what is happening in the retail financial services industry and how it is likely to evolve in the future....

... If there is one omission from the FI Scheme/AFIC principles, it is the concern to ensure that institutions can evolve in response to changing circumstances — what the Council of Financial Supervisors refers to as adaptation and innovation and responsiveness to changing customer preferences."[27]

The obvious solution to these concerns is for credit unions and building societies to work with the FI Scheme authorities to change the Scheme legislation and standards so that they are competitively neutral. For

involve a spectrum of risk, the Committee regarded banks as being near the riskless end of that spectrum…."

[27] Michael Waterhouse, op cit, pp.101, 90 and 98.

two reasons, however, this approach has been unsuccessful.

The first reason is that even if the FI Scheme management accepts that the Scheme offends the principle of competitive neutrality, some believe there are supervening reasons why it should do so. What those reasons might be we do not know; as a matter of course reasons for rejecting Industry's policy proposals are not disclosed and the Scheme processes are not themselves transparent.

The second reason is that the decision-making processes within the Scheme do not operate as planned. Instead, they have become so complex and interminable that it is virtually impossible to secure change in policy decisions of this importance.

3.3.3 Legislative change

Just as the architects of the Scheme provided for the maintenance of uniformity and stated that competitive neutrality should apply as a governing principle, so they also recognised the need to amend standards and legislation *"when the need for reform arises"*.[28] Accordingly, whenever reform submissions have been invited CUSCAL has submitted comprehensive proposals for legislative amendment, especially including each of the areas of competitive disadvantage for credit unions and SSPs identified earlier in relation to competitive neutrality.

The current round of legislative review was launched two years ago and has pursued the following course:

- AFIC called for legislative submissions in August 1994.
- AFIC simultaneously issued a draft timetable of eighteen steps that had to be taken to settle, draft and enact an amendment Act in March 1996.
- In accordance with step 2 in this timetable, CUSCAL lodged a 29 point written submission on the specified deadline— January 31, 1995.
- CUSCAL officers met with AFIC management in early February 1995 to discuss the submission.
- In mid-February 1995 CUSCAL received from AFIC a spreadsheet summarising all submissions received and AFIC's

[28] Recital E, FI Agreement.

comments on them.

- In late February 1995 CUSCAL officers met with the Legislative Sub-Committee of the MINFIN Officers Group to discuss the submission.[29] We were promised their written comments at a later date, but as in each previous round of legislative amendment, none has been received.

- In the 18 months since this last meeting we have received no further information other than advice from AFIC in August 1996 that a bill has not yet been drafted.

Two years have elapsed since this review cycle was launched. It is eighteen months since submissions were received by the authorities and twelve months since an exposure draft of a bill was due to be available. FI Scheme management continues to debate what to include in the bill. Somewhere in this process are the Credit Union Movement's proposals for legislative reform, many of which address the urgent issues of competitive neutrality. We don't know the final fate of these proposals, or who has decided it, or why any or all amendments may have been rejected, or when a bill will become available. The lack of information results from the process which is ineffective, undefined, not accountable and opaque. As a process for managing change it is the antithesis of the management system intended by the architects of the Scheme.

3.4 The inherent flaw of the FI Scheme

The purposes of this Section are to identify the inherent weakness in the Scheme's State-based structure, which accounts for its failure to operate as planned, and to conclude that the solution is to create a national Scheme that can work rather than try to fix a federalist Scheme that cannot.

3.4.1 **The politics of a State-based Scheme**

The officers and lawyers who designed the FI Scheme made two assumptions crucial to the way they conceived it would operate, namely, that State Ministers, in their capacity as members of the Ministerial Council would:

- place the national interests of the Scheme before individual State interests; and

[29] This Group and Sub-Committee are explained in the next Section.

- accept a 'national' body, one independent of their individual or collective direction, as their sole Scheme adviser.

If these two assumptions had been correct then it is likely that management of the Scheme would have worked as planned: MINFIN would confidently accept the official advice coming to it solely from AFIC, and AFIC's position as the peak administrative body would be strengthened by MINFIN's expression of confidence. The former would lead to swift decision-making by MINFIN on legislative and policy reforms to the Scheme; the latter would reinforce AFIC's capacity to demonstrate Scheme leadership, including firm action as required to maintain uniformity.

However, these two crucial assumptions were not only incorrect but also politically naive. State Ministers are variously accountable to their State Premiers, State Parliaments and State electorates. In each case they are accountable for the protection and advancement of State interests. They sit atop State bureaucracies whose role includes the provision of policy advice in all areas of Ministers' portfolio responsibilities, including functions assigned to independent statutory authorities. These State advisers are not independent of their Minister's directions. In a federalist scheme they are the local advisers most likely to consider the local impact of policy change and local reaction to it, who can proffer options not put forward in the policy recommendations submitted by statutory authorities. They have their Minister's ear most of the time, while bodies like AFIC are physically remote, unable to press their claims as easily, particularly when Ministerial Councils such as MINFIN seldom meets physically around a table. In fact, AFIC is the only administrative body in the Scheme not represented by its "own" Minister on MINFIN, the assumption behind the Scheme structure again being that in their collective capacity all Ministers are in effect AFIC's Ministers relying solely upon AFIC for advice and putting the Scheme's national interests ahead of single State interests.
For all these reasons we are not surprised that:

- until recently, four of the seven AFIC Directors appointed by MINFIN (excluding the CEO), are also Chairmen of their State SSAs; and

- State Ministers have approved the emergence within the FI Scheme of a body known as the MINFIN Officers Group.

With regard to the first of these developments, it is true that there is nothing in the FI Agreement or Scheme legislation proscribing the appointment of SSA personnel to AFIC, in the same way as there is, for example, in relation to the appointment of credit union officers to the boards of SSAs. Yet it seems to credit unions to be obviously contrary to the intended spirit of the Scheme that these appointments should be made. That is to say, just as the Scheme explicitly recognises the potential for conflict of interest if a credit union officer were to become a member of the credit union's supervisory authority, and therefore prevents it from occurring, so it implicitly recognises the same potential conflict for persons being members both of AFIC and SSAs.

This implicit recognition arises from the Scheme's careful separation of functions between AFIC and SSAs and, by extension its equally careful separation of powers. One of those powers, which is central to the statutory relationship between AFIC and SSAs, and thus to the Scheme's planned management structure, is that AFIC has the power to make standards to be observed by SSAs. Thus the legal relationship between AFIC and SSAs is akin to that between SSAs and credit unions respectively. In each case the degree of latitude exercisable by the former is subject to the discretion, and ultimately the direction, of the latter. Having regard to the potential for disagreement and even disaffection arising between AFIC and SSAs over the use of this power to issue standards and give directions to SSAs, it is inconceivable that the designers of the FI Scheme intended that individuals could find themselves with the conflict of interest that would arise from having a foot in each camp. Despite all this, the Chairmen of SSAs are not uncommonly appointed by MINFIN to the AFIC Board.

The second of these developments, the emergence of the MINFIN Officers Group, has had a significant bearing on Scheme management as it is, rather than as it was designed to be. The Group comprises the departmental officers who advise Ministers individually and, while not formally constituted or recognised within the FI Agreement or legislation, it has come to exercise significant influence over Scheme policy and administration. The MINFIN Officers Group has in turn established a Legislative Sub-Committee which considers proposals for legislative reform of the Scheme. Participation in the Sub-Committee seems to be open to a wider range of departmental officers than those in the MINFIN Officers Group, though just how participants are chosen is unknown. NSW, for example, includes as members of this Sub-Committee reviewing proposed amendments to FI Scheme legislation, officers of the Department of Consumer Affairs, even though the Department has no connection whatsoever with the Scheme, or with the NSW Minister, or any known capacity for prudential regulation of financial institutions.

It is now possible to explain something of the process adopted for managing legislative reform of the Scheme— the real process, that is, not the theoretical model established in the Scheme legislation with its separated functions and established lines of authority. AFIC does not in fact present its recommendations directly to MINFIN as suggested by the AFIC Code, but to the MINFIN Officers Group, which in turn refers them to its Legislative Sub-Committee. We understand that the informal rule within the Legislative Sub-Committee is not to report endorsement of any proposal to the MINFIN Officers Group without the unanimous support of those who attend, and that the MINFIN Officers Group likewise declines to pass recommendations on to MINFIN without unanimous support of its own participants. At both stages the process thus gives tacit encouragement to the exercise of veto.[30] After recommendations are eventually made to MINFIN, and an exposure draft is prepared *"in a form approved by MINFIN Officers and circulated to industry, AFIC, SSAs and other interested parties, a draft bill is prepared for consideration by Officers before being sent to Ministers for final approval."*[31] For all practical purposes, therefore, this MINFIN Officers Group, which has no form and no function other than *"to advise Ministers* [but not MINFIN] *on policy and operational issues relating to the Scheme and to carry out the wishes and decision of Ministers* [as distinct from MINFIN]*,"* [32] has assumed *de facto* with the approval of MINFIN the peak legislative advisory role conferred *de jure* on AFIC.

There is yet a further aspect of this process that should be noted. The ICC, comprising CEOs and (as non-voting members) Chairmen of SSAs, has also established its own sub-committee known as the Legal Issues Group. As with the MINFIN Officers Group and its Legislative Sub-Committee, there are no formal appointments to this body. It has a fluid attendance, usually from four to eight people, mostly lawyers, who work for SSAs or are themselves an SSA. This Legal Issues Sub-Committee prepares legislative proposals which, after endorsement by the ICC, are referred to AFIC in the name of the ICC, ostensibly for evaluation by AFIC in its formulation of policy recommendations to MINFIN in accordance with its duties under the AFIC Code. As explained earlier, however, AFIC's recommendations are in reality referred to the Ministerial Officers Group which in turn forwards them to its Legislative Sub-Committee. At that point the process becomes ridiculously circular because some of the same individuals who, as members of the Legal Issues Group, had earlier prepared submissions for endorsement by the ICC en route to AFIC, now find themselves reviewing AFIC's recommendations to MINFIN in their capacity as members of the Legislative Sub-Committee of the MINFIN Officers Group!

Given these interminable processes, in which States are reluctant to yield to each other and all are united in their reluctance to yield to AFIC, it is no wonder that nothing has emerged in two years from the latest round of legislative review. Nor is it any wonder that AFIC

[30] This practice compares with the FI Agreement provision that legislative amendment requires a majority, not unanimity, of MINFIN support.
[31] "The Process of Effecting Legislative Change," attachment to correspondence from MINFIN Secretariat [Qld Treasury] to CUSCAL, September 1994.
[32] Ibid.

appears to be equally impotent in relation to enforcing Scheme uniformity. The political reality is that it cannot succeed in the role of peak administrative body in the Scheme unless it has the strong, public support of its Ministerial Council. Strong, public support is not synonymous, we submit, with MINFIN’s approval, whether tacit or overt, for the creation of an alternative, non-statutory Scheme management system.

3.4.2 **Conclusion**

While credit unions are disappointed with the effect on the FI Scheme of these political and federal tensions, we accept that they are an integral part of the Australian political landscape. We accept the political reality that State Ministers will have difficulty putting national interests ahead of State interests in their capacity as policy directors of national Schemes. We accept that such Schemes, just like the former Uniform Scheme for Regulating Companies and Securities, will more than likely founder on the politics of their formation. We therefore accept for these reasons that the FI Scheme is unlikely to improve in performance or achievement of its stated goals.

In our view the solution is simple and obvious. It is not to expect States, State Ministers and State politics to become something alien to their political culture, but rather to transform uniform regulation into national regulation and assign its political ownership to where it best fits our federal system of government — that is, to the Federal Government.

We submit that it will not be until the governance of credit union and building society regulation is addressed in this fundamental way that regulation and supervision will become uniform Australia-wide, or competitively neutral, or free of functional duplication, or that the system will become adaptable and responsive to a changing market. Our recommendation is that these necessary goals cannot be attained within the framework of a State-based system; that the FI Scheme should be repealed, and that responsibility for credit union regulation and supervision should be assumed by the Commonwealth Government.

4. The post-Campbell/Martin regulatory environment

The previous two Sections of this submission focussed on the role of credit unions in the financial market-place and the deficiencies of the current framework of credit union regulation and supervision under the FI Scheme. Before canvassing CUSCAL's preferred regulatory reforms, it is necessary to examine other (non-credit union specific) features of the current framework of financial system regulation. In assessing this broader regulatory landscape, our aim is to construct a system of regulation which rectifies the deficiencies of the FI Scheme by establishing a consistent regulatory framework for similar financial service functions.

This Section identifies the principal characteristics of the post Campbell/ Martin regulatory structure by reference to its underlying policy objectives, the various tools of regulation employed and its implications for different types of financial institutions. The next Section then examines the most significant market, technological and regulatory developments which together are challenging the ability of existing regulatory arrangements to achieve their underlying policy objectives.

4.1 The rationale for regulatory intervention

In CUSCAL's view, regulation of the finance sector is only justified where its objective is:

a) to maintain the stability of the financial system and promote consumer confidence in that system;

b) to protect consumers by ensuring that they are provided with sufficient information to make informed decisions; or

c) to prevent the abuse of market power and promote fair market conduct.

The first of these objectives is generally achieved through the prudential regulation and supervision of financial institutions.

The second objective is usually achieved by requiring product or service providers to disclose clear information about the product or service on offer. Clear disclosure facilitates informed decision-making by consumers and promotes competition between market participants.

The last objective is achieved by legislation which promotes fair market conduct and prohibits certain activities (eg, collusive dealing, price-fixing, certain takeovers or mergers) which are considered to involve an abuse of market power. Once again this form of regulatory intervention aims to encourage competition between the providers of products and services in order to promote efficient markets.

Whatever the objective of the regulation, or the form that the regulation takes, it should ideally be sufficiently flexible to accommodate product innovation and market developments. Conversely, if regulation becomes inflexible, then it should be reviewed.

The three regulatory objectives identified above may also at times be in conflict with each other. For example, pursuit of objective (a) necessarily involves the creation of barriers to entry in certain markets or product areas and to that extent may reduce competition. Similarly, compliance with disclosure requirements may impose considerable costs on product providers and cause some to withdraw from the market, while takeover or merger restrictions can potentially encourage inefficient operations or place limits on competition.

A desirable regulatory structure, therefore, is one that strikes a careful balance between potentially conflicting objectives and is regularly reviewed to ensure that its benefits outweigh its costs. As discussed below, regulation of the Australian finance sector has traditionally sought to achieve a range of objectives but has often failed, in our view, to strike an appropriate balance between them.

4.2 *Wallis, Campbell and Martin — similar objectives*

The Wallis Inquiry's Mission Statement requires the Committee to recommend a regulatory structure that will best ensure *"… an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness"*.

While the Campbell (1981) and Martin (1984) Inquiries were not given an explicit Mission Statement, the primary aim of both reviews, as evidenced by their terms of reference, written reports and recommendations, was to establish the most suitable regulatory framework for an efficient, competitive, flexible, fair and stable financial system. This similarity between the respective aims of the Campbell, Martin and Wallis Inquiries suggests that the policy objectives underlying regulation of the financial system have changed little over the past fifteen years. However, the best means of achieving those objectives does change over time: regulatory structures should respond to changes in financial markets, changes in products and institutions, and to changes in consumer behaviour.[33]

Although it took some years for most of the Campbell and Martin recommendations to be implemented, and despite further changes since that time, the current regulatory structure for the finance system still derives its principal features from these reviews which are now over ten years old.

The Campbell/Martin Reports heralded the deregulation of the Australian financial system. However, that deregulation had no direct beneficial consequences either for credit unions or building societies. This neglect of credit union / building society regulation stemmed from the considered conclusion that banks were special and therefore warranted particular regulatory arrangements.

4.3 *Primary concern with systemic stability*

Financial institutions (including banks, credit unions, building societies, insurance companies, finance companies, etc) are now subject to a raft of regulatory requirements under Commonwealth and State/Territory law, and are responsible to a variety of regulators, all of which seek to achieve one or more of the three policy objectives identified above. Although this regulatory framework has evolved progressively over the past decade, it has its origins in the major reviews of the financial system by the Campbell and Martin Inquiries.

The importance of financial intermediation to the economy generally led both the Campbell and Martin Inquiries to recommend a framework of regulation which accorded very high priority to the need to maintain the stability of the financial system and the viability of certain institutions operating within it. Both Inquiries concluded that such stability could best be achieved by establishing high entry requirements for banking by restricting what banks could and could not do and by subjecting banks to close prudential regulation and supervision by the RBA.

In seeking to promote a competitive and efficient financial system, both the Campbell and Martin Inquiries also recognised:

- that competition would be maximised by a regulatory system which imposed few barriers to entry and few restrictions on the activities of financial institutions;

[33] The importance of keeping regulatory arrangements under review was well recognised by both the Campbell and Martin Committees, eg, *"… the experiences of recent years underline the importance of a responsive and adaptive financial system … changing conditions have also emphasised the need to keep the various areas of financial regulation under review so as to avoid unintended and unwanted impediments to change"* (*Report of the Martin Review Group,* 1994 p 34).

- that efficiency and competition may be impeded if regulation impacts unequally on providers of the same types of financial services; and

- that it was desirable for there to be a broad spectrum of risk/return across financial products.

The concern to maintain the stability of the financial system determined the essential features of the regulatory arrangements advocated by Campbell and Martin. This concern with systemic stability was thought to justify regulatory arrangements which imposed high barriers to entry for certain activities and which applied differently to different types of institutions. Most particularly, it was considered necessary, in order to preserve systemic stability, to maintain a critical distinction between banks and non-banks.

4.4 The distinction between banks and non-banks

In considering the most appropriate regulatory arrangements for the financial system, the Martin Committee identified the bank / non-bank distinction as a threshold issue:

"At the most basic level is the question of whether there is a desire to see the continuation of banks as distinct participants in the financial system. If banks were not to remain a functionally unique institutional class, then the whole significance and importance of a policy on participation in banking, as distinct from the question of participation in the financial system, would be removed."[34]

While Campbell and Martin differed in some of their recommendations, their views on this threshold issue, and the justification for those views, were substantially the same. The Campbell Committee's views were summarised in the following terms by the Martin Report:

"*… believing that an efficient financial system should involve a spectrum of risk, the Committee regarded banks as being near the riskless end of that spectrum and constituting a distinctive class of institutions."*[35]

In reviewing Campbell's conclusion, Martin noted that:

"… the Group supports, as a general principle, the continuation of a basic distinction between banks and non-bank financial institutions … this reflects the view that undoubted confidence in banks is crucial to a well-functioning and stable financial system."[36]

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[34] *Report of the Martin Review Group*, 1984 p 50.
[35] *Report of the Martin Review Group*, 1984 p 52.
[36] *Report of the Martin Review Group*, 1984 pp 52-53.

These observations led to regulatory arrangements which, rather than setting the parameters for participation in certain financial service functions, instead created different regulatory requirements for different types of financial institutions. The central concern was to establish a suitable regulatory structure for banks which would satisfy the overriding policy objective of maintaining a stable financial system. Both the Campbell and Martin Committees identified three particular roles of banks which, it was argued, both defined their unique institutional status and warranted a particular form of regulation. These three roles were:

- the role of banks as the major repository of consumers' savings;
- the pivotal role of banks in the payments system; and
- the role of banks as the major source of liquidity for businesses.

Although other financial institutions (including credit unions, building societies, merchant banks, finance companies, etc) performed some of these functions, banks were considered special both because of their size and because they alone traditionally performed all three of these financial intermediation functions. These 'special' characteristics of banks were seen (by Campbell and Martin) to warrant a framework of financial regulation with the following features:

4.4.1 **Special prudential regulation for banks**

Banks alone would be subject to regulation by the RBA and, in order to operate as banks, they would need to satisfy stringent licensing criteria and be subject to close prudential regulation and supervision by the RBA. The precise nature of this prudential framework was largely left for the RBA to determine but it was recognised that banks would need to meet prescribed capital and liquidity requirements and have certain limitations imposed on their balance-sheet activity.[37] In short, the RBA's role was to regulate and supervise banks in relation to 'prudential matters', a term defined in the Banking Act to embrace:

[37] The prudential regulation of banks in the period before implementation of the Campbell/Martin recommendations was largely achieved through specific regulations designed to achieve the RBA's monetary policy objectives. The progressive dismantling of those regulations in the 1980s coincided with the establishment of formal prudential standards for banks.

"… matters relating to the conduct by the bank of its affairs …

(a) in such a way as:
(i) to keep itself in a sound financial position; and
(ii) not to cause or promote instability in the financial system; and
(b) with integrity, prudence and professional skill."[38]

4.4.2 Special competition regulation for banks

Although both the Campbell and Martin Inquiries favoured some relaxation of the entry requirements for participation in banking (eg, by recommending the granting of licences to foreign banks), the Martin Review concluded that bank ownership restrictions under the Banks (Shareholdings) Act should remain in place. This Act, which prevented any one bank shareholder from holding more than 10% of a bank's voting shares, was considered to provide an important adjunct to the prudential regulation of banks. The requirement for a wide dispersion of bank shareholding was justified on the basis that it:

- avoided a bank's solvency and that of its dominant shareholder being interdependent;
- provided greater protection to depositors against the risk that a bank might be operated to serve the interests of a dominant shareholder; and
- enhanced a bank's capacity to raise additional capital in times of financial difficulty.

Both Campbell and Martin recognised that these bank ownership restrictions would limit competition in the banking sector (by creating a barrier to new entry) and that they may inhibit efficiency and innovation by reducing the likelihood of bank takeovers. Despite these competition and efficiency concerns, however, the Martin Group favoured the retention of bank ownership restrictions, arguing that its recommendation *"… reflects the substantial weight which the Group places on the protection afforded depositors by dispersion [of shareholders]"*.[39]

Once again, therefore, the overriding policy concern was to maintain the stability of the financial system, and specified institutions, by insulating banks from takeover and/or undesirable shareholder

[38] *Banking Act 1959* (as amended), Section 5(1).
[39] *Report of the Martin Review Group,* 1984 p 57.

influence. Efficiency and competition objectives were considered secondary to the aim of maintaining systemic stability.[40]

4.4.3 Separate regulation for non-bank DTIs

While it was acknowledged by Campbell and Martin that credit unions and building societies also engaged in the three important intermediation activities mentioned earlier, it was thought inappropriate to subject these institutions to the same regulatory arrangements as banks. Three sets of reasons were canvassed by Campbell and Martin to support this view.

- Firstly, it was noted that the intermediation functions performed by credit unions and building societies, while similar to those performed by banks, nevertheless differed in important respects. In particular, it was noted that banks alone had the right to issue cheques and to access the payments system directly and that banks were the major providers of liquidity to the economy generally.

- Secondly, it was considered desirable for there to be a wide risk/return spectrum and, in order for *"… the system to provide a safe haven for depositors, particularly small unsophisticated depositors"*, bank deposits would need to sit *"… at the near-riskless end of that spectrum"*. Hence, when Campbell recommended a uniform State-based system of regulation for credit unions and building societies, it was assumed that such a system would need to be "less-rigorous" than that established by the RBA for banks. According to the Martin Report, *"… the fear was that over-extension of prudential regulation might create a 'gap' in the investment risk spectrum"*. In considering the possibility of non-bank DTIs being regulated by the RBA, the Martin Group expressed concern that *"… even if it* [RBA] *were to apply less rigorous standards than those for banks, there would probably be a blurring of the distinction between non-bank DTIs and banks and a consequent risk of strengthening impressions that deposits with non-bank DTIs were virtually riskless"*.[41]

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[40] Although bank shareholding restrictions were justified by Martin on the basis discussed above, and continue to be justified by the RBA for the same reasons, their retention by successive Governments has been in part based on a concern to limit mergers between banks and between major banks and large insurers. That is, far from limiting competition (as Martin and Campbell feared) they have been justified as a tool of competition policy.
[41] *Report of the Martin Review Group*, 1984 pp 87 and 165-166.

> The third reason advanced for excluding credit unions and building societies from 'bank-style' prudential regulation was that they did not, both by virtue of their smaller size and their limited role in the payments system, pose a significant threat to systemic stability.

This reasoning was — and is — self-fulfilling. That is, credit unions and building societies were considered different because they did not engage in certain activities which were proscribed by regulatory restrictions. Further, to the extent that these institutions did engage in functions similar to banks (eg, taking retail deposits), they did so with their depositors bearing greater risks, an outcome that was considered desirable from a public policy perspective. Being considered riskier institutions, however, meant that it was not appropriate for them to be granted direct access to the payments system or the right to issue cheques.

4.4.4 Concessional disclosure regulation for banks and non-bank DTIs

Notwithstanding the existence of different regulatory regimes for banks, credit unions and building societies, all DTIs were considered by Campbell and Martin to warrant additional regulation by virtue of their deposit-taking activities. This prudential regulation was especially important for banks, as discussed earlier, but it was also accepted that credit unions and building societies warranted some form of prudential oversight, albeit of a less rigorous form and by State/Territory Governments rather than the RBA.

Owing to their subjection to prudential regulation, it was not considered necessary (by Campbell and Martin) for DTIs to comply with much of the separate disclosure requirements to which non-DTIs were subject. The major categories of such regulation in the mid 1980s were the public-offer prospectus requirements administered by the State and Territory Corporate Affairs Offices (on the deposit/ investment side) and the State Credit Acts (on the lending side). By holding a banking licence, and therefore being subjected to close regulation and supervision by the RBA, banks were granted specific exemption from the public-offer prospectus requirements.[42]

Although the Credit Acts had not commenced at the time of the Martin Report, the draft legislation was seen by Martin as inappropriate for banks and led to the Review Group "*… expressing its hope that the State authorities will reconsider the implications of the proposed legislation before proceeding with it*".[43] The State authorities

[42] Credit unions and building societies were also granted a similar exemption.
[43] *Report of the Martin Review Group*, 1984 p 171.

subsequently acknowledged that their major concern was with non-DTIs (particularly finance companies) and responded by granting specific exemptions to banks, credit unions and building societies from the licensing requirements and the substantive disclosure requirements of the Credit Acts.

4.4.5 Regulation of non-depository non-banks

The Campbell and Martin reviews also identified many other types of institutions (including finance companies, merchant banks and insurers) which were engaged in financial intermediation activities. Once again, however, the activities of these non-DTIs were considered quite distinct from those of banks and, apart from some limited controls on insurance companies, it was considered that these institutions did not warrant prudential regulation. Instead, the investment products offered by these institutions were best regulated by the imposition of disclosure requirements for debenture issues, insurance policies, annuities, etc.

It was assumed that the additional risk arising from the absence of prudential regulation would be matched by these institutions offering correspondingly higher returns under their investment products.

4.5 Summary of post-Campbell/Martin regulatory framework

In terms of the 3 policy objectives behind regulatory intervention identified in 3.1 above, the framework of finance sector regulation in the mid-1980s had the following important features.

- **Primacy of prudential regulation**

  As the major participants in financial intermediation, banks were a pivotal concern and therefore warranted not only a separate licensing framework, but also a continuing regime of prudential regulation and supervision by the RBA. The aim of this regulatory framework was to maintain the stability of the entire financial system and hence the economy generally.

  Credit unions and building societies warranted a less-intrusive form of prudential regulation, largely because they were smaller, did not engage in a full range of financial service functions and therefore did not pose the same threat to the stability of the financial system.
  Apart from insurers, which were seen to warrant a degree of prudential regulation, the non-DTI financial intermediaries were not subjected to comprehensive institutional (or prudential) regulation, and were generally not thought to pose a threat to systemic stability.

- **Disclosure regulation only a secondary concern**

  The general policy aim to provide consumers with adequate information on which they could base their decisions was considered to be satisfied, particularly for banks, by the separate application of rigorous prudential and supervisory requirements. With this regime in place, it was considered unnecessary to require DTIs to meet the detailed disclosure requirements to which other institutions were subject.

- **Regulation to ensure fair market conduct**

  This policy objective was achieved by the requirements of the Trade Practices Act (TPA) and its enforcement by the Trade Practices Commission (TPC). The aim of the TPA and the TPC was to encourage competitive market activity, prevent the abuse of market power and generally to facilitate fair dealing between the users and providers of products and services. In the case of banks, however, the over-riding concern with systemic stability was used to justify additional ownership restrictions (under the Banks Shareholdings Act) which necessarily impacted on competition within, and new entry to, the banking sector.

- **Resolution of conflicting objectives**

  The regulatory arrangements which followed the Campbell and Martin recommendations were specifically intended to improve the efficiency of and competition within the financial sector. However, the primary concern with maintaining the stability of the financial system placed limits on the achievement of these two objectives. The result was a regulatory framework which, notwithstanding its ‘deregulatory’ emphasis, resulted in:

  - a special and preferential regulatory regime for banks;

  - a sub-optimal and non-uniform framework of State-based regulation for credit unions and building societies;

  - different regulatory treatment of identical products offered by DTIs; and

  - privileged access by banks to certain intermediation activities such as cheque-issuing and direct access to the payments system.

The following Section examines the major regulatory, market and technological developments that have occurred since the regulatory structure favoured by Campbell and Martin was partially implemented during the 1980s. These developments have exacerbated the weaknesses of those regulatory arrangements and have undermined their capacity to meet their policy objectives.

5. Assessment of the existing regulatory environment

The current regulatory arrangements for the finance sector retain the essential features advocated by Campbell and Martin, in particular the important distinction between banks and non-banks and between DTIs and non-DTIs. Over the past decade, however, the role of the established regulators has changed, new regulators have emerged and there has also been a considerable expansion of regulation into new areas. These changes have in turn been attributable to market and product developments, a perceived change in the role of certain financial intermediaries and a policy objective to enhance consumer protection. To some extent, therefore, regulatory arrangements have adapted as circumstances have changed. The critical question for the Wallis Inquiry to address, however, is whether this evolution of regulatory arrangements has provided the necessary foundations for "*… an efficient, responsive, competitive and flexible financial system*".[44]

In CUSCAL's view, the current regulatory arrangements are seriously deficient and will become more so in the future. In particular, current regulation is impeding competition and efficiency and does not have the capacity to respond adequately to technological developments and the increasing globalization of financial markets.

To explain the reasoning behind this conclusion, this Section examines:

a) the expansion of regulators and regulatory functions;

b) the application of different regulatory requirements to similar products and financial service functions offered by different institutions;

c) the extension of consumer protection regulation through State/Territory legislation; and

d) the implications for the regulatory system of new technological developments.

5.1 Expansion of regulators and regulatory functions

As financial system stability was the primary policy concern, the regulatory framework advocated by Campbell and Martin focussed on banks and their institutional regulation, and assigned the regulatory responsibility to the RBA. Other financial institutions and other policy objectives were of secondary interest.
We now have a regulatory system with the following features:

[44] *Wallis Inquiry Terms of Reference,* Mission Statement.

- The RBA, AFIC and SSAs have responsibility, respectively, for the prudential regulation of banks, SSPs and credit unions / building societies, while also performing an enhanced role in relation to disclosure and competition/ownership issues. In addition, SSPs require approval from the RBA in relation to their payments system activities.

- The ISC, formed in 1987, is responsible for the prudential regulation of insurance companies, oversees the trustee requirements for superannuation funds, establishes detailed disclosure regimes for superannuation and insurance products and regulates the activities of insurance agents and brokers.

  Notwithstanding their separate institutional regulation, bank, credit union, SSP and building society groups with insurance or managed fund subsidiaries are also regulated by the ISC. Like the RBA, the ISC also performs a secondary role in relation to competition and ownership issues through its responsibilities under the Insurance Acquisitions and Takeovers Act.

- The ASC, formed in 1991, has a primary responsibility for the regulation of companies and securities markets but also, within that broad role, oversees disclosure requirements for 'public-offer' investment products and licenses investment advisers.

- The ACCC, formed in 1995 from the amalgamation of the former TPC and PSA, is primarily responsible for enforcing the fair market conduct and competition objectives of the TPA, but has taken an increasingly active interest in consumer protection and disclosure issues, through its involvement with Codes of Conduct and dispute resolution mechanisms.

- The various State and Territory Bureaux of Consumer Affairs are responsible for the licensing or registration of credit union providers and the enforcement of the detailed disclosure requirements of the State Credit Acts and the proposed Consumer Credit Code. Significantly, the disclosure requirements of the Credit Code and the associated licensing/registration requirements apply to all financial intermediaries, including banks and credit unions.

- The Privacy Commissioner has responsibility for the Commonwealth Privacy Act and in that capacity prescribes detailed disclosure requirements for institutions which exchange financial information. Several State and Territory Governments are also proposing an expansion of privacy regulation into the private sector and the creation of additional, State-based, privacy regulators.

If these respective regulators were each achieving their policy objectives, without unduly adverse effects on competition or efficiency, then the actual number of regulators would not of itself be a cause of concern. Adverse effects on competition and efficiency do arise, however, both for individual institutions and the financial system as a whole, if:

- the responsibilities and/or objectives of regulators overlap or conflict with each other;
- the existence of numerous regulators creates unnecessary costs for those being regulated;
- the existence of institutionally-based regulators accords unwarranted preferential treatment to certain types of institutions; and
- products and services which are essentially identical are accorded different regulatory treatment, by different regulators, depending on which type of institution provides them.

Some of these negative consequences were already in evidence in the mid 1980s, and they have become progressively more serious as the range of available products and services has expanded and as particular types of institutions have engaged in a far broader range of intermediation functions. The result is a regulatory framework which, so far from promoting competition and efficiency in the financial system, has actually become a significant impediment to the achievement of those goals. These anti-competitive and inefficient outcomes arise from the interaction of market/product developments with the regulatory structure, and stem in particular from:

- the increased involvement of non-banks in financial activities previously considered the sole preserve of banks;
- changing patterns in the savings/investment behaviour of consumers;
- the expansion of State-based regulation of financial activities; and
- technological developments which have facilitated new delivery channels and improved consumer access to financial services and thereby fostered an increasingly national, and in some cases international, market for financial services.

Each of these developments is briefly considered below.

5.2 *Similar 'banking' functions regulated differently*

5.2.1 **Credit unions**

Credit unions now provide, particularly at the retail level, a very similar range of products and services to those provided by banks. These include a diverse range of deposit and lending products and payment/transactional services.

On the deposit side, the at-call and term deposits offered by credit unions are identical to those offered by banks. That is, regardless of the type of institution which provides them, these products involve a commitment to repay to the consumer, either on demand or after a specified term, both the amount deposited and a pre-disclosed rate of return.

On the lending side, credit unions provide personal and housing loans and a variety of revolving credit facilities on terms identical to such products offered by banks.

In conjunction with SSPs, credit unions also provide a full range of retail payment services including credit and debit cards, cheques, EFTPOS and ATM facilities, and direct entry. Significantly, it was the provision of such payment services that the Campbell and Martin Committees considered a distinguishing characteristic of banks and hence a justification for their separate regulatory treatment. For this reason, those Committees opposed access by credit unions (and building societies) to direct settlement facilities with the RBA and supported the retention of a privileged role for banks in relation to cheque issuing, credit card facilities and other payment streams such as the CEMTEX (direct entry) system. Such restrictions on credit unions have either been substantially relaxed or removed in recent years. In particular:

- credit unions have been accorded direct access to the major retail payment streams through the granting to SSPs of RBA Exchange Settlement Accounts;

- credit unions are significant debit/credit card issuers (in fact credit unions, in total, are the largest issuers of debit cards in Australia);

- credit unions participate fully in the direct credit payments system;

- SSPs are members of the Australian Payments Clearing Association; and

- the Government has agreed to amend the Cheques and Payment Orders Act to enable credit unions to issue their own cheques.

This progressive expansion in the range of credit union products and services has in turn led to broad community acceptance of credit unions as mainstream retail financial institutions, to significant industry asset growth over the past decade and to credit unions providing, to use the words of the Martin Review Group, *"… a safe haven for depositors, particularly small unsophisticated depositors".* However, credit unions have performed this role despite their subjection to regulatory arrangements which differ significantly from those imposed on their major competitors.

As explained in Section 2, credit unions remain subject to a regulatory framework which is restrictive, inflexible, inefficient and unnecessarily costly to the industry. This regulatory framework is increasingly limiting the ability of credit unions to compete with banks and other non-banks and, if not reformed, will leave credit unions very poorly placed to compete in the future in a marketplace characterised by low entry barriers and new (non-bank) product providers.

5.2.2 Other non-banks

As 'full service' providers of retail banking services, all DTIs are facing increasing competition from non-DTIs such as insurance companies, finance companies, superannuation funds and mortgage originators. These financial intermediaries are using various mechanisms to compete directly with the traditional DTIs in the retail banking market. The ability of these intermediaries to offer competitive products, on both the deposit and lending side, is in part due to their use of lower cost delivery channels and/or their avoidance of the substantial overhead costs incurred by the 'full service' DTIs. However, these institutions also benefit from a considerably less-costly and less intrusive regulatory structure. Unlike banks, credit unions and building societies, they are not subject to the costs associated with an intensive prudential and supervisory regime, and have therefore been able to offer very competitive deposit and loan rates.

On the deposit side, insurance companies are offering products, with a 'guaranteed' return of capital and income, under the guise of 'whole of life' insurance policies or immediate annuities. These products, such as AMP's 'Guaranteed Income Plan' (described in Attachment A), are being directly marketed as an alternative to term deposits with DTIs. They contain the essential features of DTI term deposits (ie, a commitment to return capital and income to the depositor at an agreed time) yet do not require the product provider to be subjected to intensive prudential regulation.

Finance company debentures and deposits received under Solicitor's Investment Schemes (see example in Attachment B) offer depositors a similar certainty of capital and income return but once again are provided within a regulatory regime quite different from that encountered by DTIs.

Some of these deposit-like products (such as finance company debentures) are not new, and were regarded by both Campbell and Martin as useful components of the risk/return spectrum for depositors/ investors. However, as can be seen from recent comparisons between deposit rates offered by DTIs and non-DTIs (see Attachment C), there is now little or no risk premium evident in the rates offered by non-DTIs. This equivalence of return suggests either that the underlying risks associated with the respective products are similar or that consumers have little understanding of those risks. Consumers could be excused for drawing either of these conclusions when they choose between deposit products with identical returns offered by, for example, a bank-owned finance company, an insurance company *"… with a AAA credit rating"*, a major bank or a relatively small credit union.[45]

Notwithstanding their compliance with the most stringent regulation of all institutions, credit unions appear to rate poorly when consumers are confronted with such comparisons. This is confirmed by the results of market research commissioned recently by CUSCAL.

Some of the findings of that research, the report on which is reproduced in full in Attachment D, were:

- that consumers assess the relative risk of investment/deposit products by reference to the institution which provides them, not the underlying features of the product (eg, debentures issued by bank-owned subsidiaries are considered to be as secure as bank term deposits);

- that consumers believe banks are more secure than other financial institutions as a result of their relationship with the RBA, and that some consumers believe the RBA guarantees their deposits;

- that consumers have little understanding of the actual legal or regulatory arrangements applying to particular products and therefore make their decisions primarily on their judgements about institutions; and

- that credit union deposits are considered less secure than bank deposits or debentures issued by bank-owned finance companies (eg, *"… a debenture offered through a bank will be safe because a bank is safe …. A term deposit with a credit union will be more risky than a term deposit with a bank because the*

[45] Advertising for AMP's 'Guaranteed Income Plan' (see Attachment A) states: *"… your capital and returns are guaranteed by AMP, Australia's largest financial institution"*.

RBA wouldn't support a credit union".)[46]

On the lending side, significant competition is emerging from mortgage originators through the use of securitization vehicles. While such mortgage originators do not take deposits directly from the public, and therefore do not warrant prudential regulation, they nevertheless benefit from the regulatory restrictions placed on DTIs. As explained in Section 2, this is particularly the case for credit unions whose own efforts to offer lower-rate housing loans through the process of securitization have been consistently impeded by the unnecessary and costly intervention of their institutional regulators.

A recent survey of housing loan interest rates (see Attachment E) indicates the extent to which the lower costs incurred by non-DTIs have enabled them to undercut rates offered by DTIs, and shows that twelve of the fifteen cheapest loan products were provided by non-DTIs.

5.2.3 **Competition and the regulatory framework**

The involvement of non-banks in product areas that were previously considered the sole preserve of banks has intensified competition in the retail deposit and lending market. Those competing in this market, however, are not doing so on equal terms due to regulatory arrangements which either advantage or disadvantage specific institutions. The disproportionate impact of regulation leaves credit unions particularly disadvantaged as they experience few of the advantages associated with 'bank-style' prudential regulation yet remain restricted in ways that their non-bank competitors are not.

In seeking to preserve their competitive position both credit unions and banks have sought access to growing markets which have traditionally been serviced by non-DTIs. In particular, they have endeavoured to access the rapidly growing managed funds and retirement savings market. Once again, as discussed further below, their efforts have been impeded by the current system of institutional regulation.

5.3 Changing savings patterns

When the Campbell and Martin Committees advocated a special regulatory regime for banks, based on a system of prudential regulation under the oversight of the RBA, it was assumed that banks would provide the major vehicle by which ordinary consumers would save. However, the exponential growth in superannuation deposits, as indicated in Figure 2, has meant that ordinary consumers no longer rely on banks to perform this role. This growth

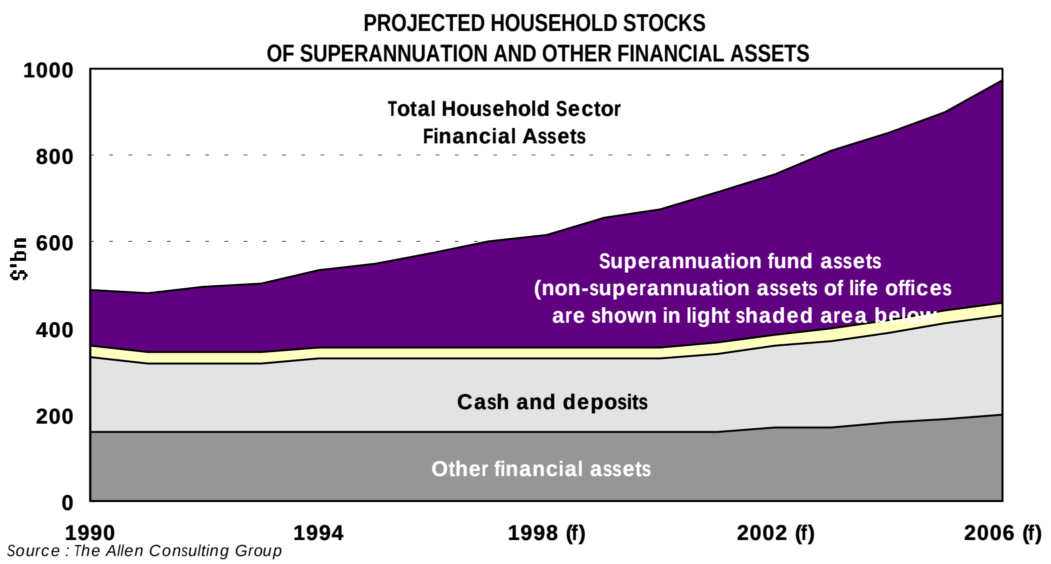
[46] *Eureka Strategic Research*, p 32 (See Attachment D)

in superannuation savings and other managed fund products has occurred within a regulatory framework which:

a) impedes the capacity of DTIs to participate in the market for superannuation savings, notwithstanding their subjection to rigorous prudential regulation; and

b) arguably provides insufficient protection to the superannuation savings of ordinary consumers.

Figure 2



Source : The Allen Consulting Group

5.3.1 Access by DTIs to the managed funds market

With the exception of the recent proposals to permit Retirement Savings Accounts (see Section 5.3.2 below), DTIs are prevented, by their institutional regulators, from providing managed fund products on their own balance sheets. In response to this restriction, many banks, SSPs, credit unions and building societies have established subsidiary companies to enable them to access the growing managed funds market. Depending on the precise vehicles used, these managed fund subsidiaries operate under the regulatory umbrella of either the ISC or the ASC and must comply with the requirements of the SIS Act (in the case of superannuation products) or the fundraising provisions of the Corporations Law (eg, in the case of public unit trusts).

The consequence of these regulatory arrangements for a DTI is that entry into the managed fund market necessarily brings with it obligations to satisfy, and report to, up to three different regulators. This occurs because the DTI's 'institutional' regulator (either the RBA, AFIC or an SSA) is required to closely scrutinise its funds management activities. This scrutiny can result in the imposition of additional requirements which effectively extend the DTI's obligations under the relevant functional legislation (whether the SIS Act or the Corporations Law). A detailed list of these requirements, as they apply to credit unions and SSPs, is reproduced in Attachment F, and include:

- a requirement for consolidated group accounts to be submitted to AFIC or the relevant SSA;
- SSA or AFIC approval before subsidiaries can be established;
- the capacity for SSAs or AFIC to require the parent entity to hold additional capital to cover risks associated with its subsidiaries; and
- SSA or AFIC approval before service contracts or guarantees can be entered into between the parent and its subsidiaries.

These regulatory requirements place DTIs at a disadvantage compared with non-DTI competitors. As DTIs, they are already subject to intensive prudential regulation and supervision yet are precluded from offering, on their own balance sheets, savings products which have now become the primary vehicle through which ordinary consumers save. Where DTIs establish separate entities in order to access these savings flows, they are subject to an additional layer of regulation beyond that imposed on non-DTIs.

It is for these reasons that DTIs have sought, and recently received, Government approval to provide Retirement Savings Accounts (RSAs) on their own balance sheets. As explained below, however, the proposed regulatory arrangements for RSAs will once again result in identical products being regulated differently depending upon the institutional status of the product provider.

5.3.2 Regulatory arrangements for RSAs

RSAs are designed to be a particular form of superannuation product which, unlike other superannuation funds, will involve a 'capital guarantee' and a pre-disclosed rate of return. The disclosure requirements relating to RSAs, which are yet to be finalised, will be determined by the ISC and prescribed under the SIS Act. Deposits in RSAs will be subject to the same taxation concessions and preservation requirements as other superannuation funds. Although this 'functional' regulation of RSAs will be the same for all product providers, the prudential regulation of these providers will differ depending on their institutional status. This prudential regulation will be conducted by the

RBA for banks, by AFIC for SSPs, by SSAs for credit unions and building societies and by the ISC for insurance companies and superannuation funds. Although the precise form of the prudential supervision of RSA providers is yet to be determined, it is almost certain that the respective institutional supervisors will not adopt a uniform approach.

Even if the RBA, AFIC and SSAs were to adopt uniform prudential standards in relation to RSAs, regulatory conflicts could still arise from the proposed involvement of the ISC. This involvement, while supposedly confined (for DTIs) to the functional regulation of RSA products, will also extend to what have traditionally been considered 'prudential matters'. Hence, RSA providers will be required to register with the ISC, provide the ISC with annual compliance reports, pay a supervision levy to the ISC and be subjected to an ISC 'authorisation process' which will include "*… an assessment that the institution's proposed systems and staff training will be adequate to ensure compliance*".[47]

In summary, the proposed regulatory arrangements for RSAs:

- are likely to result in different regulatory requirements depending on the institutional status of the RSA provider; and

- are likely to produce duplication, or conflict between, the prudential involvement of the ISC, the RBA, AFIC and SSAs.

5.3.3 Different regulation for similar products — managed funds

The problem of different regulation of similar products and financial service functions is particularly acute for the non-deposit or managed funds sector, notwithstanding recent efforts by the ISC and ASC to harmonise some of their requirements.

Both the ISC and the ASC provide consumer protection and disclosure requirements which, although covering very similar products, are quite different in their approach. This can impose very considerable compliance costs for institutions offering these products. Moreover, it provides scope for some institutions to seek a competitive advantage by designing products that attract the most favourable regulatory regime.

For example, the ISC and the ASC have adopted different approaches to the basic principles of disclosure for consumers. On the one hand, the ASC administers s1022 of the Corporations Law (the prospectus requirements) in a non-prescriptive manner; that is, it has simple

[47] Attachment to Treasurer's press release on '*Retirement Savings Accounts*', 20 August 1996 p 6.

requirements that place the onus on the institution to provide a consumer with all the information they might reasonably need to know. These requirements apply to personal investment plans and products such as unit trusts.

By contrast, the ISC has recently issued a s153 Determination which contains 129 separate clauses detailing the information that must be provided by public offer superannuation funds to consumers. These 129 clauses outline recommendations for a regulated document that is only six pages long!

The ISC's approach is prescriptive, inflexible and detailed. It is almost diametrically opposed to the non-prescriptive approach adopted by the ASC.

These conflicting regimes impose very real costs on institutions. For instance, CUSCAL's master trust, The Portfolio Service, provides consumers with both superannuation products and personal investment products in the same vehicle. However, two sets of disclosure documents have to be developed for consumers of The Portfolio Service, presenting similar information in different formats, and at least doubling the compliance costs for the provider.

The consequent overlap and duplication is another negative consequence of the different regulatory treatment of similar products and functions.

5.4 Expansion of State-based regulation

Over the past decade the States and Territories have become increasingly involved in regulating the activities of financial intermediaries. In addition to their responsibility for the FI Scheme the States/Territories have progressively expanded their involvement in regulation designed to protect consumers through enhanced disclosure. Such State-based regulation poses difficulties for nationally-operating financial intermediaries and has emerged as a significant impediment to the development of a competitive, efficient and flexible financial system. These adverse consequences are particularly evident in the following two areas.

5.4.1 **Credit legislation**

The existing State Credit Acts are not uniform and are proposed to be replaced, on 1 November 1996, by new uniform legislation (the Credit Code) which will be enacted in each State and Territory. Compliance with the existing Acts has created major inefficiencies for nationally-operating credit providers, with many credit unions finding it necessary to establish different computer systems and lending procedures to support their operations in different jurisdictions.

It is intended that these inefficiencies will be remedied by the enactment of the new uniform Credit Code. However, the fact that it has taken over ten years for the States and Territories to agree upon a suitable regulatory framework reveals the inherent weakness of ‘uniform’ State-based regulation. The Parliaments of Tasmania and Western Australia are still to enact the agreed legislation and recent advice suggests that the Credit Code will not commence until March 1997 in Tasmania, some 4 months later than other States. Even should the Code ultimately be implemented in all jurisdictions, there is no guarantee that it will remain responsive to market developments and product innovation. As explained earlier in Section 3, our experience with the FI Scheme suggests that timely amendments are impossible in a structure which requires agreement from among eight jurisdictions, each with its own policy and political imperatives.

While we support the Code’s underlying policy objectives (namely, to ensure that consumers receive accurate and timely disclosure in relation to lending products), we see no justification for the involvement of the States and Territories in this form of finance sector regulation. The market for loan products is now undeniably national and most credit providers operate beyond their State or Territory of incorporation. The regulatory environment for financial intermediaries should reflect these characteristics and therefore be established under Commonwealth legislation and national regulators.

5.4.2

Privacy regulation

State and Territory Governments are currently developing various proposals to extend privacy regulation to the private sector. In some cases these initiatives are well advanced and, if implemented through State and Territory legislation, are certain to produce non-uniform requirements governing the collection, use and disclosure of personal information. Ironically, these initiatives are largely being driven by concerns about the same technological developments which will render redundant notions of regional, State, or even national markets for financial services.

There is no doubt that developments in electronic commerce, particularly the widespread use of the Internet and the introduction of electronic cash (eg, smart cards) do raise significant privacy issues. This is widely recognised internationally and has already led the EEC to establish privacy principles which must be satisfied by all member countries. After 1998, these same countries will also require their trading partners, including Australia, to have in place similar privacy protection regulation before they will exchange commercial data containing personal information.

There is therefore a compelling case for national privacy regulation in Australia under Commonwealth legislation.

5.5 Technological developments

Financial intermediaries have traditionally been at the forefront of technological innovation. Over the past decade they have invested heavily in electronic payment instruments and associated infrastructure. The increased availability of electronic access mechanisms (including ATMs, EFTPOS, credit/debit cards and direct entry) has in turn been widely accepted by the Australian community and over the past five years resulted in an exponential increase in both the volume and value of electronic transactions.

More recent technological advances, such as the explosive growth in the use of the Internet and proprietary electronic commerce networks, and the development of reloadable stored value cards, are likely in the future to significantly affect the process of financial intermediation. While the precise impact of these new technological developments will not be known for some years, several important trends can be discerned which need to be taken into account in the design of a competitive, efficient and flexible regulatory structure for the financial system.

Firstly, the essential feature of the more recent technological developments is that they all facilitate new product distribution channels and thereby broaden consumers' access to financial services.

Secondly, the use of the Internet will enable financial transactions to take place anywhere, anytime and between any two parties which have access to the necessary technology. In this regard the more recent technological developments differ from those (eg, ATMs, EFTPOS, credit cards) of the past decade. It may be some time before 'on-line' technology is sufficiently secure to accommodate the widespread transmission of payments, but it is already possible to enter financial contracts via the Internet in relation to deposit accounts, loans and credit cards. Consumers can access such services with any product provider, regardless of its geographic location or its particular institutional status.

These two features of the new communications technology have the potential to produce significant benefits for consumers, product providers and the financial system generally. In particular, they should facilitate competition, as entry barriers are progressively lowered by new delivery mechanisms, and improve efficiency, by encouraging the use of lower-cost distribution systems. However, these benefits will only be realised, without offsetting disadvantages, within a framework of regulation which operates nationally and which applies equally to different products and services regardless of the provider's institutional status.

5.6 Summary of the existing regulatory structure

The existing framework of financial system regulation has evolved in various ways since the mid 1980s. Several new regulators have been established, partly as a response to market developments, the expanding role and functions of the various types of financial intermediaries and changes in consumer behaviour. These developments, and the regulatory response to them, has created an environment with many regulators, each with multiple objectives and overlapping responsibilities in relation to different types of institutions and forms of regulatory intervention.

As financial institutions have broadened their range of activities, this regulatory structure has become a substantial impediment to competition and the efficient operation of the financial system. Of all product providers, credit unions are particularly disadvantaged as they face the most rigorous prudential and supervisory regime of all industry sectors, yet remain excluded from significant growth markets.

New technological developments are expanding consumer access to financial services and facilitating the entry of new market participants. (For further detail on the range of different banking relationships and consumer profiles see Table 1 — Attachment G.) While these developments have the potential to improve efficiency and increase competition, these benefits will only materialise within a national, and competitively neutral, regulatory framework. This will not be achieved unless the States and Territories withdraw their involvement in critical areas of finance sector regulation.

In order to promote a competitive and efficient financial system, while retaining system stability and appropriate protection for consumers, a major overhaul of the current regulatory arrangements is required. As explained in the following Section, the new regulatory structure should be rebuilt from its foundations, beginning with a reassessment of the policy objectives underlying regulator intervention.

6. An alternative regulatory framework

In order to redress the undesirable features of the current regulatory structure, we recommend that it be rebuilt, from the ground up, by identifying the types of financial functions which require regulation, by designing appropriate regulatory arrangements for those functions and by aligning the responsibilities of regulators with the major types of regulatory intervention.

Such an approach does not simply involve a shift from institutionally-based to functionally-based regulation. This is because certain financial service functions undeniably create potential risks for the stability of the financial system and for that reason warrant a form of prudential regulation and supervision which can only be effectively applied to the institutions performing those functions. However, the regulatory system should not pre-judge the type of regulation required, as it does at present, by establishing different regulatory regimes solely by reference to institutional status.

This Section identifies the major financial service functions and the form of regulation appropriate to each. It then aligns a regulatory objective with a regulatory instrument and a single regulation. The resultant regulatory system is considerably rationalised and consolidated leaving three regulators for the sector.

6.1 Types of financial service functions

The activities of financial intermediaries, and the products and services which underlie them, can be broadly categorised into five types of financial service function, as follows:

- **Savings instruments**

  This category includes all forms of investments or deposits which involve a relationship within which consumers make a payment (or payments) to a financial intermediary with an expectation of deriving some form of financial benefit from doing so. The precise terms of the arrangement will determine the nature of this expected benefit which may involve an expectation of monetary return.

- **Risk management**

  This category includes life and general insurance products but also extends, in the wholesale or corporate market, to a variety of derivative instruments such as swaps, options and forward rate agreements.

-

Lending

This category includes all financial arrangements under which a financial intermediary lends money to a consumer with an expectation that it (the financial intermediary) will be repaid at a later time.

- **Payment/transactional services**

  This category includes all arrangements under which a financial intermediary, either directly or indirectly, facilitates exchanges of value between external parties and itself or among external parties, whether consumers, other financial intermediaries, other corporations or Governments.

- **Financial advice**

  This category encompasses circumstances in which a financial intermediary provides advice to consumers in respect of any of the four preceding financial service functions.

The nature of the arrangements within each functional category should determine what type of regulatory intervention is warranted. Whatever form the intervention takes, it ought to apply equally and consistently to those engaged in similar activities, regardless of their particular institutional status, should be administered in the most efficient manner possible, should aim to achieve a clear regulatory objective, and should involve the minimum degree of intrusion necessary for its objectives to be achieved.

The particular features of financial service functions which warrant regulatory intervention are canvassed further below.

6.1.1 **Savings instruments**

Savings instruments can assume many different forms and are offered by most financial intermediaries. These products involve contractual arrangements between financial intermediaries and consumers which impose liabilities on the intermediary. The appropriate form of regulation for such products should be determined by considering:

- the nature of the liability borne by the financial intermediary; and

- the financial sophistication of the investor.

In most instances, regulation should simply be designed to ensure that investors are provided with sufficient information to enable them to make informed decisions. This can be achieved by requiring product providers to disclose, in a clear and timely manner, the important features of the relevant savings product. In other cases, where the liability borne by the product provider is high, and where a failure by the provider to meet its liabilities could undermine the stability of the financial system, a more intrusive form of regulation is warranted. An example of such a high degree of liability — capital-guaranteed investments — is discussed below. This can be achieved through a regime of prudential regulation and supervision which aims, through the imposition of appropriate balance sheet controls and independent oversight by a regulatory body, to increase the likelihood of the product provider meeting its liabilities.

There are also circumstances where neither disclosure or prudential regulation is justified. This will be the case, in particular, where the liability imposed on the product provider is low and the financial sophistication of the product user can reasonably be expected to be high. An example — market-linked investments — as discussed below.

While there is a wide spectrum of savings instruments, they can be broadly categorised as follows:

a) **Capital-guaranteed investments**

The important characteristics of investments in this category are that:

- the product provider bears a high degree of liability;
- the product provider is committed to return to the consumer, either at the demand of the consumer or after a pre-agreed term, the amount invested; and
- the product provider pre-discloses, and is committed to pay to the consumer, a specified income return from the investment.

Currently available products with these features include at-call and term deposits offered by banks, credit unions and building societies, together with debentures issued by finance companies or solicitor's investment schemes and certain annuities offered by insurance companies.

b)

Market-linked investments

The common characteristics of these investments are that:

- the investor acquires an interest, either in specified assets or in a pool of assets; and

- the product provider makes no undertakings to protect the investor's capital from risk or to agree to a specified return from the investment.

Investment products with these features include equity-linked bonds or unit trusts, shares and derivative products.

Products which fall within either of these two categories should be subject to appropriate disclosure requirements. Judgements about whether prudential regulation of institutions offering savings products is also warranted, and if so the precise form of such prudential oversight, will depend on the overall activities of institutions. As explained in the following Section, any institution wishing to provide capital-guaranteed savings products should generally be subject to prudential supervision.

6.1.2 Risk management

The second category of financial activity is the provision of risk management products. Products which fall within this category should be subject to appropriate disclosure regulation. However, such regulation should be aimed primarily at those products used by retail customers since corporate users can be expected to have access to sufficient information, without regulatory intervention, to assess the suitability of available risk management products. For this reason, it is important for life and general insurance products to be subject to disclosure requirements.

The common characteristic of insurance products is that they involve a commitment by the insurer to make pre-specified payments to the insured in specified circumstances. Clearly, the ease with which an insurer will be able to meet its commitments will hinge on the nature of the circumstances upon which payments are contingent. Since an insurer's inability to meet its commitments could have severe consequences for a large number of consumers, and thereby could undermine confidence in the insurance industry generally, an appropriate form of prudential regulation is required for those performing this intermediation function. The particular features of this prudential regulation should depend on the nature of the liabilities assumed by the insurer and, as discussed in Section 6.4, on an assessment of the overall activities of the institution offering insurance products.

6.1.3 The lending function

By their nature, loan arrangements place liabilities on borrowers, not loan providers. The major justification for regulating lending contracts, therefore, should be to ensure that borrowers are provided with sufficient information to enable them to make informed lending decisions. The appropriate form of any such disclosure requirements will in turn depend on the financial sophistication of the borrower.

6.1.4 The payment function

The efficient processing and settlement of financial transactions is critical to the economy as a whole and therefore warrants close regulation to ensure that those engaged in this intermediation function are likely to meet their liabilities. For this reason, as explained further in Section 7, those who participate in this function should be subject to prudential regulation and supervision.

6.1.5 Financial advice

Many consumers lack the required expertise to make financial decisions without assistance from an external party. In order to protect consumers it is important that those providing financial advice be independent and have relevant expertise. Regulation of this function should therefore be designed to ensure the credibility and independence of those providing financial advice.

6.2 Types of regulatory intervention

As discussed earlier, there are three major types of finance sector regulation. The first is disclosure regulation and involves requirements for product providers to make available to consumers specified information in relation to the products on offer. Licensing requirements for financial advisers, securities dealers etc, can be considered a form of disclosure regulation as they involve disclosures to a third party, a regulator, which on the basis of that information assesses the credibility of the licence applicant. The second is prudential regulation and requires those who perform certain intermediation functions to be supervised, on an institutional basis, by a prudential regulator.

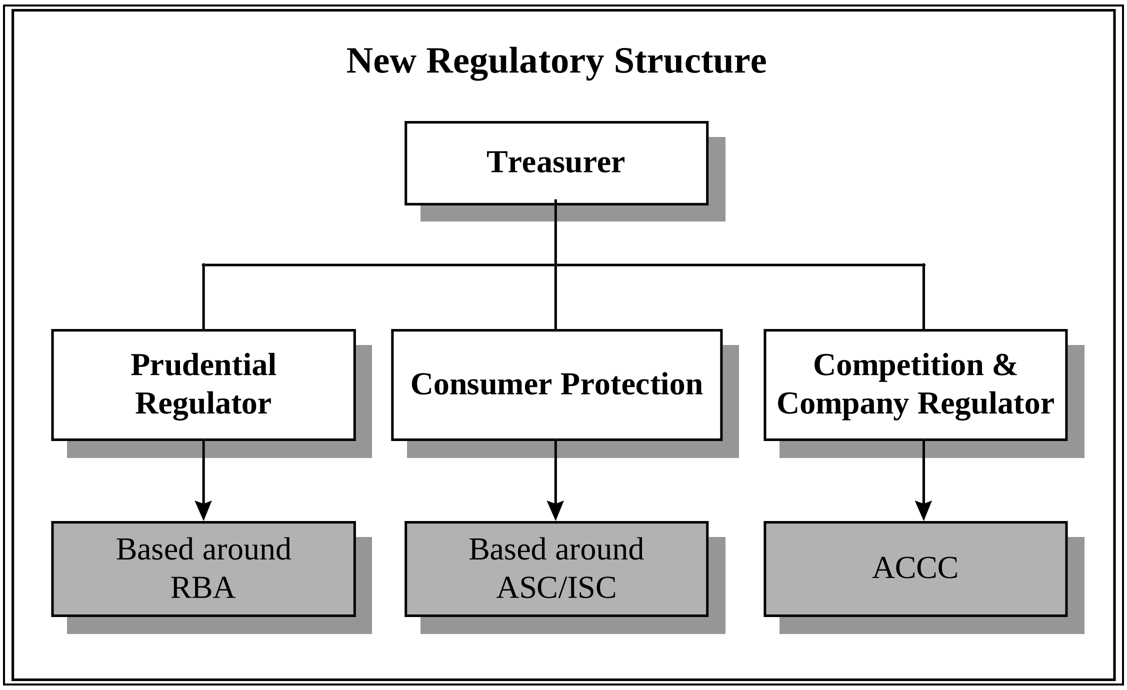
While the complex nature of financial products, and the importance of maintaining system stability, warrant particular disclosure and/or prudential requirements for those performing financial service functions, we see no justification for specific competition regulation applying to financial intermediaries. Rather, this third form of regulatory intervention ought to apply consistently to all product providers regardless of their particular sphere of economic activity.

6.3 Administration of regulation

In order to foster a competitive and efficient financial system, and to minimise regulatory overlap, the responsibility for regulation should be allocated to a minimum number of regulators. We recommend a substantial rationalisation and consolidation of existing regulators such that there be a single, national regulator for each major regulatory objective and type of regulation. That is, a single prudential regulator, a single consumer regulator and a single competition regulator (Figure 3). Each of these three regulators should be responsible to the Federal Treasurer.

This regulatory system would involve substantial legislative change, both at the Commonwealth and State level, the establishment of new regulators and, most importantly, judgements about the appropriate intensity of the prudential and disclosure regimes that should be adopted. In our view, the major objectives, responsibilities and activities of the three regulators should be as set out below.

Figure 3



6.4 New prudential regulator

As discussed earlier in this submission, different forms of prudential regulation are presently applied by no less than eleven different regulators. These prudential and supervisory regimes vary depending on the type of institutions that are subject to regulation, even though the activities of those different types of institutions may be the same. Under our proposed regulatory model, prudential regulation would be applied to any institution whose total activities were such as to pose a threat to the stability of, or could undermine confidence in, the financial system. Allocating all prudential and supervisory responsibilities to a single national regulator would improve the consistency, efficiency and flexibility of regulation and would help promote competitive neutrality among all institutions providing similar financial service functions.

The major objectives of the new prudential regulator would be to:

- promote the stability and integrity of the financial system;
- promote consumer confidence in both the financial system generally and the particular institutions subject to prudential regulation and supervision;
- encourage prudent risk management practices, consistent with established international standards, by the prudentially supervised institutions; and
- ensure that institutions can enter and exit from the financial services industry without destabilising either the overall financial system or the confidence of consumers in it.

To achieve these objectives the prudential regulator will need to establish appropriate regulatory standards for those engaging in certain financial service functions, together with a flexible supervisory regime to ensure that compliance with those standards is maintained. While the appropriate standards will vary depending both on the particular functions performed by institutions and the regulator’s overall assessment of the risks borne by each entity or group, the following three requirements should provide the core of the prudential regime:

- **Capital requirements**

  Capital provides a final buffer against losses which may otherwise unsettle the stability of the financial system and also improves the capacity of the regulator to manage industry exits without undue disruption either to other institutions or the overall system.

- **Risk management requirements**

  The prudential regulator should prescribe minimum risk management standards for institutions, consistent with the activities in which they are engaged, and should oversee objective entry criteria to satisfy itself that the management of institutions will implement adequate risk management systems.

- **Reporting and supervision**

  The regulator should establish reporting and supervisory regimes that provide it with sufficient comfort in relation to institutions' compliance with the relevant capital and risk management standards, and which provide scope for the regulator to take remedial measures to prevent disruption to systemic stability.

In designing an appropriate combination of capital, risk management, reporting and supervisory requirements, the prudential regulator will need to take particular account of the various activities performed by financial conglomerates, each of which may involve different risks and/or the potential for contagion across different areas of market activity. This task necessarily requires consideration of group, as well as single-entity, delivery structures and may justify regulatory requirements for certain financial functions to be performed within a single entity. As discussed in the following Section, we recommended that the provision of capital-guaranteed investment products and payment services warrant the most rigorous form of prudential regulation with the attendant requirement for such functions to be performed by a single legal entity.

6.4.1 **Prudential regulation and monetary policy responsibilities**

Owing to the functions presently performed by banks, credit unions, building societies and some insurance companies, it would be appropriate for each of those categories of institution to be subject to a form of prudential regulation. The new prudential regulator may take the opportunity to review and rationalise prudential standards and supervision.

There is clearly a body of considerable expertise in prudential regulation within the current structure of institutional regulators. As the largest of those regulators, the RBA is well placed to provide the foundation around which the new prudential regulator could be built. We see little difficulty in the responsibility for monetary policy being conducted by the new prudential regulator. The combination of regulatory and monetary policy responsibilities within the RBA has not, in our view, caused difficulties in the past and should be allowed to continue within the new regulatory regime.

6.5 Consumer protection regulator

There are currently three different categories of finance sector regulation which have a common objective of protecting consumers. They are:

- regulation which requires clear disclosure of the terms and conditions attaching to particular products and services;
- regulation which gives consumers an assurance that certain market participants are appropriately qualified; and
- regulation which requires product or service providers to establish dispute resolution mechanisms.

Responsibility for these three types of regulation is currently shared between the Commonwealth and State/Territory Governments and is overseen by a variety of regulators, including the ISC, the ASC, the Privacy Commission and the State/Territory Bureaux of Consumer Affairs. This sharing of consumer protection responsibilities has led to inconsistent regulation of similar financial products and non-uniform legislative requirements.

In our view, there is no rational justification for the existence of multiple and overlapping consumer protection regulators. We therefore recommend that a single national consumer protection regulator should perform all of the regulatory functions identified above. This approach would improve the efficiency of regulation and assist the development of consistent regulatory requirements for similar finance service functions.

The consumer protection regulator would be responsible for determining appropriate disclosure requirements for all of the savings, risk management, and lending products described earlier in Section 6.1. In making those judgements, the regulator should focus its attention on the needs of retail consumers, as professional or corporate users of financial services can be expected to have adequate information on which they can assess the suitability of particular products and services.

To ensure that consumers are not exposed to unscrupulous market operators, the consumer protection regulator should also establish minimum standards, and licensing procedures, for insurance agents and brokers, financial advisers and securities dealers.

While the carriage of the regulatory functions identified above would require the establishment of a new regulator, it would be desirable to utilise, as far as possible, the knowledge and expertise of those performing similar functions within the existing regulatory structure. We therefore recommend that the new consumer protection regulator should be structured around the ISC and the ASC, with relevant staff drawn from the ACCC, the Privacy Commission and the Consumer Affairs agencies.

6.6 Competition and company regulator

As discussed earlier in this submission, mergers between institutions within the finance sector have been impeded by specific restrictions under the Banks (Shareholdings) Act and the Insurance Acquisitions and Takeovers Act. The requirement for the approval of certain mergers by the Foreign Investment Review Board or the Federal Treasurer has further restricted consolidation within the finance industry.

In our view, the ACCC ought to be the sole arbiter of merger proposals between institutions of any type. The Trade Practices Act contains adequate provisions to ensure that mergers do not produce a *"… substantial lessening of competition"* within the relevant market. It ought to be left to the ACCC to assess, based on the relevant circumstances, the parameters of the relevant market for particular products or services.

We therefore recommend that the specific finance sector restrictions on merger activity be repealed. This would include repeal of the Banks (Shareholdings) Act which, in our view, does not fulfil a sufficient prudential function to warrant its retention.

The ACCC should also retain its existing responsibilities in relation to the maintenance of fair market conduct.

6.6.1 **Company regulation**

The ASC is presently responsible for overseeing those requirements of the Corporations Law such as company incorporation, governance, equity raising, creditors' entitlements, charges and winding-up. These are essentially watchdog and registry functions necessary for the protection of shareholders, creditors and consumers. Since the need for such a regime of corporate regulation applies to all areas of economic activity, the regulatory oversight of these matters should be left to a separate, economy-wide regulator. Should the Inquiry support the establishment of a new consumer protection regulator, as proposed above, to encompass activities currently performed by the ASC and the ISC, it may be appropriate to allocate the responsibility for general company regulation to the ACCC. Combining regulatory functions in this way would recognise the fundamental importance of maintaining corporate structures which best promote fair market conduct, prevent abuse of market power, and provide a baseline of rules for participation and competition in the market-place.

6.7 Intensity of regulation

The framework outlined above has a number of advantages over the existing system of financial sector regulation. In particular:

- it does not predetermine the form of regulation to be applied by reference to institutional status, but rather applies similar regulation to those, whatever their institutional status, who perform similar financial service functions irrespective of their institutional status;

- it will enable the intensity of regulation to be adjusted, commensurate with the development of new products and services, without requiring product providers to change their desired institutional form; and

- it will achieve an alignment between the three major regulatory objectives, the three types of regulatory intervention and the responsible regulators.

Consistent with the second of these advantages, implementation of this new regulatory framework should enable a careful reassessment of the prudential and disclosure requirements applied by existing regulators under a range of Commonwealth and State/Territory laws. While we have not endeavoured to provide an exhaustive account of the detailed requirements that should apply to those engaging in the various intermediation functions, we canvass in the following Section our preferred requirements for those activities which are of primary concern to credit unions.

7. How the new regulatory framework would apply to credit unions

Within the broad framework of regulation outlined previously, this Section explains the particular regulatory requirements that should apply to the primary activities of credit unions. These activities are:

- offering capital-guaranteed investments;
- the provision of payment services; and
- the provision of loans.

In determining the particular requirements which should apply to these three functions, we have sought to apply the following principles:

- regulatory attention should focus primarily on the function being performed, not the institution, and should avoid determining institutional structure as far as possible;

- regulation should be closely related to the particular risk inherent in performing the function;

- regulation in any form should serve a distinct regulatory objective; and

- the intensity of regulation should be set at the minimum level necessary to achieve the relevant regulatory objective.

7.1 Capital-guaranteed investments

As explained in Section 6.1, capital-guaranteed products involve a commitment by financial institutions to return investors' capital and a pre-disclosed amount of income, either on demand or after an agreed term.

Products of this type include term deposits, at-call deposits, some debentures and some types of annuities. It is important for all products which have the same characteristics or which are described using similar terms, such as 'deposit', to be grouped together and regulated in a similar manner.

Consumers group together products like deposits and debentures. Consumers also place great store by the words used to describe a product: the word 'deposit' for instance implies a very special product to consumers:

"*Term deposits are easy to understand. I know that I am going to get my 3.5% with the CBA and that in two years' time it is going to be there. Other investments, such as shares, I don't know much about. I don't understand it, so I am not going to put my money into it.*"

"With my term deposits, I know I am not getting a high return, but I know I can sleep at night."[48]

Accordingly, we recommend that any product which makes a capital-guaranteed claim, as described above, should be regulated as such, irrespective of which institution offers it or what it is called. Similarly, because the word 'deposit' carries such specific meaning in consumers' minds, any product which is marketed as a 'deposit' should attract similar regulation.

7.2 ***Types of regulation for capital-guaranteed investments***

A high level of prudential supervision is required for institutions providing capital-guaranteed investments. As explained in the previous Section, systemic stability is achieved by regulatory intervention which increases consumer confidence in the likelihood that institutions can meet their commitments to consumers. A loss of widespread consumer confidence can result in runs on institutions. The greater the burden of risk taken on by an institution, the more intense is the regulatory intervention required to provide that degree of confidence. For that reason alone, a high level of prudential supervision is required of those offering capital-guaranteed investments because of the very high burden of risk they assume.

Capital-guaranteed products will also attract disclosure and consumer regulation in order to address the asymmetry of information between consumers and product providers, since most retail consumers will have access to much less information than corporations offering products.

The providers of these products will also be subject to competition regulation, although as discussed earlier in Section 6, there is no reason why there should be competition regulation specific to this function other than that provided generically in the Trade Practices Act.

The major instruments of prudential regulation for capital-guaranteed products include capital requirements, liquidity requirements, depositor protection and ownership requirements. These instruments need to be assessed against the principles outlined above. That is, are they institutionally neutral in character, do they relate clearly to a regulatory objective and to the risk inherent in the product and do they involve the minimum intrusion necessary to achieve their regulatory objectives?

7.3

[48] Research undertaken for Credit Union Services Corporation by Eureka Strategic Research, 1996

Prudential regulation for capital-guaranteed investments.

7.3.1 **Capital**

While the primary role of capital is to cushion an institution against loss it also fulfils a broader purpose indicated by the RBA's observation that:

"*Capital is the cornerstone of a bank's strength.. The presence of substantial capital re-assures creditors and engenders confidence in a bank.*"[49]

The international standard for capital adequacy is set by the Basle Capital Accords. Whatever the shortcomings of that approach, it is simply not practicable or desirable for Australia to differ substantially from the approach adopted in the Accords. This international standard requires an institution to hold capital of at least 8% of its risk-weighted assets (RWA) to cover credit risk. An additional requirement is currently being developed for appropriate capital backing to cover market risk.

Accordingly, capital adequacy rules should remain the cornerstone of the prudential supervision of capital-guaranteed products.

The requirement to maintain a capital ratio of 8% RWA ratio should be a minimum. The prudential supervisor should retain the discretion to require an institution to hold higher levels of capital to cover additional levels of risk and will need to be satisfied that an institution has adequate access to additional capital if required. However, any requirement to demonstrate access to extra capital would need to be institutionally neutral, and should not presume that an institution is a company with ordinary shareholders, as is currently the case.

We accept that there would be a need to demonstrate to a supervisor that capital adequacy is likely to be maintained over time. Over the medium term, credit unions may also need to develop additional means of capital formation. However, the need to raise additional prudential capital (other than from retained earnings) has not arisen so far as a general issue for the credit union industry, since it is more than adequately capitalised (about 15%).

Internationally, a number of different approaches are taken by retail banking mutuals to demonstrate that they have adequate access to capital. In some countries such as Canada, individual credit unions issue share capital of various types which do not compromise their mutuality, and in particular do not compromise the principle of one

[49] RBA Prudential Standard C1, page 2, March 1996

member-one vote. These include forms of participative equity which are not tradeable in the open market.

In other countries, such as the Netherlands, co-operative banks do not raise share capital by issuing permanent shares at all, but rather capitalise the industry as a whole out of retained earnings, supported by a strong interlocking network of obligations between members of the co-operative bank. In effect these co-operative banks are assumed to have one consolidated balance sheet for the purpose of calculating capital adequacy.

European retail banking mutuals have recently confronted the challenge of EC directives which set minimum standards for capital adequacy and formation. Different institutions have taken different paths, but all have demonstrated a capacity to meet the requirements of the directive.

Credit Union Services Corporation is currently examining international approaches to capital formation among retail banking mutuals to determine an appropriate approach for Australian credit unions. Given the very high levels of capitalisation among credit unions, we do not believe this is an urgent problem. However, it is important that the prudential requirements for access to capital are expressed generically and do not preclude the sorts of arrangements adopted by retail banking mutuals internationally.

7.3.2 **Liquidity requirements**

The purpose of liquidity requirements is to ensure that an institution has sufficient funds at hand to meet potential outflows. Appropriate liquidity requirements are particularly important where a capital-guaranteed investment is provided at-call to the customer. However, even those products with an agreed term are usually for relatively short periods, and are effectively available at-call to the customer, albeit at a penalty for early withdrawal.

Existing prudential supervisors use a number of different instruments to ensure appropriate liquidity management by institutions. In addition to a general requirement that institutions adopt appropriate internal liquidity management policies, a number of prescribed requirements apply. The RBA’s requirements include Non Callable Deposits and a Prime Asset Ratio, while the FI Code contains provision for an Emergency Liquidity Support Scheme, a Prime Liquid Assets ratio and an Operational Liquidity Requirement.
It is not clear how each of these requirements contributes to the objective of ensuring that an institution has sufficient funds at hand to meet potential outflows. Some of the requirements appear to involve an unnecessary level of intrusion. For example, Non Callable Deposits

are not available to meet the liquidity needs of a bank and so seem to be an unnecessary imposition on banks.

The requirement that a credit union maintain operational liquidity of 6% on top of a Prime Liquid Assets ratio of 7% appears to be overly intrusive. Credit unions themselves are likely to be the best judge of their operational liquidity needs, and a common ratio is likely to be too high for some and too low for others. We recommend that NCDs and Operational Liquidity requirements should not apply under the new prudential regime.

While the Emergency Liquidity Support Scheme (ELSS) provided in the FI Code does contribute to the liquidity management objective, it does so in an overly intrusive and inflexible manner. The ELSS requires credit unions to:

- provide liquidity support to another credit union of up to 50% of the PLA requirement at the direction of AFIC;
- identify very high quality assets available for security against a loan extended under the ELSS equal to 10% of total assets; and
- complete a number of Deeds with AFIC and a SSP which provides the detailed terms under which liquidity support can be extended under the ELSS.

The ELSS provides collective liquidity support arrangements that are relatively intrusive, and because of their statutory base, inflexible. ELSS arrangements are best left to institutions which support such collective endeavour to determine themselves on a self-regulatory basis.

The main instrument of liquidity supervision should remain a PLA or PAR ratio, which should be set at the same level for all institutions offering capital-guaranteed investments, with a discretion for the supervisor to raise or lower the level as appropriate given the overall liquidity risk faced by the institution.

A feature of co-operative banking sectors around the world is a mechanism for aggregation of liquidity. In Australia, credit unions are able to hold liquid funds with CUSCAL and still count them towards liquidity ratios. Such collective mechanisms are integral to co-operative banking and would need to be accommodated in any future system.

When considering appropriate liquidity controls for the future, the prudential regulator will need to take account of emerging risk management tools. The rapid growth of securitisation programs fundamentally alters the liquidity risk faced by traditional intermediaries, making it possible to achieve a much closer match between the liquidity of liabilities and assets. Accordingly there may be reason to reduce the intensity of liquidity controls and to keep the level of such controls which are retained under constant review.

7.3.3 Depositor protection

Existing prudential supervisors oversee a number of different depositor protection measures, including statutory priority for deposits and statutory contingency funds. Although no regulator guarantees repayment of deposits to consumers, consumers themselves appear to believe that some deposits are guaranteed. This sentiment emerged strongly in recent market research conducted for Credit Union Services Corporation:

"*To the consumer, your money is always secure with a bank...you can't lose*."[50]

Under current arrangements, it is not immediately clear whether depositor protection measures are meeting a prudential regulatory objective related to general confidence and systemic stability, or whether they are meeting consumer protection or fair conduct objectives. Where these objectives are unclear or confused, it becomes difficult to assess the appropriateness of the regulatory intervention.

As an instrument designed to pursue a prudential objective an implicit or explicit guarantee of deposits is inappropriate because it increases moral hazard, perversely increasing the likelihood that an institution might fail. That is, a government guarantee may well encourage an institution to accept higher levels of risk because of the confidence supplied by the guarantee and because the guarantee insulates the institution from market sanction. This appears to have been the case in Australia with the failed State Banks which carried a government guarantee. The new prudential regulator of institutions offering capital-guaranteed investments should therefore seek to make it very clear that it does not guarantee the repayment of deposits.

Statutory contingency funds may well have a similar effect as a government guarantee or deposit insurance in increasing moral hazard. While a statutory contingency fund has the advantage that it prices the 'guarantee', nonetheless it may still have the negative consequence of actually encouraging risky behaviour. Contingency funds should not be provided in statute as a prudential measure, although industries may choose to operate self-regulatory funds as a consumer protection measure.

[50] Research undertaken for CUSCAL by Eureka Strategic Research, 1996.

As statutory contingency funds are wound up, their balances, both capital and earnings, should be repatriated to credit unions.

The prudential objective of depositor protection will be met where consumers have confidence that, in general, an institution is soundly managed. Given the high degree of burden taken on by an institution that offers capital-guaranteed investments, it is important that this function is given the highest priority by the institution. Such a priority is reflected in the priority accorded by statute to depositors on the wind up of a bank.

We would support the extension of a statutory depositor priority to all institutions offering capital-guaranteed investments, provided it does not have other unintended consequences. For instance, the RBA currently requires credit unions to grant first charges over their assets to their settling agent (Credit Union Services Corporation) as a condition of their indirect participation in the payment system. Such charges would need to rank after the claims of depositors at liquidation, and unless the new prudential regulator accepted such a change, credit unions and other indirect participants in the payment system may be unintentionally excluded from it. This matter would need to be resolved before statutory depositor priority were extended.

7.3.4 **Ownership requirements**

There are a number of requirements currently restricting ownership of banks which are neither institutionally neutral nor clearly linked to a prudential objective. These include the requirements of the Banks (Shareholdings) Act limiting shareholders to 10% (or 15% with the Treasurer's approval); restrictions on foreign ownership of banks; and the requirements of RBA's Prudential Statement B1 that no single shareholder or group of shareholders be in a position to exercise undue influence over a bank.

The RBA explains the purpose of these provisions as follows:

"*The objective is to ensure that banks pay appropriate regard to the interests of their depositors ... an essential feature of banking ... requires that depositors have confidence in banks as safe havens for funds without having to be on continual inquiry as to the current and detailed condition of banks ... In general, the interests of a bank's depositors are likely to be enhanced where operations are in the hands of a board of directors which is broadly representative of the shareholders as a whole.*"[51]

[51] RBA Prudential Statements B-1, October 1994

However, it is still not clear from this statement how a wide spread of shareholdings necessarily ensures that the interests of depositors receive greater attention than they would with a smaller number of larger shareholders. Indeed the Campbell Committee earlier concluded that such ownership restrictions did not serve a prudential purpose and should be repealed.[52]

While it is unclear what these restrictions contribute towards a prudential objective, some of their practical effects are clear. These include significant inhibitions to the formation of financial conglomerates in any form other than with a ‘bank on top’. The restrictions also prevent the formation of a mixed conglomerate that would include a bank as a wholly-owned subsidiary. For example, BHP could not successfully apply for an Australian banking authority as it might do in the United Kingdom.

There seems to be no prudential reason why restrictions on shareholdings should remain. If there are competition policy objectives met by these restrictions, then they should be administered by the competition policy regulator, and the policy underlying them clearly articulated. Accordingly, we recommend that the Bank (Shareholdings) Act should be repealed.

Current ownership provisions also indicate a presumption in favour of companies with ordinary shareholders and permanent share capital. As such they exclude the possibility of a mutual holder of a banking authority. In earlier consideration of this point, the Campbell Committee considered that:

“Banks should be allowed flexibility in capital structures (eg, co-operative institutions owned by a group of co-operatives should be eligible for authorisation); and a joint stock corporate structure should not be mandatory.”[53]

As has already been shown, co-operative banking is a significant part of the banking sectors in Europe and North America. Regulation should not preclude such co-operative banking in Australia, and so ownership provisions should accommodate mutual company structures.

7.3.5 Supervision arrangements

Prudential regulation is monitored by supervision of institutions, which is a more intensive form of regulatory activity than the compliance monitoring associated with disclosure based regimes.

[52] *Report of the Campbell Committee*, 19.56; 32.55
[53] *Report of the Campbell Committee*, 24.34

Both the issuing of an authority to offer such products and the relevant supervisory arrangements should meet the same set of principles referred to earlier in relation to the regulation itself. That is, they should be neutral as to institutional character; they should be clearly related to the prudential purpose of the regulation; and they should intrude as little as possible.

Institutional neutrality will mean, for instance, that supervision should not differentiate on the basis of the size of the institution. In particular, the supervisory approach should not assume that size of institution has a direct correlation with risk. For example, a well managed credit union with assets under $20 million, offering only a simple savings and loans service to a small number of loyal members may have a much lower risk profile than a much larger, more complex bank.[54] Accordingly, current requirements such as that the holder of a banking authority must have a minimum of $50 million paid up capital and hold an Exchange Settlement Account are inappropriate.

Mechanisms of supervision which are appropriate to the needs of small retail banking mutuals like credit unions will need to be adopted. A number of different examples in Australia and overseas are worthy of consideration. In Europe, various forms of consolidated reporting for the sector as a whole exist, so that core ratios are applied to a group central bank such as Rabobank or Deutsche Genossenschaftbank in Germany. These central banks in turn exercise 'supervisory' controls over the balance sheets of their member banks. Alternatively, in Canada, while the balance sheets of individual credit unions are supervised, arrangements are being developed where the responsibility for supervising those balance sheets is devolved by the supervisor to an industry body.

Institutional neutrality will also mean that supervisory arrangements should reflect the nature of the institutions, not the other way round. Current approaches to supervision emphasise the need for an authority holder to provide a broad range of banking services. For instance, a holder of a Foreign Bank Branch Banking Authority
"*While ... not required to offer a full range of banking services, ...[is] expected to maintain a significant presence in Australia and add some depth to the local banking market.*"

The Campbell Committee recommended that requirements of banks that they perform a specified range of functions should be eased.[55] It should be possible for the new prudential regulator to allow an institution to

[54] For an expert discussion of the relationship between size of institution and risk see the paper by Ian Harper for Credit Union Services Corporation, October 1995.
[55] *Report of the Campbell Committee*, 24.34

choose to specialise in products and services of a particular type, without a requirement that it provide a generic range of services.

Under new prudential supervisory arrangements, a number of existing requirements will remain important. The prudential regulator would need to be armed with the power to put an institution under direction or administration as currently provided for in the Banking Act and the FI Code.

The institution offering capital-guaranteed investments should also be required to do so through a clearly distinct entity. A separate entity is required because the main instruments of prudential supervision for this function are balance sheet controls and the institution’s balance sheet needs to be clear and transparent to the supervisor. So while it might be possible to combine this function with others that have very similar regulatory requirements, such as payment services, it might be much more difficult to combine this function in the same entity with most others, such as insurance. (This would not of course prevent insurance and capital-guaranteed functions being combined in the same group).

While capital-guaranteed investment products would need to be offered through a separate entity, they will also usually not be offered on their own. Within the same entity, payment services may be offered, and within the same group, insurance or unit trust products may be offered. While the prudential regulator would apply the prudential requirements discussed earlier to the entity offering capital-guaranteed investment products, it would also make an assessment of the overall risk of a business. If the particular combination of businesses increased risk, an additional prudential requirement would be imposed. If on the other hand the combination of businesses reduced risk, the overall group requirements might be reduced.

In accordance with the principle that regulation should be reduced to the minimum necessary to achieve its objective, balance sheet controls could be reduced. Tight restrictions over the nature of an institution’s business, such as the so-called primary objects test for credit unions (which requires 60% of its assets to be in loans to members, and limits commercial loans to 10% of its book) or the restrictions on banks holding equity, should be removed since they do not appear to contribute to the prudential objective. The purpose of prudential regulation is not to prevent institutions accepting risk, nor to choose the mix of risk they accept, but rather to ensure that appropriate risk management policies are in place. Any additional risk represented by a decision to make commercial loans or hold equity should be reflected in changes to other instruments of supervision for instance, in capital requirements linked to credit or market risk.

7.4 Capital-guaranteed investments — disclosure/consumer regulation

The providers of capital-guaranteed investments will also be subject to a regime of consumer regulation designed to ensure that investors are provided with sufficient information to enable them to make informed decisions, and to protect them from unfair conduct.

Major elements of this requirement are currently found in the common law. There may be some need to review banking law in future to ensure that it applies neutrally to all products and producers within the same function, in this case capital-guaranteed investments.

Many consumer protection requirements are codified. The Credit Union, Building Society and Banking Codes of Practice provide minimum standards of disclosure for deposit type products, as well as standards for the calculation of interest and the like. These are all designed to provide benchmarks of fair conduct, to correct asymmetry of information and to provide cheap avenues of redress for consumers.

These provisions have been recently drafted and are supplementary to the general obligations that institutions face under Part V of the Trade Practices Act and the mirror provisions in the State Fair Trading Acts. Under new arrangements, Part V of the Trade Practices Act would continue to provide a baseline of consumer protection. Built above this baseline would be specific provisions of statute law applying to capital-guaranteed investments and also any self-regulatory Codes of Conduct. The consumer protection regulator would assume responsibility for industry specific statutes and for supporting the development of self-regulatory Codes of Conduct.

While the provisions of statute law should apply equally to all institutions offering the function, these Codes represent additional rules to which institutions voluntarily submit. It should be open to different industry sectors to seek to establish more or less onerous voluntary regimes according to their priorities. Accordingly, there should not be an assumption that the Codes of Conduct should be rationalised into one, that the related dispute resolution mechanisms should be merged into one.

7.5 Capital-guaranteed investments — competition regulation

Regulation of this function has traditionally involved tight controls over ownership of the providers of the products. As discussed above, these are properly controls which aim to achieve competition policy objectives, rather than strictly prudential objectives.

It remains to be seen whether there are reasons why the general framework of law in Part IV of the Trade Practices Act is not sufficient to correct for abuse of market power among institutions offering capital-guaranteed investments. While such controls (limiting shareholdings to 10%, restricting foreign ownership of banks, requiring a wide spread of shareholders) do not affect mutual institutions like credit unions, the need for such specialist controls remains unclear.

Certainly there appear to be question marks over the effectiveness of such controls. For example, it is conceivable that foreign entities denied the right to wholly purchase a bank subsidiary in Australia may successfully seek to access the market from offshore via the Internet.

Arguments can be made that these ownership controls unfairly restrict competition by preventing institutions pursuing their preferred strategies, for instance by combining banking and insurance business in a group where the bank is a subsidiary. Institutions are finding ways to circumvent this restriction. AMP’s Priority One, for instance, appears to be offering a deposit product actually provided off the banking authority held by National Westminster partnership. However, this may not be the most efficient arrangement possible were restrictions around the holding of a banking authority to be eased. Such arrangements have the further disadvantage that they are not transparent to the consumer. In the case of the example just quoted, it will not be immediately clear to a consumer which institution is really bearing the risk— AMP or the bank.

On balance, credit unions do not believe that a strong case can be made for the retention of these specialised competition policy measures in addition to the provisions of the Trade Practices Act.

7.6 ***Payment services***

A second important function for credit unions is payment services. Payment services include arrangements where an institution facilitates the transmission of value between external parties and itself or among external parties, whether consumers, other financial institutions, other corporations or governments. Examples of payment services include cheques, direct entry, consumer electronic systems such as EFTPOS, debit and credit cards and stored value cards, and high-value electronic systems.

Some of the major payment systems listed above involve clearing and settling of obligations between financial institutions and are regulated under the four clearing streams administered by the Australian Payments Clearing Association. These include the paper clearing system, the bulk electronic clearing system, the consumer electronic clearing system and the new high-value clearing system.

However, very significant payment systems lie outside the framework of APCA and include credit cards such as Bankcard, charge cards such as Amex and

Diners Club, and store-based credit cards.

Significant new developments in payment services are arising from developments in technology such as the provision of stored value cards and the potential for a large telecommunications carrier to provide payment services by allowing the transfer of value between its customers. These arrangements would also lie outside the purview of APCA and the APSC since they do not generate institutional clearing and settling obligations.

The type of regulation required to supervise this function will firstly involve prudential regulation to deal with systemic risk. Payment systems provide the capacity to transfer failure throughout the financial system and so give rise to systemic risk. In addition, a failure in payment systems could trigger a catastrophic loss of confidence in the financial system.

The provision of payment services will also involve disclosure and fair conduct regulation. Payment services should also remain subject to the general provisions of competition policy under the Trade Practices Act.

7.6.1 **Payment services - prudential regulation**

Traditionally the provision of payment services has been closely associated with the provision of deposits. Major payment instruments such as cheques, or direct entry involve parties generating payment instructions that eventually draw on deposits held with financial institutions. Clearing between institutions occurs via exchange settlement accounts at the RBA.

Prudential regulation is appropriate for payment services not because of the association with deposits, however, but rather because of the potential risk to systemic stability. This risk is particularly high where settlement risk is involved, as is the case in Australia where settlement of net obligations occurs twenty-four hours after those obligations are cleared. The capacity for one institution to fail and to transfer this failure to others has justified the requirement that participants hold banking authorities and an Exchange Settlement Account at the RBA.

With the development of real time gross settlement systems, initially for high-value, high-priority transactions, the level of settlement risk is reducing. It is conceivable that a system might emerge where there is no delay in settlement for a payment order of any value: that is, that all payments are made in real time. Settlement risk would then be almost entirely eliminated.

It is not clear though that systemic risk itself would be eliminated. For example, should a system of real time gross settlements fail, a back-up system with delayed settlements would need to take over, temporarily re-introducing settlement risk.

Moreover, the operational failure of a payment system could easily shake public confidence in the integrity of the financial system, posing a threat to systemic stability. So even where there is no settlement risk involved, there is still a prudential interest in supervision of payment systems.

7.6.2 Payment services - instruments of prudential regulation

The more orthodox instruments of prudential regulation (capital and liquidity ratios, risk management policies) are appropriate for providers engaged in payment services involving deposits, settlement risk, or where settlement risk might arise upon failure of a system.

Where settlement is required between institutions, it is also appropriate to require a provider to have access to an exchange settlement account with the new prudential regulator, since there is no feasible mechanism for providing finality of settlement otherwise. It remains important to allow participants to clear and settle indirectly— that is to allow credit unions for instance to settle indirectly through a chosen agent.

However, these arrangements exclude very significant payment services which currently lie outside the scope of the APCA, and also exclude significant potential growth areas in payment services made possible by the reduced barriers to entry as a result of technological development.

These types of payment services will not involve settlement risk since they do not involve clearing and settling with other institutions. Failure of a large payment service provider, or a failure of their systems, may generate systemic instability through a crisis of consumer confidence. Traditional capital and liquidity controls are probably not the most appropriate prudential response. Rather, compliance with appropriate operational standards may be desirable for payment service providers.

Appropriate regulation of payment services will need to be constantly monitored as greater use of new technology opens up new payment systems. Accordingly, we recommend that the prudential regulator should examine the need for operational standards for payment systems, including those outside current APCA arrangements.

In keeping with the principle of institutional neutrality, any payment service provider which can meet the appropriate prudential requirements should be allowed to participate in the payment system. That is, where settlement risk is involved, compliance would be required with the range of traditional prudential controls outlined above; where no settlement risk is involved, then compliance with the relevant operational standards would be sufficient. Institutions should not be excluded from participation in the payment system, either directly or indirectly, simply because of their institutional character.

One outstanding matter remains the amendment of the Cheques and Payment Orders Act to allow credit unions, building societies and their SSPs to issue cheques. Despite ten years of debate, and a Government decision to amend the Act, the relevant amendments have still not been drafted. We recommend that these amendments be drafted and introduced as a matter of urgency.

7.6.3 **Payment services - disclosure and fair conduct regulation**

There are also a small number of disclosure and fair conduct rules that apply to the provision of payment services, again correcting asymmetry of information, and ensuring fair conduct for consumers.

One such example is the EFT Code of Conduct, currently overseen by both the RBA and the ACCC. Provisions of the Credit Union Code of Practice also relate to the provision of payment services and these, together with those of the EFT Code should apply equally to all who provide the relevant service. However, oversight of these two Codes should pass from the ACCC and the RBA to the new national consumer regulator.

7.7

Lending

Lending as a function includes all financial arrangements where an institution lends money to a consumer, for a credit charge, with an expectation that it will be repaid at a later time. This function involves lending by DTIs and finance companies. However it also covers lenders previously excluded or exempted from regulation, including solicitors.

The lending function involves almost an exact reversal of the burden of risk to the capital-guaranteed function: the consumer (borrower) takes on the burden of the contract, not the institution.

Consequently, the regulation of this function does not involve prudential regulation, since there are unlikely to be systemic implications arising from the default of a borrower on a loan.

While DTIs might feel the competition of new competitors in the loans market (particularly securitisers) quite keenly, and wish to subject these competitors to the strictures of the prudential regulation that they face, the economic nature of the lending function does not support such regulation.

Disclosure and fair conduct rules are the appropriate forms of regulation for this function. These rules will differ depending on whether they are intended to cover retail or fully commercial transactions. The underlying market failure being corrected by consumer regulation is either asymmetry of information or abuse of market power. In both cases, an ordinary consumer will need higher levels of protection than a business consumer.

7.7.1 **Lending — disclosure and fair conduct regulation**

Regulation in this area currently includes the general duties owed by a banker to a customer under the common law; the codified disclosure requirements found in the Uniform Credit Code; the duties of confidentiality owed under banking law and under privacy law; and prohibitions on misleading and deceptive conduct and on unconscionable conduct found in the Uniform Credit Code, Part V of the Trade Practices Act and the mirror provisions of State Fair Trading laws. Many of these provisions are reflected in the Credit Union, Bank and Building Society Codes of Practice which provide cheap, simple redress mechanisms for consumers.

The principles underlying this sort of regulation rely on full and open disclosure, together with prohibitions on unfair conduct, to allow consumers to make decisions in the market place on a fair basis. Therefore the regulation is appropriate to the market failure it is aiming to correct.

Where regulatory initiatives proceed beyond this broad objective, for example by seeking to modify pricing decisions of institutions, the regulation is likely to over achieve its goals.

7.7.2 Lending — administration of disclosure and fair conduct regulation

The major difficulty of regulation of the lending function is the administration of uniform provisions. It is an area traditionally dominated by State law, with all the associated difficulties of keeping the regulation consistent with market developments, and of maintaining national uniformity.

For example, the history of consumer credit law is that it has been constantly outpaced by market developments. Consumer credit law has, in turn, been too slow in its development, too narrow in its coverage, too prescriptive, inflexible and non-uniform. Not only does such poor legislation impose significant compliance costs on institutions, it also allows regulatory arbitrage and leaves large numbers of consumers unprotected. The most recent incarnation of consumer credit law, the Uniform Credit Code, overcomes many of these problems. However, it has taken at least ten years to develop and win the agreement of the States and there is still no mechanism to ensure that it remains flexible and responsive to market developments.

A similar situation is arising in the area of privacy protection, with State Parliaments each beginning to legislate for privacy protection of consumers of financial products, in a way which does not seek national uniformity.

In addition to the proliferation of non-uniform State-based law, there is scope for the specialised finance sector disclosure and fair conduct law to be out of step with the national baseline legislation provided by Part V of the Trade Practices Act.

Finally there is a profusion of agencies at both the Commonwealth and State level, responsible for disclosure and fair conduct regulation of the lending function, as well as of industry based redress mechanisms.

Significant scope for rationalisation exists to make this area of regulation truly national.

We recommend that the Federal Parliament take legislative leadership in this area, and enact consumer credit and privacy legislation which could be mirrored by State Parliaments. Drafting of such legislation would need to ensure consistency with Part V of the Trade Practices Act. The new national consumer regulator would have primary responsibility for the specialist bodies of law and the associated industry Codes of Conduct and redress mechanisms. The ACCC could agree formally with the national consumer regulator that the latter was primarily responsible for consumer protection in this area.

7.8 ***Other functions***

There is a number of other important financial service functions including those involving insurance contracts and those involving various forms of market-based investments. Credit unions have a particular concern that regulatory requirements for these other functions be institutionally neutral. As discussed earlier in Section 5.3, credit unions currently are disadvantaged by the institutional nature of regulation of many managed funds products. For example, the increasing intensity of regulation of the financial advice function, reviewed recently in the ASC's Licensing Review, still unintentionally puts credit unions at a disadvantage compared with other institutions. While it is possible for a bank's funds management arm to provide proper authorities to bank tellers to provide simple advice to consumers, it is not possible for the credit union funds management arm to provide proper authorities to credit union counter staff, since to do so would be to accept a proper authority from an external licensee in breach of s809 of the Corporations Law. Accordingly, for regulation in this area to be institutionally neutral, either the consumer regulator must be given an exemption power to allow it to recognise the collective character of credit union participation in the market-place, or else the law should be changed to allow generic product advice to be given to consumers.

As institutions combine these functions in different ways, with different corporate structures, there will be a need for the regulators to take account of the effect of combining different functions or businesses. This is most clearly the case for the prudential regulator, which will need to add to its prudential assessment of each function an assessment of the risk profile of the group as a whole. This assessment may identify a risk profile that varies with the changing combination of businesses or functions in the group. The assessment would then need to be reflected in the prudential requirements for the group.

8. Incorporation and regulation of credit unions

Currently credit unions are incorporated and regulated under the provisions of the FI Code by State Supervisory Authorities, while Special Services Providers are incorporated and regulated by AFIC.

Under the approach already outlined, credit unions would be prudentially regulated by a national prudential regulator by virtue of their provision of capital-guaranteed investments and payment services.

Two issues arise from this recommendation: the scope of the Commonwealth's power to regulate credit unions and the best means to achieve this.

8.1 The scope of the Commonwealth's powers.

Regulation of credit unions involves two significant aspects: the incorporation of credit unions and the ability to supervise them prudentially. We believe there is ample constitutional power for the Commonwealth to regulate in both these areas.[56]

The two most relevant heads of power under the constitution are the banking power (Section 51(xiii)) and the corporations power (Section 51(xx)).

8.1.1 **The banking power**

If it is accepted that credit unions fall within the banking power of the Commonwealth, then it gives greater scope for regulation, since it confers on the Commonwealth power over incorporation, whereas the corporations power itself does not.

Our advice is that credit unions can be considered 'banks' within the meaning of Section 51(xiii) based on a detailed consideration of Australian case law concerning banks and banking. Briefly, it concludes that credit unions fall within the appropriate definition because:

a)

[56] Expert legal opinion on the scope of the Commonwealth's banking power and its corporations power and their applicability to regulation of credit unions is contained in an opinion prepared by Phillip Podzebenko and David Daniels of Tress Cocks and Maddox for Credit Union Services Corporation, July 1996.

They are engaged in a business; and

b) A significant proportion of their business involves engaging in the following activities:

   i) the collection of money from deposits on loan under such terms as agreed upon; and

   ii) the lending of moneys so collected; and

c) Section 51(xiii), being a grant of plenary legislative powers, must be interpreted in the broadest possible manner in determining the scope of the power granted by it.

8.1.2 **The corporations power**

The other possible head of power for the Commonwealth to regulate credit unions is the corporations power which gives the Commonwealth power to make laws in respect to 'foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth'.

This power does not give the Commonwealth capacity to make laws for incorporation. Banks appear to be excluded from the corporations power by virtue of the banking power. It appears clear that if credit unions were held not to fall within the banking power, then they would fall within the corporations power. They are already held to be 'financial corporations' for the purpose of the Financial Corporations Act (Commonwealth) 1974. This would mean that the Commonwealth could not in its own right provide for the incorporation of credit unions.

However, States could transfer the authority to incorporate credit unions to the Corporations Law. This would involve amendment of the Corporations Law which in turn involves:

- consultation with the Ministerial Council;
- its formal approval;
- exposure of the proposal for public comment for a 3 month period; and
- tabling of the Ministerial Council's advice in Parliament when introducing the Bill.

Using either the banking power, or the corporations power, it is therefore clear that the Commonwealth has power to regulate credit unions once formed.

As for incorporation, we are advised that the banking power gives the Commonwealth the capacity to provide for the incorporation of credit unions. A mechanism exists for States to allow incorporation under the Corporations Law by agreement.

8.2 Preferred means of incorporating and regulating credit unions

Credit unions would prefer a generic approach to incorporation and regulation, in keeping with the overall objective of moving away from institutionally specific regulation. Accordingly, we would envisage that the successor to the Banking Act would provide for the prudential regulation of credit unions and SSPs where required by the functions they undertake. This Act would be administered by the new national prudential regulator. Credit unions would incorporate under the Corporations Law, which would need to be amended in a number of respects, since it currently explicitly excludes credit unions and building societies from its scope.

An orderly transfer of responsibility would need to be negotiated between the Commonwealth, the States and the industry, but we do not envisage any great difficulty, particularly given the extensive constitutional powers granted to the Commonwealth under Section 51(xiii) of the Constitution.

Our preferred course would be to repeal the F I legislation and make necessary amendments to the Banking Act and the Corporations Law to provide for Commonwealth regulation of credit unions. However should this approach fail to achieve sufficient support from States and Territories to allow timely introduction of the reforms, then it would be open to the Commonwealth itself to provide for the regulation of credit unions in specific legislation enacted under the banking power. State legislation would cease to apply to the extent that it is inconsistent with Commonwealth law.

8.3 Use of the name ‘credit union’

The FI Code currently regulates the use of the name ‘credit union’, both preventing its use unless licensed to do so under the FI Code, and requiring that an entity seeking to use it be mutual in character. The first restriction has a prudential purpose in preventing use of names which indicate a high level of prudential supervision unless that supervision is present. We would expect a similar provision in the successor to the Banking Act, preventing the use of the name credit union (or indeed bank or building society) unless the entity is licensed to do so by the prudential regulator.
The second restriction, requiring that an entity which uses the name credit union have a mutual character has no prudential purpose. But it does have a fair conduct purpose in that consumers associate the name credit union with a mutual organisation. Accordingly, we would expect that the Corporations Law

would prevent the use of 'credit union' in a trading name except where the entity has a mutual structure.

9. Conclusion

This submission has set out the reasons why the current regulatory system should be rebuilt from the ground up. It has provided a detailed description of the fundamental problems with the current FI Scheme and recommended its abolition and replacement with a national system of regulation for credit unions.

The submission has also provided an assessment of the existing regulatory environment and recommended that the basis of regulation should be re-directed from institutions to functions. An alternative regulatory framework has been discussed, with more detail provided on how it might be applied to the major functions that are important to credit unions.

We expect that the Wallis Inquiry will set out the principles that should underpin the architecture of a regulatory system. Clearly, there will not be time for the Committee to detail recommended legislative and administrative change, or to review the content of regulation itself.

Given the importance of these reforms, and the pace of change in the marketplace, we think it is important for the Committee to consider how the principles it enunciates should be implemented and in what order. Without implementation of recommendations of this sort, the work of the Committee may well not see the light of day for many years.

The Committee should first enunciate the general principles which should underpin the regulation of the financial system, and describe the basic architecture of that system.

The Committee should then identify broadly the steps necessary to move the current system towards the recommended system. Such steps would include the major administrative changes necessary, the proposed allocation of responsibility for particular regulatory statutes and the administrative boundaries to be drawn between regulators. For each implementation step, the Committee might suggest an appropriate body to assume responsibility.

The Committee's recommendations will need to go further still if the full potential for reform is to be realised. Within each regulatory instrument, there is scope for substantial reform to achieve regulation which is institutionally neutral, is clearly linked to a regulatory objective and to the requirements of the function or activity being regulated, and is at the minimum intensity possible.

While the Committee itself may not have time to consider these detailed matters, it could recommend parties who should be responsible and mechanisms for industry and consumer involvement in that further work. It should also recommend principles to guide this further review and against which existing regulatory principles should be measured. For example, a review of prudential regulation might be co-ordinated by the Council of Financial Supervisors, while a review of the current regulation of payment systems might be undertaken by the Australian Payments Systems Council. The Commonwealth Treasury will not always be the most appropriate body to carry forward further work.

Finally, the Committee could indicate what priorities it allocates to the major implementation steps, which should be dealt with urgently by Government and which might reasonably wait a longer period.

The timeframe for any regulatory reform needs to be spelt out and discussed with industry to ensure adequate planning for a smooth transition. It is assumed that given the complexities involved, the need for major legislative changes and major changes to current administrative arrangements, the new system could not be in place for at least two years.

There are several issues affecting credit unions which we believe should be addressed in the meantime as a matter of urgency. These issues include the passing of amendments to the Cheques and Payments Orders Act to allow credit unions to issue cheques in their own right. The former and current Commonwealth Governments have both supported these amendments but they have not been given sufficient priority within Government to ensure their passage through the Parliament.

The abolition of the FI Scheme and its replacement with a national system of regulation will involve detailed discussions between the Commonwealth and State Governments. These discussions will need to commence as soon as possible after the Wallis Inquiry is concluded. We consider that the appropriate forum for these discussions is the Council of Australian Governments (COAG). A working group of COAG will need to be established to undertake the detailed work, again with a formal industry consultation process also to be established.

The COAG working group could also address other issues that we believe require urgent attention. These are the transfer of State-based consumer credit legislation and privacy legislation to the Commonwealth Government.

Attachments