

Submission to the Financial System Inquiry

Commonwealth Bank



Submission to the Financial System Inquiry

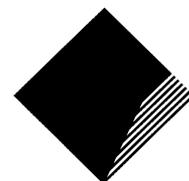
Commonwealth Bank of Australia

September 1996

Table of Contents

1 EXECUTIVE SUMMARY	1
1.1 Objectives	1
1.2 Outcome of Deregulation	1
1.3 Assessment of Current Arrangements	2
1.4 Recommendations	7
2 THE FINANCIAL SYSTEM	14
2.1 Introduction	14
2.2 Functions of the Financial System	14
2.3 Financial Institutions	16
2.4 Financial Functions	17
2.5 Performance Measurement	19
2.6 Principles of Regulation	21
2.7 Community and Government Involvement	24
3 OUTCOME OF DEREGULATION	26
3.1 Objectives of Deregulation	26
3.2 Operational Efficiency	26
3.3 Dynamic Efficiency	26
3.4 Allocative Efficiency	28
3.5 Stability	30
3.6 Conclusion	30
4 CHANGING INDUSTRY DYNAMICS	32
4.1 Technology and Distribution	32
4.2 Function Decomposition	35
4.3 Entry and Exit Conditions	36
4.4 Changing Consumer Needs	37
4.5 Market Globalization	39
4.6 Regulatory Implications	41
5 REGULATION	Error! Bookmark not defined.
5.1 The Role of Banks	1
5.2 Collective Investments	12
5.3 Bank Holding Companies	19
5.4 The Structure of Financial Supervision	41
5.5 Competition	69
5.6 Other Regulatory Issues	81





1 Executive Summary

1.1 Objectives

An efficient, safe, responsive and dynamic financial services industry is essential to the daily operation of the national economy and the well-being of all Australians. The overriding national objective should be to ensure that future generations of Australians are provided with a financial system that is at least as good as, but preferably better than, the one in which we currently operate.

The essential challenge for the Inquiry is to preserve what is of value to the community in the current system, while providing the maximum flexibility to adapt to forces that can create new value for customers and ensure that the system contributes to a globally competitive Australian economy.

The tests to be applied to the existing financial system and its regulatory infrastructure, and any proposals to modify it, should require:

- A relatively stable, safe institutional framework for community savings and a payments system of sufficiently high integrity to maintain community confidence.
- Cost effective supervision in support of the above, on a national and globally synchronised basis.
- Widely available services at the lowest practicable cost to users, achieved through effective competition with an incentive to innovate.

These objectives and tests require trade-offs to be made such that there is no perfect answer or model. Historically, financial disasters make it clear that protection of the community's savings necessitate a body of skill, maintained in Australia, to authorise and supervise banks and maintain surveillance. In this regard, the system applied in Australia for most of the period since the problems of the 1890s has been superior in world terms.

1.2 Outcome of Deregulation

The Australian financial system that has emerged post the Campbell Inquiry is vastly better (ie more efficient and more competitive) than the one that existed in the earlier regulated environment.

Spurred by competitive pressures, banks have achieved substantial progress in reducing operating costs. Benefits are also clearly evident in the much wider range of financial products available to consumers and the improved access to banking services. Greater flexibility and efficiency now exists in the marshalling of scarce national savings and the transfer of these funds for investment in productive purposes.

All the potential benefits of deregulation have not yet been achieved. The dramatic ending of 20 years of inflation and related asset price escalation interrupted the process and took most banks time to recover.

New management style and skills have had to be adopted and this is a continuing process.

The overhang of the savings banking regulations has also left many Australians with a very low perception of value of the convenience of retail transactional services. This will continue to inhibit the allocation of resources to this service unless a reasonable commercial price is obtained.

1.3 Assessment of Current Arrangements

1.3.1 Safety and Stability of the System

Against the tests outlined earlier, the stability objective of regulation has been quite well accomplished.

Some banks and other financial institutions failed. But those episodes did not lead to contagious runs on otherwise solvent institutions. The test of prudential regulation for system stability objectives is whether banks (or other systemically important institutions) which are mismanaged can exit the industry without creating a financial crisis and without loss to bank depositors. Against that test, current supervisory arrangements have performed well.

There were some pockets of difficulty in the late 1980s and early 1990s but those can be attributed to poor management, earlier inflation excesses and the unavoidable pain of the move to a permanently lower inflation environment, associated cyclical corrections in asset markets, and a general learning process for institutions, borrowers and investors in the transition from the earlier tightly regulated financial system.

No bank depositors lost any of their savings and there was no contagious financial crisis.



The episode was not unique to Australia. It was a global phenomenon associated with the same processes of transition to deregulation and to low inflation. Indeed, it is highly noteworthy in considering alternative regulatory models adopted elsewhere that the financial instability that occurred in Australia during this period was less than occurred in most other countries.

Most noteworthy of all, the recovery from this episode of turbulence was quite rapid. This recovery owed a great deal to the institutional structure of the Australian financial system.

Australia's large, nationally operating, well-capitalised banks, with diverse shareholding and access to additional capital injections when needed, were able to cope with the stresses of the correction from earlier excesses without risk to the system or to depositors.

Similarly, although a number of foreign banks, state banks and former building societies which opted to become banks were subject to significant financial stress, there was a relatively orderly adjustment process.

The pivotal role of Australia's major banks has also avoided any problems in the exchange of value that underpins Australia's highly efficient payments system.

In summary, the combination of prudential regulation administered by the central bank and the character of Australia's nationally operating banks has given the community a financial system that is sound and in which they can place their trust and confidence.

Included in the arrangements is the long-standing combination in the central bank of responsibilities for both monetary policy and banking supervision. CBA strongly believes that these arrangements have been effective and that there are significant complementarities between monetary policy and systemic stability objectives. On these grounds, responsibility for banking supervision should continue to reside with the Reserve Bank.

Apart from institutional solvency, the absence of violent movements in financial asset prices is a desirable characteristic of a stable financial system. On this dimension, Australia's financial performance has been far less impressive.

The poor inflation record of the 1970s and 1980s led to undesirable speculative movements in asset prices, particularly in long-term interest rates, while eventual corrective action to address those inflation excesses at times saw short-term interest rates rise to extraordinary heights. The exchange rate and equity prices experienced similar gyrations.



A contributing factor to this turbulence has been Australia's poor savings performance. The resultant excessive reliance on overseas capital exposes domestic markets unduly to the vicissitudes of external conditions and foreign investor perceptions of domestic economic performance.

The solutions to these problems of financial instability do not lie directly with financial regulation.

These are issues for macroeconomic and taxation policies. While deficiencies in the taxation system go beyond the scope of the current Inquiry, the pervasive effects of taxation imperfections on the very foundation of the financial system need to be recognised and understood.

1.3.2 Protection of Customers

Consumer regulation should conform with the following broad principles:

- It should seek to address the source of the market imperfection (information asymmetry), not to supplant the market process.
- It must achieve its objective at least cost, because the costs it imposes are borne by the users of the financial system.
- It should be uniform.
- It should be competitively neutral.
- It should be national in scope.
- It should be flexible, adopting an objective-based approach rather than a rigidly prescriptive approach.

Much existing consumer protection regulation does not conform with these principles.

There is an unfortunate tendency to resort to 'black letter law' as a solution to perceived problems of the market. Rarely are the costs of this approach considered, let alone any attempt made to ensure that the benefits outweigh those costs.

The State-based Consumer Credit Legislation is a classic example of this approach.

Not only is this very prescriptive approach excessively costly, it constrains the ability of financial institutions to adapt to changing market conditions and the diverse financial needs of their customers.

In some cases, consumers are overloaded with information which is neither necessary nor sought, but for which they ultimately bear the cost.



Lack of uniformity in some consumer protection provisions, such as disclosure requirements and accreditation of financial advisers, adds to costs for businesses operating across various product markets, creates confusion for customers in comparing similar products and breaches competitive neutrality where the burden varies by nature of the institution providing the product or service.

The multiplicity of agencies which administer consumer protection is a further problem.

Indeed, the area of regulatory structure where there is greatest scope for rationalisation is in regulation designed to protect users of the financial system.

Each of the specialist financial regulation agencies (viz RBA, AFIC, ISC and ASC) has elements of consumer protection oversight. At the same time, non-financial regulators, most notably the Australian Competition and Consumer Commission and the various State and Federal Consumer Affairs Ministries, exercise responsibilities in this area.

Avenues of consumer redress are also excessively fragmented.

In the entire area of consumer protection there is much regulatory duplication, overlap, inefficiencies and excessive cost burdens.

On any assessment, there are serious deficiencies in consumer protection regulation which the Inquiry should address.

1.3.3 Promotion of Competition

Competition in the financial services sector has greatly intensified over recent years.

The market is characterised by a mix of both major institutional groups and smaller, more specialised product or customer segment focussed players.

This market structure is common in a range of other countries which have efficient and competitive financial systems.

It provides a good balance between the economies of scale and scope which financial conglomerates offer, and the specialist product or functional skills and customer service competencies which niche players can provide.



On these grounds, the financial services market is assessed as being highly competitive.

There are, however, some elements of competition regulation applied to the financial services sector (as distinct from Australian industry more generally) that require attention.

1.3.4 Change Dynamics

Competition holds the key. It is competition that drives alternative providers to strive continuously for better ways to meet customer need, to satisfy shareholders, and to promote rewarding, challenging careers for employees.

Convergence, as different institutional groups have progressively widened their array of financial service offerings to the point where there is a 'blurring of distinctions' between the functions of major financial conglomerates, is one dimension of that competitive process.

Deconstruction, whereby financial intermediation can be disaggregated into discrete activities, such as mortgage origination, is another dimension of the competitive process. Barriers to entry have fallen, both to particular component activities and to broader market participation.

Technology is opening up new ways to meet customer need, through a combination of greater convenience and lower costs, new options for customers to access services, and product innovation made possible by new ways to manage and process information. Technology is also adding to the intensity of competition by giving customers access to a broader range of suppliers.

Finally, developments in communications technology, such as on-line computer networks of which the Internet is the most ubiquitous, are ushering in 'location-independent' delivery of financial services. This has the potential to create a truly global financial services system.

The regulatory challenge is to allow financial markets and financial institutions maximum flexibility to anticipate, adapt and respond to the forces of change, while meeting other legitimate regulatory objectives at least cost to the users of the system.



1.4 Recommendations

1.4.1 Over-Arching Principles

Having regard to the requirement for global synchronisation of prudential supervision and the sound track record of Australia's institutional arrangements, the Bank recommends continued adherence to three core principles:

- The separation of commerce and finance.
- A clear regulatory distinction between deposit-taking intermediation and other forms of investments.
- Preservation of the special character and role of banks.

1.4.2 The Integrity of the Payments System and Safety of Community Savings

The institutional group called 'banks' play a fundamental role in the financial system. To preserve that role, the high standard of prudential regulation is justified and requires:

- a special supervisory position of the central bank; and
- the preservation of certain functions to banks.

Accordingly, the CBA recommends that only authorised banks:

- should be able to accept deposits without either issuing a prospectus or being subject to the licensing requirements of collective investments;
- should be able to participate in the settlement dimension of the payment system through the conduct of Exchange Settlement Accounts with the Reserve Bank; and
- should be allowed to use the term 'bank'.

Consistent with these principles, Reserve Bank supervision should not be extended to other institutions in a way which could compromise the unique role of banks in underpinning the financial system and its payment mechanisms.

The existing depositor provisions of the Banking Act should be retained and should remain the responsibility of the Reserve Bank.



1.4.3 Non-Bank Deposit-taking Institutions

While building societies and credit unions are currently subject to a form of prudential supervision, they do not qualify for a banking authority because of their distinguishing characteristics. Most notably, they are mutual entities rather than corporations, they have limited access to equity markets for capital raising, they are subject to less stringent corporate governance disciplines, their total balance sheets tend to be relatively small, and their asset composition and geographic reach are more narrowly focussed than licensed banks.

Non-bank deposit-takers should either:

- (a) if applicable, demutualise and seek a banking authority; or
- (b) be formally required to issue prospectuses in which case access to the RBA's Exchange Settlement Account arrangements should not apply; or
- (c) be allowed a special short form of 'public notice' prospectus issued under special statutory guidelines (distinct from banks) administered by the RBA, with no state-based supervision, but with requirements for financial disclosure, and liability of directors for disclosure breaches and the normal Corporations Law requirements.

The major issue for consideration is the extent to which depositors will anticipate or expect intervention and, by implication, require financial support from the public purse in the event of a collapse of one of these institutions.

1.4.4 Collective Investments

To the extent that there is a trend towards using managed funds as a repository for discretionary savings (as distinct from contractual savings such as superannuation), it is important that investors understand the different risk characteristics of deposits and managed funds.

The authorities need to be watchful that the burden of regulation imposed on banks and other prudentially supervised institutions does not accentuate the flow of savings towards less regulated forms of investment.

Provided the shift towards market-linked products reflects informed decisions by the investing public, undistorted by regulatory effects, the resultant diversification of household savings represents a desirable characteristic of a mature and innovative financial system.



CBA recommends that prospectus requirements and product disclosure standards for investment products, other than deposits, should aim for a clear understanding by investors of the nature of the investment and the price risk involved.

1.4.5 Financial Conglomerates

Bearing in mind the special role and supervision required of banks, and the need for efficiency gains from economies of scale and scope, the best balancing of these stability and efficiency objectives is achieved through a holding company form of group structure.

By separately constituting a banking entity under a holding company, it can be quarantined from other entities in the group for prudential supervision purposes.

The holding company model allows for the various separately-capitalised subsidiaries to be configured according to judgement about the most efficient corporate structure for the performance of the functions concerned, without prejudicing the interests of depositors of the bank.

The non-bank subsidiaries will need to be capitalised to the standards imposed by the market (and rating agencies) for other (stand alone) entities engaged in the same line of business. Where regulatory capital is required for those lines of business (eg insurance), the subsidiary would be subject to the same regulations, and be supervised by the same regulatory agency, as any other institution performing the same functions.

Such a structure would be more flexible, with changes able to be effected rapidly in response to internal innovation and external competitive demands. Hence there should be minimal regulatory impediments to the dynamic efficiency gains that accrue from institutional flexibility and the capacity for rapid response to changing market circumstances.

Approval should be granted for a non-operating holding company structure for financial conglomerates, subject to:

- the provisions of the Banks (Shareholdings) Act applying to the holding company entity, where it has a banking subsidiary;
- normal provisions of the Corporations Law;
- the Reserve Bank of Australia, in its capacity as the banking regulator, having oversight of the relationship between the bank and the holding company;



- supervision of the bank entity being conducted on a non-consolidated basis, except for the bank's own subsidiaries (to comply with BIS standards);
- other subsidiaries in the group meeting regulatory standards and market practices consistent with the functions they perform; and
- a lead regulator system being used to exchange information between regulators involved with different entities in the group, provided that the RBA normally be the lead regulator of any group having a bank entity.

Conglomerates, and by definition their shareholders, should be free to choose between two different structures: the existing model with quasi separation but consolidated supervision; or the holding company model with legal and economic separation.

1.4.6 Regulatory Structure

Much of the debate about alternative regulatory structures concerns the respective merits of institutional versus functional regulation.

The functional approach, which seeks to regulate the same financial functions in the same way, irrespective of the nature of the provider, has appeal on competitive neutrality grounds. In application, however, the functional approach breaks down because in some circumstances regulation needs to have regard for institutional solvency. A combination of institutional and functional regulation therefore is unavoidable.

However, by using an objective-based approach, financial regulation can be divided into that directed at systematic risk objectives and regulation directed at conduct of business objectives.

Using this approach, the Bank recommends that the current regulatory structure should be streamlined by creating two, and no more than two, agencies to undertake all financial supervision.

The function of Systemic Risk Regulator should reside with the Reserve Bank and be broadly consistent with its current responsibilities for the banking and payments systems, and the liquidity and overall stability of the financial system. Therefore the RBA should continue to be responsible for both monetary policy and bank supervision.

The function of Conduct of Business Regulator (eg a 'Financial Services Commission') should embrace the regulation of all financial products and institutions currently exercised by the ISC, ASC, AFIC, ACCC and State Consumer Affairs Ministers, with a view to achieving uniformity and simplification of regulation of financial products.



1.4.7 Competition Policy

In the area of merger policy, the Bank believes that all merger proposals in the financial sector should be assessed on their merits, within the same criteria as applied across the economy. The Treasurer, however, should have the discretion to approve or disapprove mergers solely on prudential grounds on the advice of the Reserve Bank.

The powers available to the ACCC to prevent mergers which are anti-competitive provide adequate protection to all stakeholders in the financial system. However, the ACCC guidelines on bank mergers are fairly narrow and fail to take account of current and emerging business configurations in the financial sector.

Studies of scale economies in banking have been generally inconclusive because of one or more factors, for example -

- They are applied across the total business mix of individual banks.
- They include distortions caused by regulatory overhang, high inflation and, in some cases, periods of large credit losses.
- They sometimes ignore national differences, such as taxation of institutions or transactions, size of economy, citizens' wealth or geographic diversity.
- They exclude the operation elsewhere in an economy of a significant, sometimes government run, institution which takes on large scale transactional services for the community.

In CBA's experience, scale economies in some segments of the business are relevant. Entry and exit barriers are also shifting as new information and communication technology is applied. However, scale comparisons can be distorted by differing customer segment balances, transactional behaviour and location, as well as revenue distortions caused by pricing constraints.

In the event that approval were sought for a merger among the major nationally-operating participants in the Australian financial services industry, ACCC should apply a public benefit test in each case because:

- competitive strength becomes relevant for ongoing stability and confidence, which needs to be assured as far as is practicable;
- there needs to be an incentive (on the basis of commercial pricing) for existing and new institutions to invest in continuing and widely available services; and



- non-merged entities need to maintain the capacity to compete and preferably retain the scope of certain activities, where scale economies may either deter new entrants, or unnecessarily raise the prices charged by alternative suppliers.

The Bank therefore concludes that a public benefits test is mandatory, that scale advantages are potentially available provided commercial pricing principles are first applied, and, as a consequence, all potential alternative proposals should be considered.

1.4.8 Other Regulatory Issues

(i) Prudential Regulation -

- Banks should be able to use their own internal models for capital adequacy measurement purposes;
- Appropriate legislative amendments should be made to facilitate counterparty netting;
- The Reserve Bank should include Tier 3 capital resources when including market risk in capital adequacy measures;
- Formal PAR requirements should be abolished where a bank's internal management system matches PAR. A wider range of assets should qualify as eligible PAR holdings;
- NCD requirements on banks should be abolished; alternatively a market rate of interest should be paid on these deposits;
- Disclosure provisions regarding investment risk associated with purchase of funds under management products should be standardised;
- Prudential requirements governing banks' involvement in securitisation activities should be harmonised with arrangements applying in main OECD countries; and
- In conjunction with insurers, the ISC should develop a more appropriate solvency measure.



(ii) Consumer Credit Act -

CBA fully supports the Australian Bankers' Association call for a substantial simplification of the Credit Acts through removal of prescriptive disclosure requirements and the removal of civil penalties. In line with the recommendation for a rationalised regulatory structure, administration of the Acts in respect of banks should be removed from the province of state authorities and be assumed by a Federal regulator.

(iii) Disclosure -

CBA recommends that product disclosure requirements for financial services be linked to the nature of the product being offered rather than the offering institution.

A standard disclosure document should be developed for each of the broad categories of financial products. The level of detail required should be tailored to the risk and complexity associated with the product, with the overriding objective being to provide the consumer with sufficient information in the most cost-effective form to make an informed decision.

(iv) Government-Imposed Overhead Costs -

Major recommendations include:

- Financial Institutions Duty/Debits Tax (FID/DT) - These taxes on financial transactions are distortive, regressive and inefficient and should be abolished.
- Financial Transaction Reports Act (FTRA) - Banks' responsibilities in relation to this legislation should not extend to identification of social security and tax fraud; prescriptive account opening procedures should also be reviewed.

Sydney
9 September 1996





2 The Financial System

2.1 Introduction

The financial system plays a vitally important role in the economy by providing its payments mechanism and by facilitating the transfer of funds from savers to those who can make best use of them. This process promotes capital investment, which is what adds to the productive base of the economy. A properly functioning financial system thereby enhances the productiveness, competitiveness and wealth-creating potential of an economy.

In this way, policies that promote the efficiency of financial markets and institutions are in the community interest. Some regulation of the financial system may be justified in certain circumstances but it should interfere as little as possible with its efficiency.

The trade-offs between regulation and market efficiency are a major issue for this Inquiry to address.

2.2 Functions of the Financial System

Transactions in financial markets and through financial institutions have significant effects on the macro-economy. These impacts include:

- affecting **saving** by influencing the return and risks on the funds accumulated;
- affecting **investment** through interest rates and equity yields;
- impacting on corporate **profitability** through interest rates and the exchange rate; and
- influencing **inflation** through the exchange rate and interest rates.

Through these influences the financial sector plays an important role in determining economic activity.

The central role of the financial system is to transfer funds from savers (surplus units) to the ultimate users of those funds (deficit units). This transfer is effected in two ways.

First, there is **direct financing** in which savers buy securities from their issuers.

The alternative approach is **intermediation** in which the saver invests the funds in a financial institution, which then buys the securities issued by those who wish to use the funds, either directly or through the secondary market.

Deposit-taking intermediaries substitute their own issues of 'secondary securities' for the 'primary securities' in which the funds are invested. In this way a bank depositor in effect receives a claim on the bank (the secondary security) in exchange for the deposit. A borrower, in turn, issues a claim to the bank (the primary security).

There are some significant advantages in the transfer of funds by intermediation. Specifically, there is a:

- **liquidity and maturity transformation**, in that investors in the financial institution can be given liquid assets (eg a bank deposit withdrawable on demand) while the institution makes longer term investments;
- **reduction in the information** costs of making investments. The financial institution performs the evaluation of the ultimate investment on behalf of a large number of individual investors whose funds are aggregated in it; and
- **risk reduction** arising from the portfolio diversification effect of pooling savings and investing in a wide range of financial claims.

The advantages of intermediation are so substantial that this is the dominant form of financing.

In a market economy, the flow of funds from savers to the ultimate recipients is governed by interest rates and other returns to the holders of financial claims. Those who have access to the most productive projects will be able to attract the available funds. This process ensures the highest possible return for savers and maximises the output of the economy.

The financial system provides the **payments mechanism** of the economy.

The existence of an effective payments mechanism is a necessary condition for the efficient functioning of an economy. Any failings or blockages in the functioning of this mechanism will inhibit economic activity. **The efficiency of the payments system is crucially linked to the confidence the community places in it as a means to exchange value.**

The financial system also provides **risk management** techniques and instruments.



The insurance component of the financial sector provides risk management services in many non-financial areas (eg asset protection such as home and contents cover). Rapidly growing derivatives markets provide products that can be used to manage financial and commodity price risk.

Another important function of the financial system is the **provision of information**. The prices, such as interest rates, asset returns and exchange rates, determined within the financial system, act as signals for participants in the sector, coordinating their decisions and producing outcomes in line with consumer demands.

The growth of derivatives markets has enhanced the ability of the financial sector to generate and disseminate information. The prices of derivatives depend on the expected **future** prices of the securities underlying them. They therefore quickly reflect changes in market conditions and perceptions, which in turn reflect information effects.

2.3 Financial Institutions

The most significant financial institutions are:

- banks;
- credit unions and building societies;
- finance companies;
- money market corporations (merchant banks);
- insurance companies;
- superannuation funds; and
- managed investment vehicles (unit trusts).

Banks, credit unions and building societies are referred to collectively as **Deposit-Taking Institutions (DTIs)**.

Financial institutions can be categorised according to the nature of their liabilities.

Those liabilities can involve a fixed nominal claim or vary with market prices.



An example of the former is deposits with banks and other DTIs, and an example of the latter is units in managed investment trusts (managed funds). This distinction is vitally important in differentiating between the strength of the contractual undertaking given by various types of financial institutions and between the nature of the risk borne by the depositor/investor.

The contractual undertaking that underpins those liabilities can entail a promise to:

- pay on demand;
- pay at a point in time (fixed term);
- pay in pre-specified circumstances (insurance); and
- pay if circumstances allow (equity).

Hence, the two distinguishing features of financial liabilities are:

- whether the claim is fixed in value or of uncertain value; and
- the circumstances in which payment will be made.

Based on the characteristics of their liabilities, the financial institutions listed earlier can be generalised into:

- deposit-taking institutions;
- insurance institutions;
- superannuation funds; and
- collective investments.

The distinction between superannuation and collective investments (ie other managed funds) rises from different regulatory treatment (particularly taxation) which affects the nature of their liabilities.

2.4 Financial Functions

Traditional institutional boundaries have broken down in the face of financial innovation, the growth of full service financial conglomerates and, at the other end of the spectrum, the emergence of 'mono providers' through the decomposition of financial functions.

The decomposition process makes it logical to treat a 'function' as the basic unit of financing. Under this approach, financial institutions are then defined in terms of the aggregation of the functions that they perform.



The functional approach breaks down the financial system into six fundamental functions:

- Provision of payment facilities.
- Mechanisms for pooling funds.
- The transfer of economic resources (geographically, over time, and between users).
- Risk management.
- Provision of price information.
- Dealing with incentive problems (by providing ways to deal with asymmetric information and agency problems when one party to a financial transaction has information that the other party does not).

The functional approach is a useful analytical tool in dealing with the problem of the blurring of distinctions between various financial institutions. It focuses on the function performed rather than the institutional form used to perform it.

In a financial system free from external constraints, certain elementary functions will tend to be provided together because there are advantages in doing so. These 'natural clusters' of functions occur because:

- consumers of financial services prefer to purchase the functions concerned as a single package (there are economies of scope for the consumer); and
- there are cost advantages in providing the elementary functions making up the natural cluster in conjunction with each other (there are economies of scope in the production and distribution of these functions).

A natural cluster of elementary functions is a financial product or service, and a financial institution is an organisation that provides one or more of these products or services.

An example of a cluster is provided by housing lending. It consists of the following elementary functions:

- The mortgage origination (approving the extension of credit to the borrower).
- Servicing of the mortgage (collecting repayments, following up arrears, record keeping etc).



- Holding the mortgage as an asset (funding the extension of the credit).
- Providing related products such as mortgage offset accounts or redraw facilities.

In a market system, the relative efficiencies in providing functions jointly or separately, together with the preferences of users of the functions, will determine the optimum institutional configuration and the respective roles of institutions and markets.

Regulation, whether formal or via moral suasion, will bias this clustering process towards less efficient outcomes.

2.5 Performance Measurement

The contribution that the financial sector can make to the economy depends on its performance and efficiency. There are a number of elements in the measurement of this performance. They are the:

- **operational efficiency** of institutions and markets;
- **allocational efficiency** of the financial sector;
- **dynamic efficiency** of the sector;
- **completeness** of the financial system; and
- **stability** of financial markets.

Operational efficiency is achieved where financial institutions and markets perform their functions at least cost in terms of the resources used. The interest rate margin is often used as an indicator of this type of efficiency for intermediaries, but it is an inadequate measure. The other services provided by financial institutions and the fees charged by them for the value they deliver also need to be considered. In the case of financial markets, the average spread between the buying and selling prices quoted in the market is a measure of operational efficiency.

Allocational efficiency is achieved where the financial system directs savings into the highest yielding investments so as to maximise the output of the economy. A related form of efficiency is **informational efficiency**, which refers to the capacity of a financial market to generate and process information. In this case, an efficient market is one in which all available information is fully reflected in prices. Informational efficiency is a necessary, but not a sufficient, condition for allocational efficiency.



Dynamic efficiency describes the capacity of the financial system to generate financial innovations (or to adopt and adapt financial innovations development elsewhere). These innovations can take the form of new risk management products or developments which enhance the liquidity of existing products. They increase the contribution that the financial sector makes to the general economy.

Current and prospective developments in information technology present a multitude of opportunities for financial innovations. Financial systems unable to take full advantage of these opportunities will impose significant **opportunity costs** on the economies of which they are a part.

The **completeness** of the financial system refers to the existence of a full range of products and services across the risk spectrum so that market participants can achieve their desired positions. Completeness adds to the allocational efficiency of financial markets. The growth of derivatives has added to the completeness of financial markets because it allows market participants to create hedged positions and to short-sell commodities and securities.

Instability in financial variables can have a negative impact on economic activity. It increases the risk of financial transactions and provides a disincentive for carrying out the related activities. It is desirable that a financial system not create **unnecessarily** high volatility. The word 'unnecessarily' needs to be stressed because variations in the prices of financial assets are obviously necessary so that the financial sector can carry out its allocational function. As discussed above, financial prices act as signals and they need to be flexible to allow them to adjust to changed circumstances. An attempt to fix financial magnitudes will incur significant costs. In addition, derivatives can be used to insulate decision-makers from financial volatility.

Financial **stability** is also affected most importantly by the **solvency** of financial institutions. A stable financial system requires that financial institutions can enter and exit (including through financial failure) the industry without undue disruption to the smooth functioning of the system. The potential for the failure of an institution to lead to **contagion effects** on other institutions, and in the extreme case to induce a system-wide financial crisis, is one of the primary reasons for regulation of the financial system.



Efficiency, in the various forms discussed here, is best promoted by a competitive market which is **as free as possible from government intervention**. Competition forces financial institutions to operate at least cost. Competition also ensures that funds are directed into the areas yielding the highest returns relative to risk, thereby ensuring the allocational efficiency of financial markets. Finally, competition drives the quest for financial innovations because the institutions introducing the new products or services receive the competitive benefit through providing better value to their customers.

Regulation imposes **efficiency costs** by limiting market competition and restricting the flexibility of financial institutions. **Regulatory costs must therefore be balanced against assumed benefits in an optimum regulatory model.**

2.6 Principles of Regulation

A necessary but not sufficient condition for government intervention in the financial system is the existence of **market imperfections**.

The specific rationale for the regulation of the finance industry revolves around efforts to achieve the following objectives:

- to safeguard the **safety and stability** of the financial system;
- to protect the **interests of users of financial services**; and
- to **promote competition** in the interests of efficiency, innovation and consumer choice.

A particular concern of financial regulation is **systemic stability**.

Systemic risk refers to the potential for the failure of one institution to lead to 'runs' on other institutions, possibly causing further failures. The possibility of contagion is unique to the financial sector. It arises from the following characteristics of the balance sheets of financial intermediaries (notably banks):

- they are highly geared (this being the nature of financial intermediation);
- their assets are not readily marketable;
- their deposit base relies on confidence in their ability to meet withdrawals as required; and
- their financial position is opaque.



These characteristics in combination leave financial intermediaries exposed to the risk of a 'run'. Depositors who suspect that a financial institution is in difficulties have an incentive to be the first in line to withdraw their deposits. It makes little difference whether the suspicion arises from an objective analysis of the financial position of the institution, unfounded rumours, or the failure of a similar organisation. In this way a 'run' on one institution can have contagion effects on others.

A series of cumulative failures of financial institutions can have very damaging effects on the economy. The flow of funds from savers to borrowers is likely to be significantly impeded, with negative consequences for productive investment and economic growth; also the integrity of the payments system would be undermined. Stability of the financial system is thus a public good and there is a case for government intervention to achieve it.

The second motivation for regulation is **investor (or consumer) protection**. In an environment of perfect competition and in which consumers have full knowledge, there is no need for consumer protection.

Since these conditions are not satisfied in the real world, there is an argument for regulation to protect consumers.

This argument has been couched more technically in terms of the existence of **information asymmetries** - information may not be fully provided, it may be too costly for consumers to gain access to and continuously monitor, or it may not be reasonable to expect consumers to be able to properly interpret it.

Where there is market failure because of inadequate information, the primary objective must be to address the problem **at source** by requiring effective prior **disclosure**, in intelligible language, of the nature and extent of the risks involved in any financial transaction.

This information needs to clarify **the role that the financial intermediary is playing** on their customer's behalf (whether as principal or agent) and **the nature of the undertaking** being made (whether the financial claim is fixed in value or of uncertain value and the circumstances in which payment will be made).

In some cases **prudential** regulation, which involves supervision of **institutions** with the aim of protecting their solvency, can be justified on consumer protection grounds.



Here again, **the objective** of the regulation needs to be clearly understood. The objective is **not** to absolve the consumer from the consequence of their investment decisions nor to guarantee that no supervised institution will fail. The objective of prudential regulation **for consumer protection reasons** is the same as for disclosure - it is all about **efficiency**.

With some investment decisions, particularly those involving onerous financial obligations over an uncertain timeframe, it can be **inefficient** for individuals to have to make judgments on a continuous basis about the financial standing of a complex financial institution. In those cases, supervision by a regulatory agency is undertaken on behalf of the customers of the institution concerned as a **more efficient** way of dealing with information asymmetries.

Consumer regulation should conform with the following broad principles:

- it should seek to address **the source** of the market failure (information asymmetry) not to supplant the market process;
- it must achieve its objective at **least cost**, because the costs it imposes are borne by the users of the financial system;
- it should be **uniform**;
- it should be **competitively neutral**;
- it should be **national** in scope; and
- it should be **flexible**, adopting an objective-based approach rather than a rigidly prescriptive approach.

Protection or promotion of **competition** is an objective of regulation only insofar as is needed to address instances of market failure due to lack of effective competition in a given market.

Competition policy is grounded in the belief that efficiency, in the interests of provision of services to customers at least cost, is best achieved through the market mechanism.

In short, competition policy is not about impeding the interplay of market forces, including the market for the ownership and control of business enterprises. On the contrary, **it is about making markets work better to promote economic efficiency**.



In this quest for optimum economic efficiency, the application and interpretation of competition policy seeks to avoid undesirable market power (allocative efficiency) while facilitating least-cost provision of financial services (operational efficiency) and vigorous financial innovation (dynamic efficiency).

Market failure is not of itself sufficient justification for regulatory intervention. The intervention must be able to be demonstrated to achieve a superior outcome.

A framework within which the appropriateness or otherwise of existing and future regulation should be assessed is as follows:

- the objective must be clearly specified;
- the benefits of achieving the objective must outweigh the costs of intervention;
- all alternative methods of achieving the objective must be considered; and
- the optimum method should be selected, based on appropriate cost-benefit analysis.

In many cases apparent market imperfections actually arise from the perverse effects of existing regulations. In these situations the most cost effective approach will almost always be to correct the distortion at its source by removing the regulation causing the problems.

2.7 Community and Government Involvement

Government involvement in the financial sector has been a common feature of many systems until relatively recently. Fiscal consolidation and/or financial crises have led to significant disengagement in many countries.

The Commonwealth Bank's experience and record as a government owned institution provides a valuable insight into government involvement in banking. The Bank's strengths were sufficient to overcome typical weaknesses, for example:

- a large national operation facilitated the diversification of risk and the ability to avoid local parochial credit extension;
- although competition was not as open as today, the Bank's need to compete on the terms of the day instilled some independence of action into the culture of the Bank's people;



- oversight by Treasury helped ensure that the Bank's activities were not directed in one particular direction of sectoral assistance;
- in its recent history (1970s on) the Bank's returns were supported by a combination of its mix of savings banking, a long period of inflation and the former banking regulations which maintained margins; and
- despite the existence of deposit guarantees, this was not always a sufficient substitute for the capital needed for supervision and/or prudential compliance.

This experience supports the contention that there is little to be gained but a lot to lose from government involvement especially in a deregulated financial system.





3 Outcome of Deregulation

3.1 Objectives of Deregulation

The Australian financial system that has emerged post the Campbell Inquiry is vastly better (ie more efficient and more competitive) than the one that existed in the earlier, highly regulated environment.

The process of deregulation of the Australian financial system took place on a phased basis and over a number of years.

Improving the efficiency and competitiveness of the Australian financial system but maintaining its stability underpinned the rationale for deregulation.

3.2 Operational Efficiency

The operational efficiency of Australian banks has improved markedly since deregulation, especially over more recent years. Spurred by competitive pressures, banks have achieved substantial progress in reducing current operating costs.

This issue was addressed by the Martin Committee in 1991 which concluded:

‘There is a misconception that banks’ profitability has increased since deregulation. In fact it has fallen slightly. Had they not reduced their operating expenses, they would have been even less profitable.’

3.3 Dynamic Efficiency

Dynamic efficiency gains are clearly evident in the proliferation of new services and products available from banks post deregulation. This situation has been assisted by the combined effects of increased competition, greater pricing freedom and technological developments.

Bank customers are now provided with an increased ability to carry out transactions. There are significantly more banks to choose from and, taking into account the spread of ATMs, EFTPOS facilities and telephone banking, customers have substantially greater access to banking services.

Much of the improvement here has been directly related to advances in technology.

While it may be argued that advances in technology would have changed banking regardless of deregulation, increased competition has accelerated the process of technological development and its implementation throughout the banking industry.

Strong competition among financial services providers has given rise to an expanding range of deposit and investment services that are available to customers.

The wider choice of products available in today's competitive environment contrasts with the restricted product range available prior to deregulation.

This has been most prevalent in the home lending area. Under the regulated environment, the only housing loan product available to owner-occupiers was the standard, variable rate credit foncier loan with regular monthly payments. The move to a deregulated market has resulted in a substantial revamp of the attributes of home loan products. Major changes to the nature of these facilities have included:

- The maximum term of loan has been extended from 25 years to 30 years.
- Borrowers have the option to repay their loans at a faster rate. Along with charging of interest on a daily basis, borrowers have the opportunity to make significant interest savings.
- The availability of fixed rate loans.
- Home loan portability.
- Customers can borrow for a range of personal and home related purposes secured against a principal residence.
- The ability to redraw special repayments made over the period of a loan.

A variety of products have also been developed to assist business customers finance their operations and manage interest rate and foreign currency exchange risk.

The need for risk management tools has been highlighted by the much closer integration of the Australian economy with developments in major off-shore economies and increased volatility in financial markets.



Risk Management products available from Australian banks since deregulation include:

- interest rate and currency swaps;
- domestic and foreign currency forward rate agreements; and
- interest rate and currency options.

Prior to deregulation, banks were not able to deal in these products due to the existence of interest rate and exchange rate controls. The absence of these products from the Australian market was a constraint on the ability of businesses to protect against potentially costly financial risks.

Deregulation has also allowed banks to expand into a broader range of non-banking activities, including superannuation, insurance (both life and general), stockbroking services, and a range of managed fund investments.

3.4 Allocative Efficiency

Perhaps the single most significant benefit to flow from deregulation has been the increase in **allocative efficiency** through the ending of credit rationing. The era of tight regulation of the banking system distorted the allocation of funds.

The removal of interest rate and credit controls enabled banks to perform one of their most important tasks for the economy - credit assessment across the whole range of loan applicants with the capacity to allow interest rates to ration credit among competing users. Restrictive loan eligibility criteria have been abolished. Finance is readily available to creditworthy borrowers at market interest rates.

Home loan applicants were previously required to meet a stipulated savings requirement. The group most affected by this was first home buyers who were generally required to maintain low yielding savings deposits for an extended period prior to applying for a loan. Potential borrowers are no longer forced to subsidise home loan borrowers by being captive low cost depositors.

The shift to a competitive market system has enabled household savers to obtain more market-related rates of interest on bank deposits. This is borne out by comparison of banks' three month fixed deposit rates and the 90 day bank bill rate. Over the 1990s the differential between these rates has been quite small and much lower than during the previous decade.



The increasing sophistication of savers and ready availability of comparative pricing information have added to the intensity of competition. It is imperative for banks to pay a competitive return on deposits or suffer an erosion of market share.

The increased financial awareness of savers is apparent in the continuing shift in deposit funds to higher interest accounts. Funds held in passbook accounts and other savings accounts, which offer significant transaction services but only a modest rate of interest, currently represent a substantially lower proportion of bank deposits compared with the early 1980s. A significant feature of customer behaviour has been to retain a deposit facility for transaction purposes while transferring investment funds to a separate account that pays a higher rate of interest.

A further measure of the success of deregulation in producing a more competitive financial system can be gained from the trend in bank interest rate margins. Various studies by the Reserve Bank confirm the downward trend in bank interest rate margins.

Former controls on bank deposit interest rates meant they were forced to compete for funds on a basis other than price. In essence, banks provided deposit and transaction services either free of charge or at a price that was below the cost of making those services available.

By not charging for the full cost of these services, banks were in effect paying **implicit interest** to account holders.

While payment of such implicit interest may have been seen as 'compensation' for not receiving what otherwise may have been a higher rate of interest, compensation did not fall evenly across all customers. Customers who were heavy users of transaction accounts clearly benefited from this practice. It nevertheless worked to the particular disadvantage of low volume transactors holding sizeable balances.

Other major recipients of cross-subsidies during the regulatory period were those borrowers fortunate enough to be able to access home loan finance at controlled (but artificially low) interest rates.

A positive outcome of deregulation has been the erosion of some of the cross subsidies that had developed as a result of previous regulations. Unfortunately there are a number of obstacles to full recovery of the real cost of services being consumed. This is particularly so in the case of banks' ability to charge fees on retail transaction accounts. The offset to this is reflected in a continuation of cross subsidiaries (recently reduced) being provided by home loan borrowers.



3.5 Stability

Even though the banking system has been through one of its most testing periods since deregulation, it has remained relatively stable.

There has been no systemic shock calling into question the reliability or integrity of the payments system. The Barings crisis was managed effectively in concert with other countries' authorities. It did, however, demonstrate some areas for minor refinement. Collapses of some state banks and non-banks (neither under formal RBA supervision) demonstrated the value of the national banking system as the backstop for liquidity support.

No bank depositor has lost funds. However, losses in Victoria and South Australia were significant following state bank failure.

Nevertheless these losses were, in total, quite small compared with other similarly measurable incidents, notably in Scandinavian countries. Losses in Japan are not yet measurable in similar terms and the very large cost to United States taxpayers from the savings and loan problems do not show up in the normal banking statistics.

This outcome has been achieved without the cost to the community of a deposit insurance system.

It is, therefore, hard to justify a significant departure from the process of bank authorisation and prudential supervision currently operating.

3.6 Conclusion

While it is arguable whether the changes proposed by the Campbell Inquiry have resulted in gains to the full extent envisaged or hoped for, it is abundantly clear that the Inquiry's dual objective of seeking to promote a more **competitive financial system** as well as increasing its **efficiency** has been achieved.

Reflecting deregulation, CBA has been able to deliver an enhanced array of financial products to its customer base that are priced in a manner consistent with keen and effective competition, resulting in the delivery of tangible benefits to customers.

Borrowers are no longer unnecessarily hindered in gaining access to credit and depositors are receiving higher returns on the funds they have invested. Competition has precipitated increased efficiency within the banking industry with a flow on to customers by way of lower costs.



All the potential benefits of deregulation have not yet been achieved. The dramatic ending of 20 years of inflation and related asset price escalation interrupted the process and most banks took time to recover.

Management style and skill have had to be adapted and this is a continuing process.

The overhang of the savings banking regulations has also left many Australians with a very low perception of value of the convenience of retail transactional services. This will continue to inhibit the allocation of resources to this service unless a reasonable commercial price is obtained.



4 Changing Industry Dynamics

4.1 Technology and Distribution

The financial services business is being rapidly transformed as electronic media are used to transmit information and deliver services as an alternative and adjunct to face-to-face interaction with customers.

For banks, technology has brought a variety of more cost effective alternatives to service customer needs than extensive 'bricks and mortar' branch networks.

Those networks, which are frequently cited as a barrier to entry to the personal 'banking' market, are a legacy of a past age in which regulation imposed rigid pricing and competition was therefore played out by seeking to provide more convenient physical access.

As a consequence of this regulation-induced drive to compete through branching, and as a result of its geographic expanse and post-war urban sprawl, Australia has one of the highest densities of bank branches to population in the world.

While the branch distribution system still has a role to play, whole new delivery systems have emerged through developments in communications technology.

Growth in ATMs, EFTPOS, 'mobile bankers' and telephone access to banking services are well known. The coming wave will involve direct banking (viz exclusive telephone/electronic banking services delivered within a relationship-based model rather than a transaction-based model), PC based home banking, eventually extending to access to a multitude of financial services providers via the Internet

The impact of technology is of enormous consequence. It will occur in three interrelated dimensions: **firstly**, it profoundly affects the economics of customer servicing for both existing and potential financial services providers; **secondly**, it widens the range of activities that particular institutions can undertake; and **thirdly**, it fundamentally affects the respective roles of institutions versus markets in accommodating demand for financial services.



The **first dimension** is that new delivery systems made possible by developments in technology are overturning the economics of the financial services business. Banking by electronic means is becoming the more predominant channel for many customers. As this trend continues, the branch network is likely to become less important as a point of customer access.

That is not to say that branch networks will disappear. However, their **relative** importance within the mix of access points available to customers will recede and their function will shift from provision of transaction services to provision of help with financial decisions.

Given that electronic delivery is more cost effective than over-the-counter access, there are significant pricing implications in these developments. As new delivery systems increasingly come on stream, financial institutions will have overlapping delivery systems and excessive investment in outmoded infrastructure. The sensitive issue of how to reduce the scale of physical branch networks without inconveniencing or disaffecting valuable customers is a strategic issue the banking industry must confront.

At the **second dimension**, technology is bringing down barriers to entry to the financial services market. Banks are increasingly facing competition from a wider range of actual and potential suppliers of 'banking' services.

In this environment, the capacity to cross-subsidise unprofitable activities, such as transaction services, from more profitable services, such as some forms of lending, cannot be sustained.

New delivery channels are allowing new players and existing financial institutions from outside the banking system (the convergence phenomenon) to target profitable segments of the banking market.

In these circumstances, cross-subsidies need to be unwound urgently if banks are to maintain their competitive viability.

While the media spotlight is inevitably thrown on those prices which must **rise** to achieve recovery of their cost of supply, it is rarely recognised that the competitive process driving this outcome is forcing banks to **lower** the price of products and services that were previously cross-subsidising under-priced lines of business. Possibly reflecting this unbalanced portrayal, there is considerable political, community and regulatory resistance to the unwinding of cross-subsidies, as demonstrated by the inquiry into transaction fees held by the Prices Surveillance Authority in 1995.



Unless pricing of particular financial services reflects their underlying cost, the financial system will contribute, both directly and indirectly, to inefficient economic outcomes. In terms of economic theory, unless prices accurately reflect **both** the cost of supply and consumer demand, resources in the economy will be inefficiently allocated.

By providing price signals to bring customer preferences and costs of supply into balance, customer traffic will increasingly occur through the cheaper (and frequently more convenient) delivery channels, other than for those customers who place a high value on traditional face-to-face service. Resultant displacement of business flows to non-branch delivery channels (or to competitors if banks do not price services consistent with their costs) will potentially leave the system with excess investment in branch outlets.

Faced with this excess distribution capacity, banks can scale back their points of representation or increase the range of products and services that can be marketed through legacy distribution channels.

Several key messages can be drawn for the purposes of the Financial System Inquiry. Firstly, there is an important **public education** role to help people better understand the need for costs to be reflected in fees and charges for financial services of all types. Secondly, there is a nexus between branch rationalisation and **merger policy** - refer Section 5.5. Thirdly, if regulatory impediments to banks **diversifying** the range of products and services distributed through the branch network can be removed, prospects of sustaining a larger number of viable branch outlets will be enhanced. This raises the issue of regulation of financial conglomerates which is taken up in Section 5.3.

The **third dimension** of technological impact is the interaction between institutions and markets. Advances in communications and computer technology have reduced information and transaction costs and facilitated innovations in financial instruments.

These developments have eroded some of the value created by financial intermediaries relative to direct participation in financial markets. This process is elaborated further under functional decomposition (see below).

The important message to note at this point is **that excessive regulatory imposts on financial institutions will merely serve to accentuate the shift from intermediaries to markets, thereby proving ultimately self-defeating.**



4.2 Function Decomposition

Functional decomposition refers to the disaggregation of the financial intermediation process into its core functions.

At the most basic level, this occurs when the provision of deposit and lending services are separated. An institution like a cash management trust (or money market mutual fund in the US) can offer deposit services but engage in no credit origination, simply reinvesting in wholesale markets the funds placed with it by 'depositors'. Similarly, a mortgage originator creates loans but raises no deposits - it bundles up the mortgages and passes them through to institutional investors.

The existence of these single function providers demonstrates that financial intermediation can be unbundled, using **market** rather than institutional mechanisms where this confers competitive advantage.

Taken a step further, the **processing function** involved in financial intermediation can be separated from the credit origination and deposit raising functions. Hence, loan servicing, involving the administration of loan repayment flows, issuance of loan statements to borrowers, follow-up of loan arrears etc, can be viewed as a separable business line. The same disaggregation can occur on the deposit side, with pooling and investment of deposit funds being separated from the processing of transactional payment services associated with the deposit raising function.

Viewed from the functional perspective, the discrete functions involved in financial intermediation can be undertaken jointly, separately or in partial combination according to which is the more efficient means to deliver value to the consumer of the financial service.

Three conclusions follow from the emergence of functional decomposition. **Firstly**, cherry-picking of profitable lines of business can occur at the functional level. The capacity to **cross-subsidise** is therefore far more circumscribed. Not only do cross-subsidies between customers risk profitable **customer relationships** (ie those subsidising the cost of services provided to others) being targeted by competitors with more finely priced offerings, but cross-subsidies between functions risk the loss of the profitable **components** of a banking relationship. In a free market, these competitive dynamics drive participants to strive for increased efficiency, competitive pricing and better ways to satisfy customer need. However, when pricing constraints are imposed on some competitors, whether through explicit regulation or moral suasion, the outcome will be neither efficient nor equitable.



Secondly, functional decomposition has freed up market entry conditions. This point is taken up in the next section.

Thirdly, regulatory costs increase the competitiveness of non-bank suppliers of 'banking' services. Functional decomposition has expanded the range of actual and potential competitors by making it possible to compete without undertaking all of the processes involved in the provision of 'banking' services. Competitive neutrality therefore needs to be viewed at both the institutional and functional dimensions.

4.3 Entry and Exit Conditions

The inter-related developments of technological advances and decomposition have lowered entry barriers to the provision of 'banking' services.

Competition is not a new phenomenon to banking. Indeed the previous major inquiry into the financial system (the Campbell Inquiry) was conducted against a backdrop of regulatory distortions which had seen a secular decline in the position of banks relative to unregulated providers of 'banking' services.

The new ingredient in the current environment is the impact of technology. Communications technology has opened up **new distribution channels** which make it possible to compete effectively in some markets without the need for expensive branch networks. Technology has also made information more widely available and accessible, lowered transaction costs, facilitated innovations in financial instruments, and opened up new mechanisms to match savers and borrowers.

Supply conditions have therefore changed enormously. The market is now more highly **contestable** at both the institutional dimension and at a more disaggregated level. In short, banks are facing a much wider range of actual and potential suppliers of their services in the myriad of product, market and functional segments of their entire business.

Exit conditions have also been profoundly affected by these developments. It remains difficult for an existing major institution to exit the market, given the level of sunk investment that is not easily adapted to other uses. By contrast, new entrants that focus on target markets or functions do not face the same constraints. The level of investment required for a targeted strategy of this kind can involve a relatively short pay-back period that makes entry more easily reversible.



4.4 Changing Consumer Needs

Change in any industry is driven by dynamics on both the demand and supply side of the market.

On the demand side of the financial services industry, customer needs and behaviours are changing rapidly. This can be illustrated by the changes occurring in household savings (a financial flow) and holdings of financial assets (a financial stock).

Firstly the extent of financial deepening of the Australian economy can be seen from the rise in holdings of financial assets. As can be seen from Figure 4.1, there has been a very substantial rise in financial asset holdings over recent decades. This means that the wealth and expenditure behaviour of households is now more dependent on the characteristics and performance of financial assets than in the past.

Accompanying this rise in holdings of financial assets has been a change in their composition. As shown in Table 4.1 there has been a marked decline in the share of savings flows to banks and a marked rise in the flow to superannuation and other forms of collective investments.

TABLE 4.1: HOUSEHOLDS - NET ACQUISITION OF FINANCIAL ASSETS (PROPORTION OF FLOWS BY TYPE OF INVESTMENT)

	Bank Deposits	Life Office, Superannuation Contributions	Other (a)
	%	%	%
1970s	42	20	38
1980s	36	39	25
1990s	28	50	22

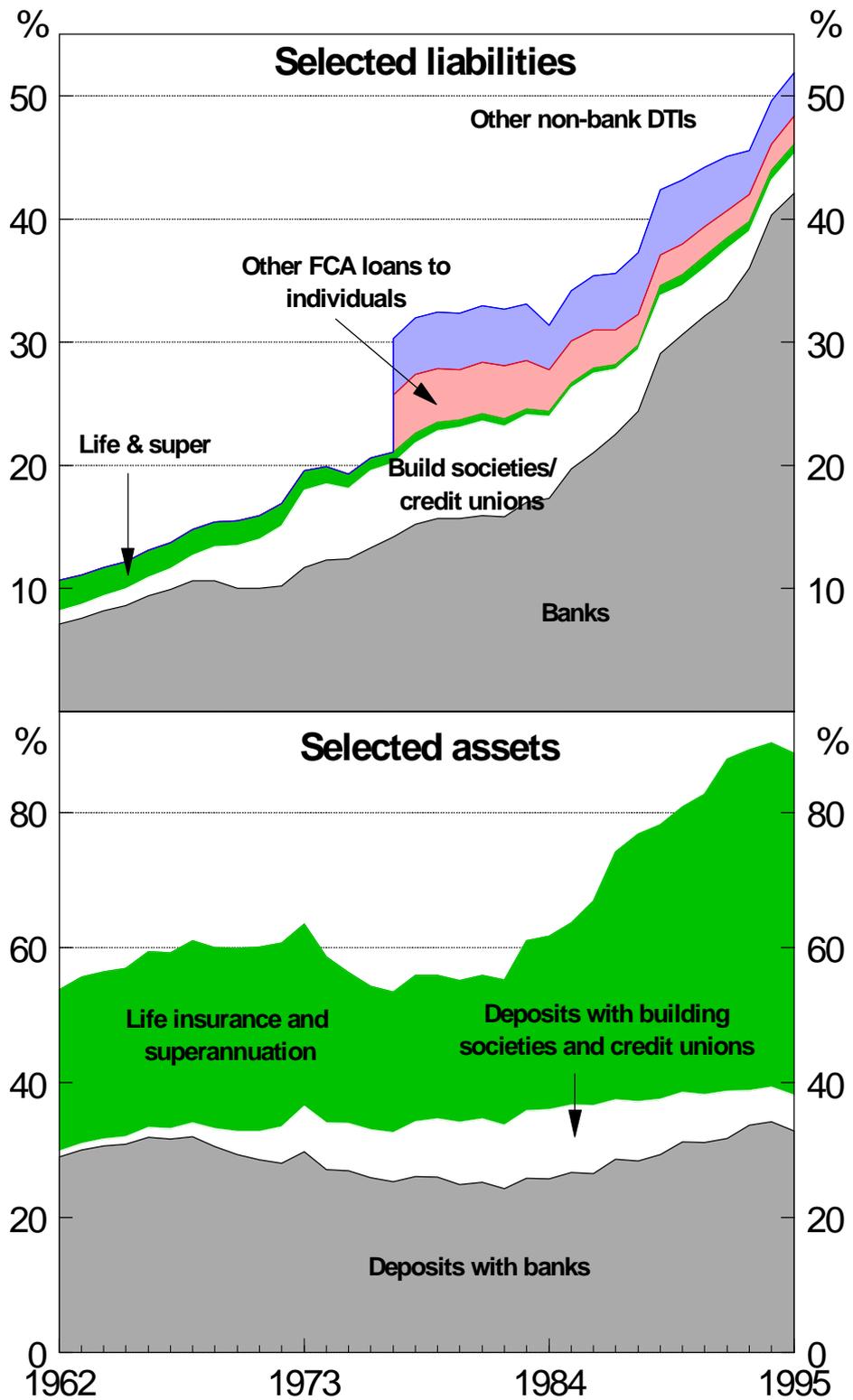
(a) 'Other' includes building society and credit union deposits, government securities, debentures, shares, unit trusts, etc.

Source: RBA and ABS

These changes in the pattern of savings are reflected in the composition of financial asset holdings shown in Figure 4.1 on the following page. The sharp rise in the store of household wealth held with life offices and superannuation funds is the striking feature of this graph.



**FIGURE 4.1 HOUSEHOLD SECTOR
PERCENT OF GDP**



Source: RBA Occasional Paper No. 8



These changes in the repositories of household savings reflect multi-causal influences - demographics, wealth and income levels and distribution, retirement income policies, and financial innovation to name but a few.

The outcome **on the demand side** is that customers are seeking a broader and more sophisticated **range** of financial products, greater convenience and choice in how those services are **delivered**, and more skilled assistance in helping them make financial **decisions**.

On the **supply side** there is intense competitive pressure to increase efficiency and innovative capabilities in order to anticipate needs and respond more effectively than competitors with value-adding services for the customer.

The customer will be the clear winner in this process. The challenge for government is to ensure that financial regulation does not distort and inhibit this competitive drive.

The regulatory consequences are taken up later in this submission.

4.5 Market Globalization

The application of new technologies will accelerate major changes in the structure of the financial services industry over coming years.

Traditionally, the necessity of face-to-face contact, as well as the logistics of processing and record-keeping, presented a geographic dimension to competition within the financial services industry.

Developments in electronic and telecommunications technologies have been progressively eroding most of these constraints. Financial services is, at its most basic level, all about storage, transmission and management of information. The development of global networks and technologies associated with the transmission of information are set to break down geographic constraints to the provision of financial services over the next few years.

Banks around the world are continuing to develop their on-line banking capabilities. As delivery infrastructure improves, customers will increasingly be able to contact their bank and engage in financial transactions with providers from remote locations, including outside their own country. One relatively recent example of this is First Direct of the UK, which is currently serving the needs of a customer base of around half a million by phone link from one location. Other banks in Europe and the US have developed similar strategies.



'Banking on the Internet' provides a further example of the bringing together of computer and communications technology. The Internet allows customers to peruse information from a world-wide range of banks and other financial services providers. The inevitable outcome of these developments will be the ability to conduct financial transactions with an offshore bank, using a personal computer and associated communications links as a banking delivery channel.

At this stage there are significant issues relating to security, speed of response and mass market user-friendliness to be solved, but the sheer volume of providers and users will ensure these aspects are progressively solved.

New information technology has other important consequences.

It is dramatically lowering the effective cost of entry to financial services, especially as it relates to industries involved in distribution. Also, it is enabling the development of focussed marketing strategies which are better capable of matching the needs of the customer to which they are targeted. Indeed, it is now common to refer to customer 'segments-of-one' - the ability to provide in a mass market environment a set of financial services appropriate to each individual. (At the same time there is an enhanced need to ensure such information, especially as it relates to consumer privacy, is not abused).

From the consumers' perspective, new information technology is dramatically widening product choice, lowering search costs and providing pricing transparency.

In this new world of global on-line 'banking', national borders become irrelevant to the provision of financial services. With overseas-based banks increasingly able to deliver financial services to Australian residents by electronic means, local institutions will need to be fully competitive with any provider, located anywhere in the world.

At the same time, Australia has a unique opportunity to become a global provider of financial services. We have human know-how, institutional competencies, world class financial infrastructure, and a solid reputation for financial safety and soundness, that can be capitalised upon **if we are cost competitive.**

In the borderless world of on-line financial services, as a nation we should have a vision to be a global competitor of major significance.



4.6 Regulatory Implications

Under the combined impact of the above influences, **the structure of the financial system has been undergoing major change**. This process is destined to gather further momentum in the period ahead.

This change is of such a profound nature as to warrant a major rethink of the objectives and application of financial regulation.

While the basic functions performed by the financial system will remain unchanged, they will be provided by a different industry structure, with a different configuration of providers, in a quite different geographic environment.

In the interests of economic efficiency and diversity of choice for consumers, financial regulation should seek to impose minimum constraints on adaptation and structural adjustment on the supply side of the market. Provided the regulatory system has inherent flexibility, competition will drive changes in institutional structure that are consistent with greater efficiency in the performance of the financial system. Those competitive forces will also drive the system towards an optimum configuration between functions carried out by intermediaries and those performed by markets. This outcome revolves around the efficiencies inherent in an intermediary structure as opposed to the efficiencies of separating out functions or products using market processes.

Two profoundly important conclusions follow from this analysis:

- banks will be unable to compete effectively with specialist institutions while they are obliged to maintain an expensive branch network and cross-subsidise transaction services which their competitors do not provide. If sustained, ultimately there will be a diminution of service and services provided.
- the functional decomposition and institutional convergence phenomenon provide powerful argument for a fundamental reappraisal of financial regulations that are based on institutional delineations. Institutional form should follow function. As financial functions change, institutional form needs to be adaptable. If regulations impede that adaptation, inefficiencies will result. The new regulatory model advocated in Section 5.4 of the submission is directed at addressing this challenge.

