5 Regulation

5.1 The Role of Banks

5.1.1 Intermediation

By acting as financial intermediaries, banks help transform an economy from dependence on direct finance to indirect finance. Banks are particularly efficient intermediaries because this role interacts with their other activities.

By pooling the funds of many savers, banks facilitate the process of physical investment in the economy. This capital formation provides for an increased flow of goods and services, and rising community wealth. The efficient use of funds in this way encourages saving.

Banks not only pool savings. They also engage in **maturity transformation**. They do so by issuing their own financial claims (secondary securities) to depositors.

The proceeds banks receive from deposit-raising are used to purchase financial claims (primary securities) of other economic units, such as occurs in home lending, loans to business, and purchases of government securities.

Through the process of issuing secondary securities to savers and taking up the primary securities of those needing funds, the balance sheet of the bank sits between the suppliers and users of the funds.

The maturity transformation process arises because the secondary securities are highly liquid (most bank deposits are withdrawable on demand or of short maturity in the case of term deposits), while the primary securities in which banks invest are typically of longer maturity and not readily marketable - there is a maturity mismatch and a liquidity mismatch.

This maturity transformation provides an extremely valuable service to the community. It provides savers with the comfort of having ready access to their savings while borrowers, covering households, small business, large institutions and government, can be extended credit of longer duration.

5.1.2 Safe Haven for Savings

The capacity of banks to be highly geared (this being the essence of the role of an intermediary) and engage in maturity transformation rests heavily on the **confidence** of the community in their ability to meet their repayment obligations.

That confidence is underpinned by the special relationship between banks and the central bank, which is the ultimate source of liquidity for the financial system.

The special relationship derives from the need to contain systemic risk and to maintain the integrity of the payments system.

Banks are subject to special prudential supervision by the Reserve Bank, covering capital adequacy, liquidity and risk management. Linked to this prudential oversight, the **depositor protection** responsibilities of the Reserve Bank help to maintain community confidence in the stability of the banking system.

In this respect it needs to be clearly understood that depositor protection does not extend to protecting shareholders or management from the consequences of poor decisions. Depositor protection is directed at **preserving the savings of depositors with banks** and in maintaining community confidence in the banking **system**.

This community confidence in turn ensures that the banking system provides a safe repository for household savings.

In a modern financial system, the alternative outlets for savings are myriad.

Within the spectrum of risk and return characteristics, there is value to the community in having a **safe haven** for risk-averse savers.

The role performed by the Reserve Bank in its prudential supervision of banks and associated depositor protection arrangements have served the community well - there has been no bank failure that has caused depositors to lose money.

In light of this experience and the public interest in maintaining confidence in the banking system, **the Bank recommends that existing depositor protection provisions in the Banking Act be retained**.

The Bank also 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 and 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**.

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.

5.1.3 Information

Banks generate and process information about their clients. In this sense, banks are in the information business.

Put simply, firms and households approach banks for loans to supplement their existing equity in order to finance intended projects. Banks analyse information concerning the projects and the financial soundness of the borrower and make decisions about extension of credit where prospects of repayment are sound.

This information function has a number of dimensions. Of particular importance is the **confidentiality** of the banker-customer relationship. Banks hold confidential information about their customers as a result of servicing their deposit and transaction needs. When applicants approach a bank for the provision of credit, they provide information about their financial position and the nature of the project for which they are seeking the finance, under the umbrella of banker-customer confidentiality provisions. This goes some way towards resolving the **information asymmetry** problem, whereby the applicant (particularly relevant in the case of small-to-medium-sized enterprises) knows more about their financial position and prospects than outsiders.

In the processing of the information, banks exercise a core competency in **credit risk analysis**. This expertise comes from a combination of long experience in the provision of credit and their investment in risk management systems that are justified by the **scale** of their operations in the business of credit origination.

Through the continuous relationship they have with borrowers, banks also have advantages in **monitoring of borrowers and enforcement of loan contracts**. This is particularly relevant to business borrowers, where the cash flow of the business passes through their various bank accounts. Their banker therefore has information advantages not available to other potential sources of external finance to the firm. The duality of the relationship, whereby the bank participates in processing the cash flow of the customer, as well as servicing its loan repayment commitments, gives banks a comparative advantage in **continuous monitoring** of the financial condition of the borrower.

Enforcement of loan contracts is also facilitated by the continuous relationship banks have with the client, together with the covenants of the loan contract, including provision of security backstops where applicable.

5.1.4 Payments Services

In providing the payments mechanism for the economy, banks underwrite the desirable characteristics of that system.

Specifically they:

- **absorb the risk of default**, so that potential transactors need to have regard for the credit-worthiness of the drawer of the instrument but not of the bank on which it is drawn;

- provide **settlement certainty**, so that participants are sure that a transaction will be executed at the specified time, cannot be reversed after settlement and cannot be initiated without proper authorisation;

- provide rapid access to funds **(rapid settlement)**; and

- give customers **convenience** by providing privacy, transaction records, a choice of payments methods and locational convenience (through their widespread and multiple delivery systems, including both ‘over the counter’ and electronic networks).

The maturity and liquidity transformation service performed by banks in their intermediation function ensures the liquidity of the payments facilities they provide.

In the sections which follow, two of the special attributes of banks are elaborated: the role they perform as a source of **finance for small business** and in protecting the **integrity of the payment system**.

5.1.5 Business Finance

Small-and medium-sized(SMEs) are an increasingly important sector of the economy.

As SMEs have increased in importance, so has their demand for capital.

Developments in information technology and market processes are increasingly facilitating capital raising by major corporates, both through markets and by placement with institutional investors. Access to publicly disclosed financial information, frequently updated analysts reports, rating agency analysis and so on, means that there are few information impediments to debt and equity raising by listed companies. Reliance on intermediated financing is therefore progressively diminishing.

For smaller entities, however, information asymmetries and search costs continue to create obstacles to issuing directly into capital markets or accessing finance from the rapidly growing managed funds sector. The information asymmetries referred to above create difficulties for SMEs in issuing directly into capital markets.

Fund managers (such as managers of superannuation funds) tend to focus on equities that are highly liquid, so that they can readily adjust the composition of their portfolio. They are therefore disinclined to take up debt instruments issued by smaller entities that are not fully marketable.

Performance monitoring tends to focus on the performance of fund managers relative to the movement in the overall share index. For this reason fund managers have a natural tendency towards index weighting in their selection of investments.

Their equity portfolios therefore tend to be heavily (if not exclusively) weighted towards the major listed companies.

In addition to these tendencies, the time, resources and expertise required to analyse and continuously monitor SMEs are significant, relative to the size of the investment.

For these reasons banks, rather than markets or managed funds, are by far the most important source of credit for SMEs. Moreover, their comparative advantage in information gathering and credit analysis, creates efficiencies that are reflected in the lower cost of bank credit to SMEs than that of alternative sources of finance.

In addition to the lower cost of credit, competition between banks for the business of SMEs has driven innovation in the characteristics of loan products. This particularly applies to loans linked to the cash flow of the business.

At the same time, the provision of tangible security (particularly mortgages over real property) by small business is a valuable option for this sector in the face of the undercapitalised structure of many small businesses and information-intensive nature of loans resting solely against business cash flows.

Banks provide these options to SMEs because of the scale of their operations, their ability to carry non-marketable loans on-balance-sheet, the diversification of risk they can achieve by portfolio management techniques, and their ability to exercise continuous monitoring due to their on-going relationship with the business customer.

The Commonwealth Bank, in its own name and through the activities of its related business units, such as CBFC and the Commonwealth Development Bank, provides substantial financing facilities to SMEs through a diverse range of products.

Credit facilities include overdrafts and fully drawn loans, term loans, lease financing, commercial bill lines, foreign currency lending and international trade finance.

Deregulation has contributed to a wider range of products being available to this market segment. Products can also be more competitively priced, innovative and flexible. This has included a number of financial packages tailored to meet the cash flow patterns, nature of available security and other special financing needs of various industry segments.

5.1.6 The Payments System

A payment represents **an exchange of value** between two parties. Apart from barter trade, with all its well known inefficiencies, cash is the traditional medium of exchange.

In developed economies cash has been replaced as the major medium of exchange, particularly outside small consumer transactions, by obligations drawn on financial institutions. In this non-cash dimension, **a payment involves the transfer of transaction balances between individual parties and their respective banks**.

The non-cash **instruments** provided by financial institutions to effect this transfer of value range from paper-based instructions, such as cheques, to a growing range of more sophisticated electronic payment products.

For payment instructions to be acted on, delivery or exchange between financial institutions must occur. Clearing and settlement processes are required to achieve this exchange.

The payments system represents the underlying infrastructure which facilitates these processes for the exchange of value. The effective functioning of the system depends on:

- the **confidence** the **community** has in the integrity of the payment instruments and the parties involved in clearing and settling;
- the **confidence** each clearing and settling participant has in the ability of other clearing and settling **counterparties** to meet their payment obligations, either immediately or at some time in the future.
- the internal **efficiency** of the process, and
- the governing rules and **regulations**.

Clearing in Australia is largely carried out on a bilateral basis between principal institutions and is primarily subject to the rules and procedures developed by the Australian Payments Clearing Association (APCA).

While the **operational** efficiency of the clearing process is obviously important, the overall efficiency of the system, and the contribution it makes to the efficiency of the broader economic system, derives from its perceived **integrity**. That integrity rests on confidence in participants' ability to settle their clearing obligations.

In addition to the **domestic** payments system, banks play a major role **in international** payments and associated risk management and other services.

5.1.7 Settlement Process

The settlement process involves the exchange of value between those institutions providing payment services. Settlement between banks for obligations which arise from clearing payment instructions is effected through transfer of balances held with the central bank.

'Central bank money' is the only medium which provides finality of payment.

Settlement between banks in Australia is achieved through transfers of Exchange Settlement Account (ESA) balances held with the Reserve Bank. Apart from licensed banks, the Reserve Bank has provided settlement accounts to two Special Services Providers, representing majority sections of the building society and credit union sectors.

Australia has a **deferred settlement** payment system. That is, one in which the settlement of clearing obligations between financial institutions occurs at some interval **after** the transfer of payment instructions, which underlie settlement, have taken place. At the moment, settlement occurs the following business day prior to 9.00am.

Deferred settlement systems carry the inherent risk of an institution paying away funds and then not receiving due settlement.

Procedures in place to deal with a situation where an institution fails to settle are contained within APCA's rules in respect of paper and direct entry clearings. The risk of failure to settle high value electronic clearing (where most risk lies) is being addressed through the development of a Real Time Gross Settlement (RTGS) system, planned to be operating by end-1997. Under the RTGS system, high-value payments will be settled irrevocably at the same time that the payment instructions are sent.

An overview of operation flows in the payment system is provided in Figure 5.1.

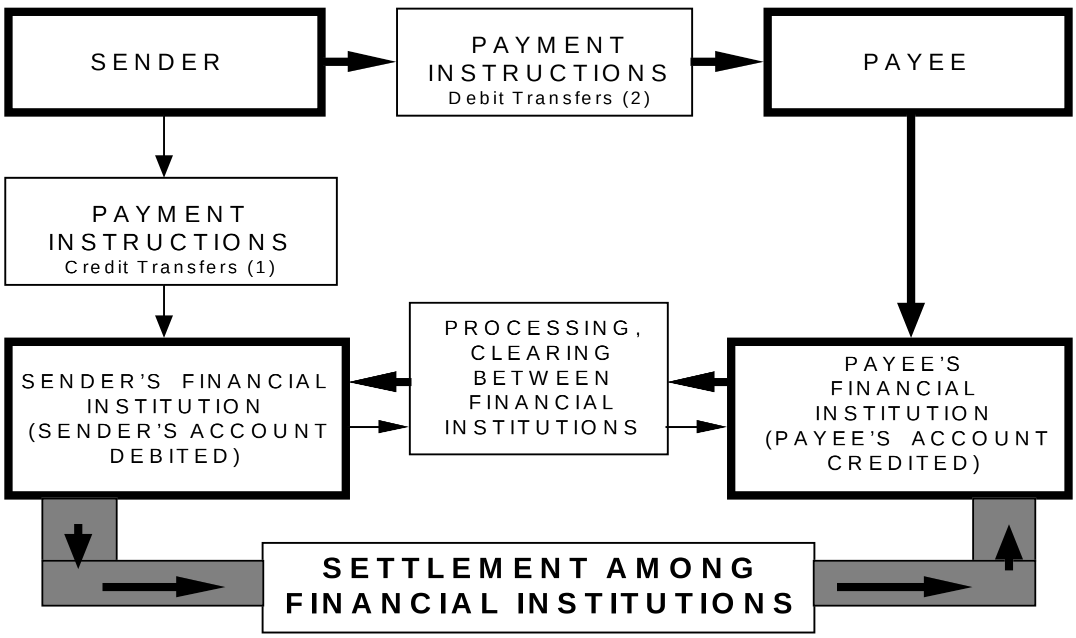
5.1.8 Banks' Role in the Payments System

A reliable and efficient payments system is vital to the smooth conduct of the nation's commerce and industry. For the payments system to operate effectively, there must be complete integrity in the clearing and settlements process.

Given the size of the flows that pass through the exchanges, and the linkage between confidence in the system and avoidance of failure to settle, licensed banks are the mainstay of the payments system.

The dimension of the payments risks handled by the banking system is denoted by the size of the flows through the exchanges.

FIGURE 5.1: PAYMENTS SYSTEM FLOWS



(1) CREDIT TRANSFERS - Direct transmission of credit funds by paper vouchers and electronic funds transfers, ie. bulk/low value direct entry (DE), individual high value payments.

(2) DEBIT TRANSFERS - Issue of claims against sender - cheques, payment orders and electronic direct debits and consumer electronic - Cards, EFTPOS, ATMs and Smart Cards.

Gross payments flows in Australia are approximately $100 billion per day. To put this in perspective, it represents the nation's entire annual GDP turning over every 4.6 days.

The pivotal role of banks derives from their ability to transfer value between bank accounts with settlement finality.

Those using a payments instrument to undertake a transaction must have confidence that it will be honoured by the institution on which it is drawn.

Given the need for confidence in institutional counterparties, the trend for non-banks to establish payments operations in only part of the payments value chain is of potential concern. Typically, such entities do not provide transaction accounts, nor can they offer finality of settlement. These functions are passed back to the banking system, usually on a netted basis.

Where non-bank institutions participate in part of the payments process, there is continuing reliance on the banking system for the ultimate exchange of value.

A logical hierarchy of components of the payments system is as follows:

- **At the highest level**, the **settlement** of value through Exchange Settlement Accounts conducted with the Reserve Bank.
- Participation in **clearing** systems but not the settlement system.
- Indirect access to clearing and settlement via **agency arrangements**, which could include organisations who collect payment instructions from consumers for the value of third parties.

Given the potential systemic consequences of the failure of an institution to meet its obligations in the settlement system, **direct participation in settlement of value through the conduct of Exchange Settlement Accounts with the Reserve Bank should be restricted to licensed banks**.

Not only are banks subject to the highest standards of prudential supervision but the nomenclature of 'bank', in a financial system regulated by a well regarded central bank (or its equivalent), carries international standing as an acceptable counterparty. It is only in this way that international payments, in an integrated global financial system, can occur seamlessly and without risk of major disruption.

Participation in the second level of the hierarchy, **clearing** but not settlement, requires a commercial arrangement between the institution seeking participation and a bank to undertake the settlement process. This access should be available on competitive commercial terms to those institutions who can establish their credentials to undertake clearing business of particular types without compromising the integrity of the system. Access to clearing systems is governed by APCA's regulations and is restricted to institutions who are providers of payment services (this is defined as providing financial deposit facilities and/or credit facilities). Direct participation in clearing should continue to restricted to those institutions complying with relevant APCA regulations.

At the lower level of the hierarchy, **indirect access** to clearing and settlement systems can be negotiated with banks which can undertake the clearing and settlement process on an **agency basis**. For those organisations collecting payment instructions, access should be available on competitive commercial terms. Banks providing clearing and settlement services should ensure that these organisations are of sufficient substance and have the credentials to undertake this type of business without compromising the integrity of the system.

5.1.9 Banking Regulation

In considering the far-reaching changes occurring in the financial system and the need for a more flexible and responsive regulatory system to accommodate that change, it is vital not to lose sight of the fundamental role the institutional group called 'banks' play in the financial system. That vital role has been recognised by **the high standard of prudential regulation to which banks are subjected**.

Banks provide a **safe repository for savings** that underpins the spectrum of risk and return alternatives in the financial system.

As covered in the next section, it is important to maintain the distinction between deposits and other forms of investment. For this reason**, the authority to raise deposits from the public without issuing a formal prospectus should continue to be restricted to banks and other deposit-taking institutions which meet the same high prudential standards.**

Banks provide a vital channel for the **provision of credit** to individuals and entities where asymmetric information, and difficulties in the monitoring and enforcement of obligations, render direct access to markets or the issuance of claims to collective investment vehicles a less viable alternative. These circumstances apply most notably to credit for **small-to-medium-sized businesses**.

The most important role of the banking system is in maintaining the integrity of the core of the entire financial system, its **payments mechanism**.

The Bank **welcomes competition** in all facets of its business. Where alternative institutional providers wish to compete in the core business of banking **- the acceptance of deposits and the provision of payments services** - those institutions should meet all the requisite **prudential standards** applied and monitored under banking regulation. In short, they should obtain a banking licence.

It is in this way that the public, both domestic and offshore, can differentiate between the institutional status of particular entities and have confidence in the banking and payments system.

The Bank therefore recommends that **participation in the settlement system, through the conduct of exchange settlement accounts with the Reserve Bank, should be restricted to licensed banks** and that participation in clearing systems continues to be governed by APCA regulation.

Indirect participation in the payments system via agency arrangements should be a matter for commercial negotiation with a bank, subject to the participating institutions meeting appropriate **standards** that do not compromise the integrity of the system**.**

5.2 Collective Investments

5.2.1 Trends

The composition of savings is shifting from deposit-taking institutions (DTIs) to managed types of investments.

As shown in Tables 5.1 and 5.2, the share of financial system assets held by intermediaries is declining relative to the fast growing managed funds sector.

TABLE 5.1: FINANCIAL SYSTEM ASSETS

	At June 1980 %	At June 1995 %
Intermediaries	74	61
Funds Managers, Insurers	26	39

Source: RBA, ABS, ISC data

TABLE 5.2: HOUSEHOLDS - NET ACQUISITION OF FINANCIAL ASSETS [a]

	Banks %	Non-Bank DTIs %	Life Office, Superannuation Contributions %	Other %
1970's	42	15	20	23
1980's	36	9	39	16
1990's	28	8	50	14

[a] This is a slightly expanded version of Table 4.1

A similar trend is evident in overseas countries. The most extreme example is in the United States where the share of total financial assets held by intermediaries fell from 58% to 37% between 1960 and 1994. Over the same period, the share held by mutual and pension funds grew from 13% to 40%. A similar, although less marked, trend is evident in the UK.

The growth of mutual funds in the US has been spectacular.

Total assets of US mutual funds now rival the size of the total assets of the US banking system.

About a third of US households now own a mutual fund investment compared with only 6% in 1980.

As a result of these developments, the household sector in the US is more directly exposed to equity and bond markets than for generations.

To the extent that these trends are indicative of future developments in the Australian financial system, some important regulatory issues are involved.

In Australia, the trend towards managed investments is most evident in the growth of superannuation fund assets.

In response to these developments, banks have diversified through the establishment of life office and funds management subsidiaries. Other large non-bank institutions have similarly diversified, with the result that **financial conglomerates are now the dominant institutional form**.

5.2.2 Different Nature of Liabilities

The liabilities of deposit-taking institutions differ fundamentally from investments with managed funds. The fundamental difference is in the price risk attaching to the principal sum deposited or invested. Deposits with DTIs involve a fixed nominal claim on the institution - the institution assumes the capital risk. In the case of managed funds (embracing both unit trusts and superannuation funds), the investor has an equity interest in a pool of assets which can fluctuate in value.

The distinguishing characteristics of the two classes of financial assets (they are assets for the depositor/investor and liabilities for the issuer) are enumerated below.

Deposits with DTIs involve:

- **a fixed nominal claim**;
- **a claim on the institution** not on the debtors on the other side of the institution's balance sheet;
- a return received (in the form of interest earnings) that does **not** depend on the return that the DTI earns on its assets; and
- depositors are protected by the **capital** DTIs are required to hold to underpin their deposit liabilities.

Investments in a managed fund involve:

- **an equity interest** in the current value of the assets of the fund;
- **a trustee relationship** between the investor and the fund;

- a return on the investment that depends on **the fund's performance**; and

- **no claim** by the investor on the fund manager.

5.2.3 Different Regulatory Treatment

The different regimes for prudential regulation of DTIs and managed funds is a direct consequence of the difference in the legal relationship between depositor and DTI, and between investor and investment fund respectively .

The contractual undertaking to depositors to meet payment of fixed nominal claims, the majority being redeemable on demand, carries a high prudential risk. It is for this reason that banks and other DTIs are subject to stringent prudential regulation.

Managed funds are not subject to special prudential requirements (but they are subject to trustee/agency provisions and the solvency requirements of the Corporations Law, the Life Insurance Act and of the SIS Act for superannuation funds). The fund is supported only by the pool of assets it holds, with the investor accepting the risk of changes in capital value.

As a result of their special regime of prudential supervision, DTIs alone are permitted to raise deposits **without issuing a prospectus**.

Prudential regulation of DTIs is concerned with liquidity risk, solvency risk and, ultimately, systemic risk. It is therefore institutionally based, rather than functionally (or product) based.

Regulation of managed funds does not generally include prudential supervision, and is therefore functionally based. Regulation is concerned with product standards and market conduct, such as pre-investment disclosure, the integrity and competency of fund managers and trustees, standards of fair dealing, and performance reporting.

The basic distinction between deposits and managed funds precludes both product types being offered on-balance-sheet by the same legal entity. The different nature of the contractual undertakings and different risks involved in deposit products and managed fund products, make it impracticable for them to be issued by, and supervised in, the same legal entity.

Financial conglomerates, consisting of separately capitalised, separately regulated legal entities, with separate balance sheets, represent the appropriate solution to the economies of scope and scale available from using common distribution channels to market products with entirely different risk characteristics.

5.2.4 Systemic Risk Implications

The prudential regulation of banks is justified because of the risk of contagion and the need to preserve the integrity of the payments system.

Whether there are any systemic risk dimensions to the growth of managed funds is a matter of judgement.

Systemic risk is virtually precluded in the case of superannuation funds because of restrictions on withdrawals.

In the case of retail unit trusts, however, if these were to grow to the relative size of US mutual funds, there could well be implications for market liquidity and asset price stability.

If systemic risk is defined more broadly than endemic institutional failure to include **violent swings in financial asset prices**, a strong build-up in retail managed fund holdings by investors seeking **short-term** capital gains could be potentially destabilising.

Of particular concern would be any public perception that investment in managed funds is no more risky and no less liquid than deposits (with banks or other DTIs).

In any market correction, these misconceptions could give rise to a flood of withdrawals, necessitating large-scale selling by the funds of the underlying assets, causing a **downward spiral** in asset values.

The character of this risk for the financial system is generalised, and more likely to have adverse **wealth** effects for investors than to destabilise the payments system, or access to credit, as might flow from the unmanaged failure of a bank. For example, there are no links between different managed funds, as there are between banks through the payments system, and, as investors in managed funds own a share of the fund's assets, the question of solvency does not arise.

Despite the risk of heightened market volatility, no basis exists for the prudential regulation of the managed funds sector. This would be contrary to the nature of the investment vehicle.

Rather, product **disclosure** standards for managed funds must be sufficiently stringent to ensure **clear understanding** by investors of the nature of the investment and the price **risk** involved.

As long as investors, knowing the risk/return characteristics of alternative **investment options**, select a managed fund investment, then there is no case for regulatory intervention. On the contrary, having these alternatives available to savers adds to the completeness of the financial system and thereby its efficiency.

The need to ensure that there is no misconception in the mind of the investor about the distinction between deposits and managed funds is a powerful reason to have banks and managed funds subject to **separate regulatory regimes and separate regulatory agencies**. To do otherwise would tend to increase moral hazard and narrow the perceived risk spectrum.

5.2.5 The Need for Informed Investment Decisions

The market offers consumers a wide variety of financial products which involve a broad spectrum of risk. Choice of products with different risk/return characteristics is an essential feature of a competitive and efficient financial system.

The market will operate effectively provided the consumer is able to discriminate between the risk profile of different products by having access to adequate product information in a simple and understandable format.

In the case of professional investors, the same issues do not arise. Product disclosure rules should therefore be capable of acknowledging the distinction between professional and retail investors.

A range of independent financial advisors and market brokers are available to assist consumers to make investment decisions. Where such advice is accessed, product disclosure information is supplemented by a range of legislative, common law, and equitable principles that regulate the nature of dealings between professional advisor and customer. The licensing of financial advisors and arrangements for regulatory advice-giving procedures are an integral part of that process. The inconsistent arrangements applying to the provision of financial advice has the potential to lead to investors making inappropriate decisions.

5.2.6 Regulatory Neutrality

If the financial system is to function efficiently, there should be **no distortion of the risk spectrum** available to savers and investors. If regulatory imposts on DTIs detract from their returns to depositors, there could be the unintended consequence of **increasing the migration to managed fund investments**. Constant vigilance therefore needs to be exercised to ensure that the **costs** of prudential regulation do not bias investments towards unregulated alternatives.

The prudential regulation of institutions, the tax treatment of products sold by different institutions, and associated disclosure requirements, should not bias investment flows. Where product offerings are comparable, disclosure requirements and the tax treatment of those products should be similar.

For competitive neutrality to be achieved, financial conglomerates which offer funds management products should not be disadvantaged relative to stand alone competitors.

5.2.7 Recommendation

A structural shift is occurring in the composition of household financial assets.

This is due to a combination of factors, including compulsory superannuation, other incentives relating to self-provision for retirement, and demographic factors.

To the extent that there is a trend towards using managed funds as a repository for **discretionary** savings, it is important that investors understand the different risk characteristics of deposits and managed funds.

Adequate **disclosure** regimes, supplemented by community education processes where relevant, are the appropriate solutions.

In addition, the authorities need to be ever wary 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**.

The Bank therefore recommends that prospectus requirements and product disclosure standards for investment products, other than deposits, should be sufficiently stringent to ensure clear understanding by investors of the nature of the investment and the price risk involved.

5.3 Bank Holding Companies

5.3.1 Financial conglomerates

One of the fundamental causes of the blurring of distinctions between providers of financial services has been the diversification of major institutions into financial conglomerates. A financial conglomerate has been defined by a tripartite group of banking, insurance and securities supervisors as 'any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities and insurance)'.

The blurring of distinctions between financial institutions is not a new phenomenon. The Campbell Committee noted its Interim Report in 1980 that 'the different institutional groups are extending the boundaries of their operations and conventional distinctions are now less sharp'.

The growing importance of financial conglomerates which provide a wide range of financial services has run further in recent years, both in Australia and overseas. Moreover, their reach is not confined to national markets: many provide a broad array of financial services across a wide range of countries.

In all developed countries, and indeed in many emerging market economies, the rise of financial conglomerates is a notable feature of institutional change over recent decades.

Reflecting the ubiquitous nature of the financial conglomerate, the terms 'universal bank', 'bancassurance' and 'allfinanz' are part of the modern lexicon of the global financial industry.

In Australia, banks have responded to the shift in savings to collective investment institutions by establishing life office and funds management subsidiaries, while life offices have expanded into non-traditional financial services, including in some cases by having deposit-taking subsidiaries (bank or building society).

The 25 largest financial conglomerates in Australia account for about 70% of total financial system assets. In the vast majority of cases the parent of the group is an operating entity. In 14 cases the parent is a bank and in 5 the parent is an insurance company.

Financial conglomerates are therefore the dominant institutional form in the financial sector.

This outcome, both in Australia and overseas, provides powerful evidence that there are efficiency gains, through economies of scope and/or scale, in moving from a cluster of services consistent with a traditional institutional form to a financial conglomerate operating across the full field of financial service activities.

The regulatory challenge is to allow institutions the **flexibility** to configure their operations in whatever corporate structure is most efficient, while maintaining appropriate oversight of **systemic risk** and **market conduct**.

5.3.2 Efficiencies of Financial Conglomerates

Australia has a significant investment in financial infrastructure.

Much of that infrastructure has arisen from investment by major financial institutions over many years in delivery channels and information processing capacity.

With developments in communications technology providing more cost effective ways to deliver financial services and potentially providing users with access to a global market, there is an emerging **excess capacity** in the financial services market.

The extent of that over capacity, and the methods by which it is rationalised, will be determined importantly by the extent of **diversification** in which institutions can profitably engage.

The diversification of financial institutions away from a narrow focus on traditional activities can strengthen the intensity of **competition** in the financial services market.

Diversification can also increase **efficiency** in the provision of financial services through **economies of scope**.

Economies of scope can relate both to **economies in production** and **economies in consumption**.

Economies of scope in production occur when financial institutions realise **internal** economies, through joint production and delivery of financial products and services through deepening customer relationships. There may also be risk diversification benefits where the risks involved in the wider range of activities are not highly correlated.

Economies of scope in consumption occur where consumers realise **external** economies through the convenience of being able to access a broad range of financial services from their preferred institutional provider.

5.3.3 An Adaptable Institutional Form

The profound change occurring in the financial system, and the inflexibilities of institutional-based regulation, demonstrate the need to provide scope for a corporate and regulatory structure that can accommodate **the dynamics of institutional reconfiguration.**

Institutional form needs to be able to adapt to changes in the way financial functions are performed as competition drives market participants to strive for better, more innovative ways to meet customer need.

A component of this dynamic process is **the interaction between institutions and markets** as financial functions shift between the two, depending on what is the most efficient means to satisfy the needs of users of financial services.

Regulations should seek to exercise a **neutral** effect on institutional form and the respective roles of markets and institutions. If regulation creates a bias in these structures and functions, it is imposing **efficiency costs** on users of the financial system.

On efficiency grounds, the case for allowing financial institutions to determine what activities they choose to undertake and what corporate form they adopt is unarguable, subject to their conforming with normal legal and corporate governance requirements.

The case for any special regulatory constraints on financial conglomerates therefore comes down to a question of **stability** considerations.

Before addressing this issue of how stability objectives can be reconciled with flexibility in institutional form, it is appropriate to review the framework of Australian financial conglomerates and alternative group structures.

5.3.4 Australian Financial Conglomerates

Australian financial groups typically originated as a traditional institutional type, most commonly a bank or insurance company.

Over time, there was a natural tendency to seek more diverse ways to service the needs of the customer base. Widening the range of activities undertaken inevitably involved the creation of separate legal entities within a group structure.

Regulation heavily influenced the process, with much of the earlier growth in subsidiaries of banks (notably their finance company and merchant bank subsidiaries) occurring as a direct consequence of the constrictions on bank asset growth imposed by the monetary authorities. While deregulation removed the need to seek ways to accommodate unsatisfied demand for credit through subsidiaries, it provided greater freedom to diversify into new activities.

At the same time, advances in technology helped to lower the costs of delivering a wider array of products and provided a solution to the information processing demands involved in managing a more complex and diverse business enterprise.

In recent times, the recognition that superannuation and other forms of funds under management are the growth areas of the financial system, has provided added impetus to the drive by major institutions to be diversified financial services suppliers.

The range of financial services in a typical Australian financial conglomerate, in various configurations, covers:

- traditional banking functions - deposit-taking, lending and payments services;
- investment banking - securities trading, structured financing, corporate advisory and risk management services;
- finance company - mainly lease financing;
- stock broking and underwriting;
- funds management - superannuation and unit trusts;

- life insurance; and
- general insurance.

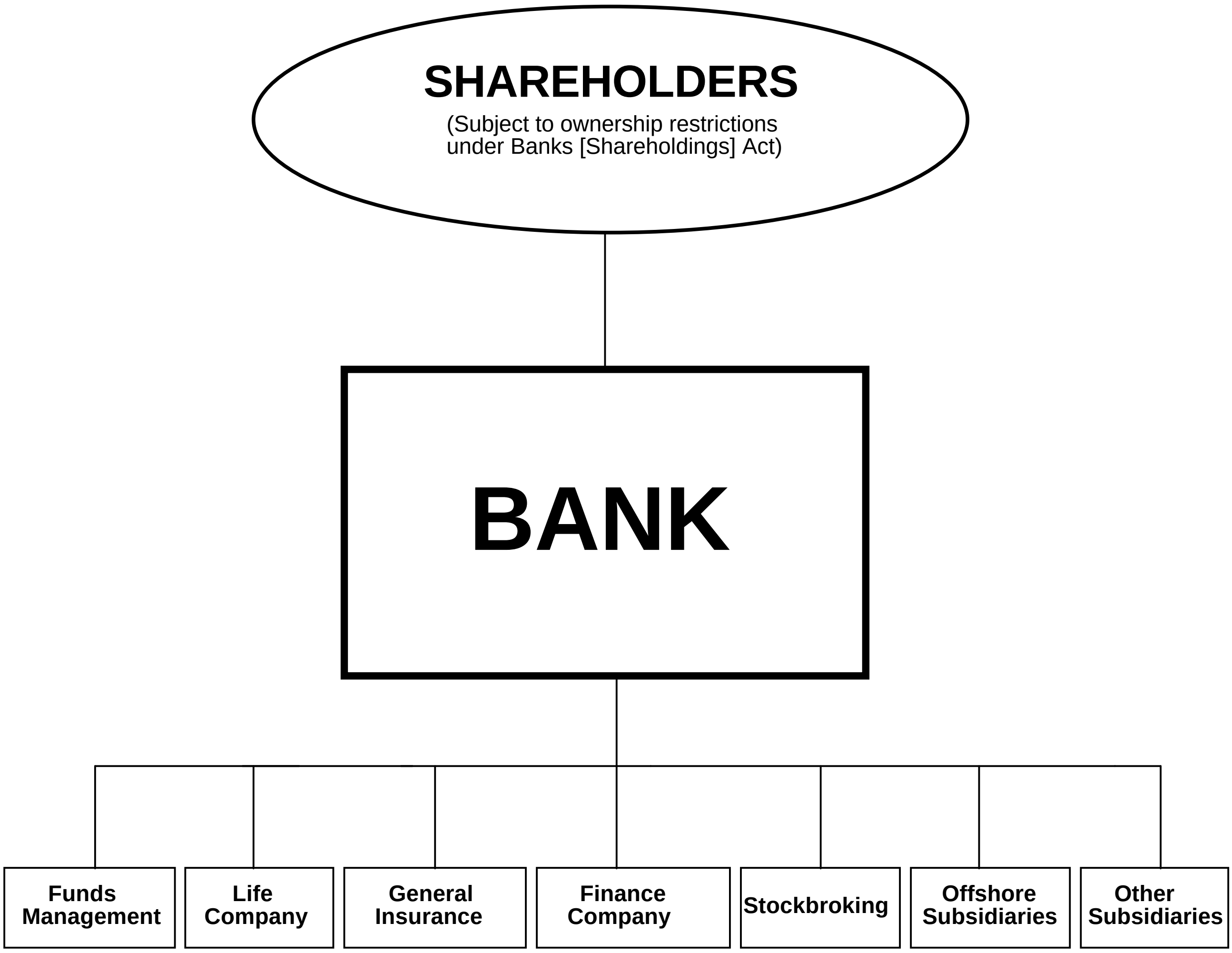
The CBA Group covers the entire range of these activities.

As a direct consequence of the evolutionary nature of the conglomerate process, the parent entity in Australian conglomerates derives from the institution of origin. In the case of banks, in all but one instance where special approval was recently given (viz State Bank of New South Wales/Colonial Mutual) the banking institution is the parent company and the dominant operating entity.

One of the paradoxes of this structure is the requirement that the bank be the parent entity but ensure that customers dealing with a subsidiary do not form the impression that the bank stands behind the subsidiary. In the case of funds management and securitisation activities, this extends to prominent disclosure to investors, and their signed acknowledgment of that disclosure, that the bank does not guarantee the investment or that the bank's resources could not in any other way be called upon to support it (refer RBA Prudential Statements C2 and G1).

In simplified form, the structure of a banking conglomerate is shown below.

FIGURE 5.2: BANK CONGLOMERATE STRUCTURE

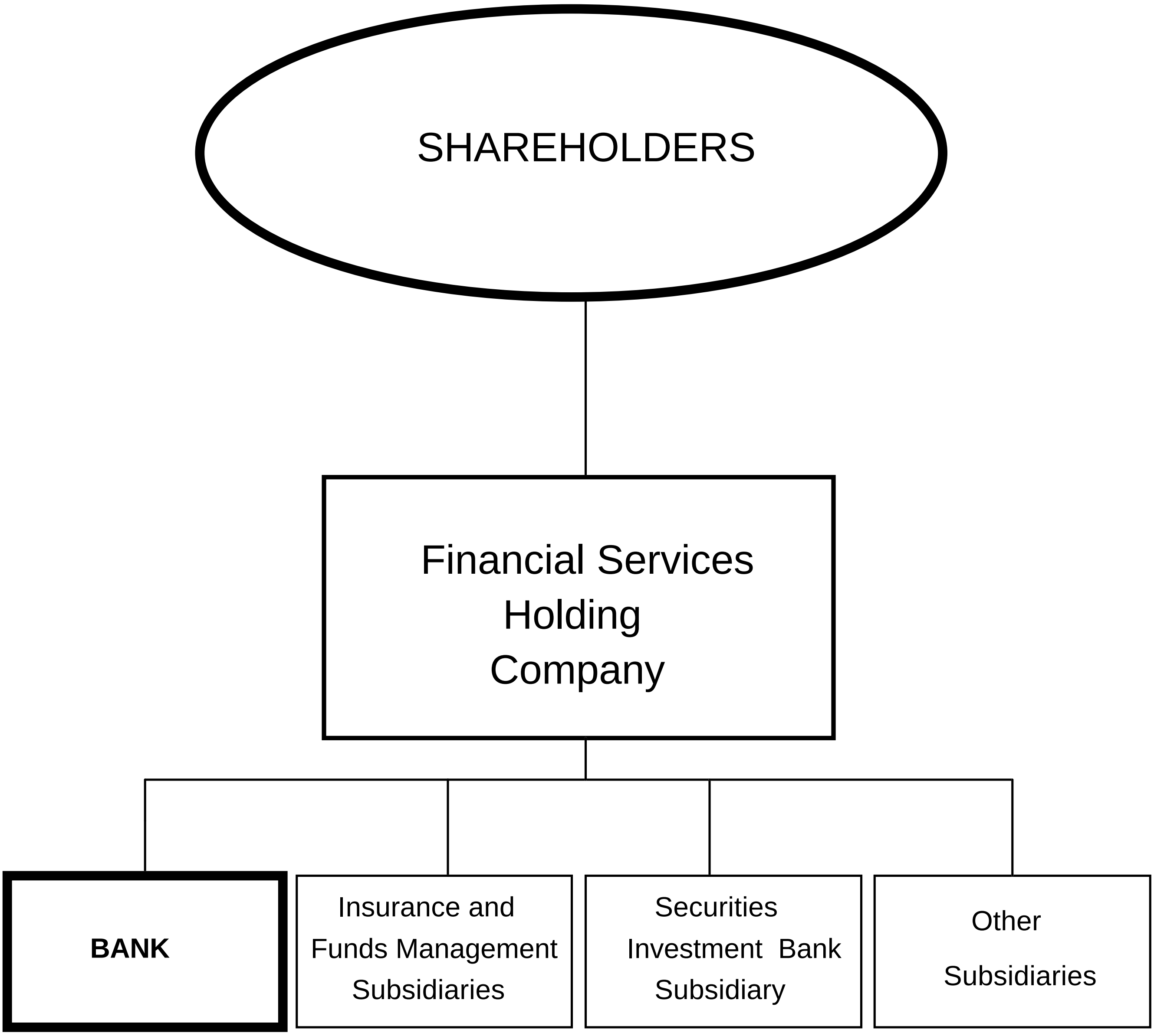


5.3.5 The Holding Company Model

As outlined earlier, Australian financial conglomerates involve a parent company that is also the dominant **operating entity**. Hence we have a bank or insurance company that is the parent entity, with a range of subsidiary companies comprising the corporate group.

There are many advantages in having a **non-operating** holding company as the parent entity. Figure 5.3 depicts a simplified group structure of this type.

Figure 5.3: The Holding Company Model



The key elements of a holding company structure as depicted in Figure 5.3 are:

- all subsidiaries, including the bank itself, are **owned by a holding company**;
- the holding company is a **non-operating entity -** it simply owns the equity in the subsidiaries;

- the holding company is owned by a **widely dispersed shareholding**. This shareholding at the holding company level can be made subject to the restrictions currently imposed by Banks (Shareholdings) Act. In this way the shareholding restrictions are simply elevated to the holding company level of the group;

- the holding company **holds shares in subsidiary companies**. These would usually be wholly owned subsidiaries but there may be cases in which a subsidiary is not 100% owned;

- each subsidiary is **fully capitalised** at a level appropriate to its activities;

- there is considerable **flexibility** as to the allocation of different activities to various subsidiaries, the only major restriction being that only **the licensed bank subsidiary** could perform the functions described in Chapter 6. Critical distinguishing features of the banking entity in the group are its authority to accept deposits without a prospectus and its participation in the payments system; and

- it would be permissible for the holding company to own **more than one bank**. A bank holding company could see advantage in owning a number of banks serving different markets. In that event there is no community interest served by enforcing a merger. This should be a matter for commercial judgement by the holding company, subject to the normal constraints of competition policy.

The holding company model is intended to maintain the separate identity and special attributes of the banking entity (or entities), while allowing the group full flexibility to engage in a broad range of financial services activities through separately capitalised entities.

5.3.6 Advantages of the Model

In proposing a model of this nature, the US Treasury states that 'banking organisations must be allowed to use their expertise to participate in the **full range of financial services** - but to do so outside the bank and outside the federal safety net. While appropriate safety and soundness limitations will be needed, the taxpayer can no longer afford the artificial restrictions that constrain a bank's ability to make maximum use of its resources and expertise in serving customers'. (Modernising the Financial System, Department of the Treasury, Washington DC, February 1991).

Under the holding company structure, the group has the **flexibility** to adapt to the needs of the market as circumstances change. The forces of change described elsewhere in this submission argue powerfully for an institutional structure that is highly **adaptable**. In that respect the holding company model is far more conducive to frequent changes in institutional form.

It also allows for what is in essence a **functional approach** to the configuration of subsidiary entities. The group can determine which activities to combine under its various, separately capitalised operating entities, subject to the regulations which apply to those functional activities. In this way **form can follow function** rather than having particular functions confined in institutional straitjackets.

The holding company model also allows for the progressive **expansion** of non-banking activities, such as superannuation and funds management, and the potential **shrinkage** of traditional bank lending and funding ‘on balance sheet’, as securitisation and other innovations create new alternatives to intermediation in transferring economic resources over time and between deficit and surplus units.

These **dynamics of institutional change** can be accommodated more readily in a flexible group structure in which the holding company is a non-operating entity. Subsidiaries can expand or contract without destabilising the group, new entities can be created as needed, activities can be in-sourced or out-sourced, subsidiaries can enter into alliances with external parties without committing the entire group, and so on.

Financial innovations are the driving force of **dynamic efficiency** in the financial system. Under the influence of technological advances and reduced transaction costs, the pace of innovation is more likely to increase than decelerate.

Institutional structures need to be able to accommodate changes in the way financial functions are performed and shifts in the provision of functions between markets and institutions.

The flexibility of a holding company group structure allows activities to be reconfigured readily in the continuing search for the optimum group structure to perform constantly changing financial services. It is in this way that a flexible group structure can contribute to efficiency in the design and delivery of financial services. Financial Innovation is not confined to the development of new products and their delivery: **innovation can equally occur in institutional structures.**

Given the reality of financial conglomerates, regulation should seek to allow the most efficient institutional configuration consistent with prudential requirements. The holding company model can balance those objectives more effectively and responsively than a group structure in which the parent entity is a traditional financial institution.

The holding company model also provides far greater **transparency** in contractual obligations. When the operating entities are related horizontally rather than vertically, there is less room for confusion about the financial resources of one entity standing behind that of another. This is not to say that care does not have to be taken to ensure that customers understand which entity they are dealing with and that these are stand-alone, separately capitalised businesses. This point is elaborated further in discussing regulatory challenges.

5.3.7 Regulatory Regimes

It has long been recognised that the supervision of financial conglomerates poses significant regulatory challenges.

At the same time, regulators (particularly the Australian regulators) have been seeking to respond flexibly to the inevitability of financial integration in the face of commercial dictates. Hence regulators have sought to permit a widening range of activities while preserving the prudential stability of the original financial entity and of the wider financial system.

Various models have been adopted in overseas countries to address the regulation of financial conglomerates.

The major alternatives are outlined in Figure 5.4 on the following page.

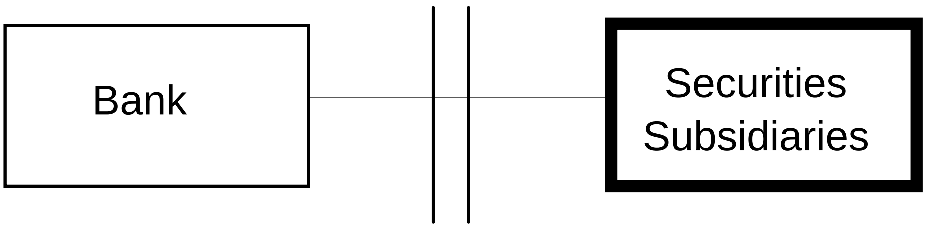
It will be apparent from Figure 5.4 that much of the regulatory debate revolves around the separation of traditional banking and involvement in the securities business.

FIGURE 5.4: ALTERNATIVE REGULATORY REGIMES

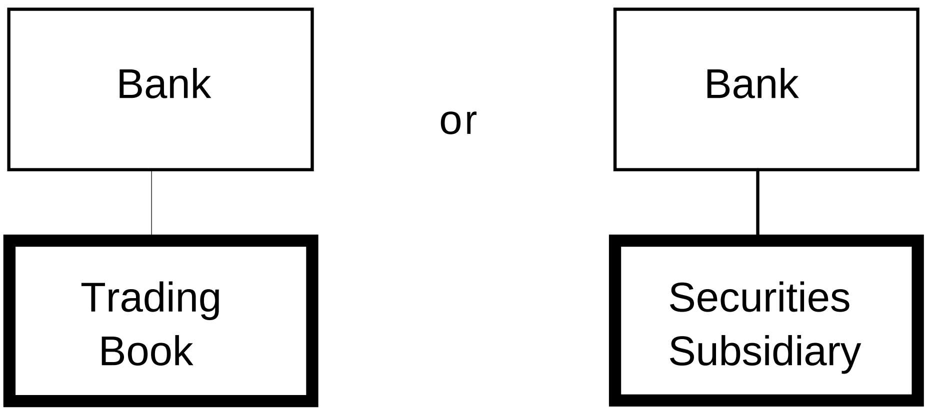
1. **The Separation Model (Glass-Steagall)**

2. **The Universal Bank Model**

3. **The Firewall Model**



4. **EU Trading Book**



Source: Richard Dale, Risk and Regulation in Global Securities Markets, 1996.

5.3.8 The Separation of Commercial and Investment Banking

The classic case of separation is the US, where contemporary opinion assumed a link between banks' involvement in securities activities and the wave of bank failures in 1929-1933, leading to legal separation of banking and securities business under the US Banking Act of 1933 (the Glass-Steagall Act).

The weight of current expert opinion is that the enforced separation of banking and securities activities under Glass-Steagall type legislation is based on a fallacious interpretation of the causes of the US banking collapse during the great depression and is an impediment to the development of an efficient financial system.

Consistent with this judgement, there have been various regulatory initiatives in the US aimed at liberalising the permissible activities of banks, through both legislative change and a more liberal interpretation of the Glass-Steagall provisions.

Using its powers of interpretation under Glass-Steagall, the Federal Reserve Board (FRB) has over recent decades greatly extended the range of securities-related activities that bank holding companies may engage in **through separately capitalised subsidiaries**. A conspicuous example was the approval in 1983 for Bank America Corporation (the holding company of Bank of America) to acquire Charles Schwab, the largest discount brokerage firm in the US.

Another spectacular breakthrough occurred in 1990 when the FRB gave approval for subsidiaries of selected bank holding companies to engage in underwriting and dealing in corporate debt and equity securities (the very essence of investment banking).

In addition to the use of regulatory discretion to get around the constraints of Glass-Steagall, there have been a number of legislative initiatives aimed at amending or repealing Glass-Steagall. Despite the support of the US Administration, the three US bank regulatory agencies and the US Treasury, passage through the US Congress has yet to be achieved.

Notwithstanding the continued existence of the statutory provisions, the effect of the liberalisation of permissible activities means that **the formal separation model continues to exist in principle in the US but not in practice.**

5.3.9 The Universal Bank

At the other extreme is the Universal Bank model in which banking and securities business occurs on the same balance sheet.

‘Universal banking is the term used to describe a banking tradition found in continental Europe in which banks engage in a full range of securities activities, usually through the bank entity itself rather than through separately incorporated subsidiaries.

Universal banking is also associated with close linkages between banking and industry which may be formalised by banks acquiring equity holdings in their client companies and seeking representation on those companies’ boards of directors’. Dale 1992.

Under this model, (the German and Swiss banking systems being the classic examples) banks engage in conventional commercial banking functions and are large players in the securities market. Their securities activities take two forms. Firstly they hold major equity positions **as principals**, embracing long-term investments (as an adjunct to lending) and short-term positions arising from trading and underwriting activities. Secondly, they undertake brokerage and funds management businesses.

In Germany, the commercial banks tend to intermingle banking and securities activities on the same balance sheet. However, it is noteworthy that where they engage in mutual fund activities and own insurance companies, these entities must be **separately incorporated.**

The key distinguishing feature of universal banks is therefore that banking assets comprise both debt and equity holdings in the corporate sector.

While the universal bank model has unique origins in the special circumstances of the German and Swiss financial systems, the European Union (EU) has effectively adopted this model as part of its financial integration and liberalisation program.

Under EU mutual recognition provisions, a bank may undertake all activities in a host country that it is permitted to undertake in its home country. Under these reciprocal arrangements, competitive pressures will likely see the universal model extend its reach.

A variant of the Universal Bank model is the Trading Book approach adopted in the EU. Under this approach, banks are permitted to engage freely in securities activities but those activities are confined in a trading book which is subject to a capital adequacy regime separate from that for the banking business.

This trend in Europe, the extension of permissible activities in the US, the increasing integration of banking systems through global competitive forces, and the advent of new competitors to markets traditionally served by banks, leave little doubt that financial conglomerates (in whatever form) are **the most efficient institutional model for a major financial services business**.

Regulatory arrangements need to allow Australian financial institutions to capture these **efficiency benefits** in the interests of the customers they serve, within a framework of supervisions that provides appropriate protection against **systemic risk**.

The holding company model, with appropriate ‘firewalls’ to address intra-group contagion risk, can reconcile those twin objectives.

5.3.10 Regulatory Issues

Regulatory concerns about bank holding companies can best be understood in terms of two hypotheses about the inter-relationship of the individual members of a holding company group.

The first of these hypotheses is that of **independence**. Under this hypothesis, the managements of individual subsidiaries behave as though their organisation is fully independent, attempting to maximise their return without regard to the effects of their actions on the other members of the group.

The second hypotheses is one of **dependence** in which the managements of individual subsidiaries take account of, or are perceived to take account of, the effects of their decisions on other members of the group. In the extreme case, all management decisions are subordinated to the objective of maximising the return to the group as a whole.

Dependence can arise from two sources. First, there may be **a public perception** of dependence. For example, customers of a subsidiary of a holding company group might believe that the group stands behind that subsidiary. Secondly, dependence can occur on an **operational level**. This would occur if the group was indeed willing to support any member that got into difficulties, but it could also take the form of shifting activities or resources between subsidiaries in ways that subordinated the interests of subsidiaries to other objectives.

While the issue of public perception is a legitimate concern, it is clear that **the problem exists under current arrangements for supervision of conglomerates**. Indeed, the perception is much more difficult to address where the parent company is the bank.

The major concern arising out of **operational dependence** is that it will involve greater risk to the banking entity than would be the case if the bank was an independent institution. This will occur if the management of the holding company uses the resources of the bank to support risky activities undertaken by other subsidiaries.

Actions of this type are termed **abusive intracorporate practices** and include:

- bank and parent **guarantees** of the obligations of other subsidiaries;
- risky **loans** by the bank to non-bank subsidiaries;
- tying purchase of the products of one subsidiary to the purchase of the products of another;
- participation by the bank in the risky loans of other subsidiaries;
- shifts of assets between bank and non-bank subsidiaries; and
- policies that weaken the earning ability of subsidiaries in order to provide tax advantages for the holding company.

These potential problems can be dealt with by a modified form of functional regulation, in which the various subsidiaries are regulated by the authority responsible for the market practices and functions they undertake, and by **firewall regulation** designed to obviate intra-group contagion.

5.3.11 Firewall Regulation

Firewalls are used to create a regulatory framework to address practices, transactions or relationships that may result in conflicts of interest, unsound banking practices, unfair competition or other adverse effects. They work on the principle that each subsidiary in a group is a separate entity, which is managed in its own right and not in the interests of other subsidiaries in the group.

Firewalls aim to achieve **risk segregation** such that a bank is protected from the exposure to financial risks generated by other entities in the group. Firewalls are used to segregate non-banking activities in **separate, strongly capitalised holding company subsidiaries**.

The concept of firewalls covers **legal separation, economic separation** and **market perception**.

Legal separation occurs where a banking entity is a separate legal entity from any non-banking affiliates, each of which will also be separate entities. Legal separation helps to prevent contagion, which is central to the firewalls concept. Contagion exists where the failure of one entity in a conglomerate has a detrimental impact on other entities in the conglomerate.

The principle of legal separation is reinforced in practice by explicit **disclosure** to an individual transacting with an entity related to a bank, to ensure that the individual is aware, and acknowledges that, they are not dealing with the bank, and that the bank does not stand behind the non-bank entity or any financial instruments sold or issued by it.

Economic separation occurs where each entity is owned by the non-operating holding company, which is owned in turn by the ultimate shareholders. The holding company owns the equity in the affiliates, each of which is **strongly capitalised as a stand alone entity**.

The capital allocation from the holding company needs to be permanent and therefore cannot be re-directed elsewhere in the group. At the establishment of the conglomerate, directors need to allocate capital across each affiliate, and may retain a reserve in the parent for emergencies.

Funding firewalls are used to place restrictions on intra-group financial transactions such as capital and/or loan funding, or asset shifting. These firewalls prevent direct exposures by a bank to its affiliates, other than within normal credit concentration limits that apply to dealings with entities external to the group.

Other intra-group transactions prevented by firewalls may include extension of credit to customers of some related entities, such as underwriting affiliates, or purchase and sale of securities between entities within the same group, other than where this occurs ‘on market’.

Market perception refers to expectations that a bank entity may support the affairs of a related entity. This issue is addressed in the next section.

5.3.12 Contractual Transparency

In addition to concerns about intra-group infection that firewalls are designed to overcome, the issue of **public perceptions** is often raised as a matter that regulation of financial conglomerates needs to address.

The concerns about perceptions are essentially of two types. **Firstly**, it is argued that customers dealing with an entity related to a bank presume that the bank 'stands behind' the entity with which they are dealing. **Secondly**, there is a view that if one part of a financial group gets into difficulties this would be seen as a threat to the entire group. In this way a run on an otherwise solvent bank could be triggered by problems elsewhere in the group.

These concerns have greater legitimacy under current conglomerate structures than they would under the holding company model.

Current Reserve Bank prudential regulations seek to go to great lengths to ensure that customers dealing with a subsidiary of a bank understand that the bank's financial resources do not stand behind the subsidiary (refer RBA Prudential Statements A1, C2 and G1).

Within a given disclosure regime, the perception problem is more difficult to combat when the parent entity is the bank.

Under the proposed holding company model, the independence of the various subsidiaries is much more transparent.

Appropriate **disclosure** by each subsidiary will be in the interests of the group as a whole, to ensure that customers are fully aware of the identity of the particular legal entity within the group with which they are dealing.

It is therefore contended that application of current disclosure requirements within a holding company model will be **more effective** than under existing arrangements.

If considered necessary, disclosure requirements could be supplemented by self-regulatory guidelines covering circumstances where staff of one entity within a group sell products of another related entity, where there is a common sales force, or where products are sold by third parties.

Appropriate competency standards and professional accreditation could also be specified for staff providing advice to customers about products of particular complexity.

In these ways, the **transparency** of the independent nature of entities within a holding company structure, combined with an effective **disclosure** regime, should obviate the risk that customers misconstrue the identity of the legal entity with whom their contractual relationship resides, or that they can look for intra-group support if difficulties arise.

As to the risk of a run on the bank subsidiary being triggered by problems arising elsewhere in the group, this can be handled by **existing arrangements for liquidity support** in the event of a crisis.

The bank would have recourse to liquidity backstops in the form of prime asset ratio holdings, other liquid assets and interbank lines of credit. In providing assurance to the market about its solvency as part of normal stock exchange requirements, the opportunity could be taken to endeavour to reassure a broader audience. In particular it would seek to reassure customers about the safety of deposit funds through a variety of communication channels. If necessary, the holding company could stand ready to inject additional equity capital into the bank.

In the circumstances envisaged, the problem could be shown to be one of liquidity adequacy, triggered by an **unwarranted** loss of community confidence because of problems elsewhere in the group, rather than one of the solvency of the banking entity as a going concern.

As the failure of an otherwise solvent bank in these circumstances would not be in the interests of the banking industry or the general community, support from the central bank and other domestic banks could be expected to be made available to deal with the problem.

In these ways an unwarranted run on a bank could be effectively dealt with, irrespective of whether the source of the crisis of confidence was linked to **intra-group** problems or matters **external** to the group.

Just as the same potentiality of a bank run exists under current conglomerate structures, the same means to address the problem could be utilised under the holding company model.

5.3.13 Specific Firewall Structure

An appropriate structure of firewalls for an Australian financial conglomerate is a combination of selected elements of the US Federal Reserve regime and the existing Australian prudential regime. This structure could consist of the following elements:

- A majority of directors, officers and employees must be different for each affiliate.
- The purchase and sale of financial assets between affiliates are not permitted 'except those assets with sufficiently broad and liquid markets to ensure the transaction is on market terms and that the bank is not incurring credit or liquidity risk through the purchase of assets'.
- Contracts for provision of services to affiliates (such as information technology or operations) must be at a fair market price.
- Explicit disclosure, and acknowledgment where appropriate, that the affiliate, and its products and contractual relationships, are separate from the affiliate bank.
- Embargoes against the extension of credit by the bank for the benefit of an affiliate within the group, including credit enhancements of securities.

In addition to these limitations, the restrictions under existing Prudential Statements G1 and G2 would continue to apply.

5.3.14 Capital Adequacy

As the entities are financially separated by the firewall structure, group consolidation is not needed for capital adequacy purposes.

The adequacy of capital for each affiliate should be determined independently, based on the risks associated with the operations of the particular affiliate and market standards for entities of that type.

Reserve Bank prudential guidelines for the capital adequacy of banks should be applied to the banking entity only. All references to the need for consolidation should therefore be removed from Prudential Statement C1.

5.3.15 Risk Management in the Financial Conglomerate

Management of financial institutions and groups involves careful attention to all the various dimensions of risk management.

Although firewalls create a corporate environment of separation between entities, risk management should be applied on a group-wide basis **for internal management purposes**.

This approach will strengthen the control of contagion risk by placing the onus on group management to maintain careful oversight of aggregate counterparty exposures and other dimensions of the risk profile of the entire group.

The best protection against risk is strong internal risk monitoring and control systems.

On this basis, Prudential Statement E1 should be amended to remove the need for large exposures to be reported in terms of the consolidated group. Large exposures can continue to be reported for the bank as a stand alone entity.

5.3.16 Lead Regulator of the Financial Conglomerate

While the existence of firewalls alleviates the need for consolidated supervision, some qualitative sharing of information between different supervisors of entities within the group is justified to enable a broader view of the financial condition of the group to be established.

The integrity of the firewalls will also need to be examined by the separate regulators.

This is best accomplished under the current regulatory structure by a **lead regulator model**. Under most circumstances, the Reserve Bank should act as the lead regulator because it is the risk to the banking entity that is important for system stability. However, this will not always apply. Where supervision of non-bank entities involves substantially more resources and logistics management than that of the bank, a lead regulator other than the Reserve Bank would be appropriate.

Under the rationalised regulatory structure proposed in the next chapter, lead regulator arrangements should be relatively easy to establish and administer.

5.3.17 Recommendations

The **special role of banks** in the financial system requires special regulatory oversight of banks.

At the same time, the efficiency gains from economies of scale and scope, make it essential that banking groups have the flexibility to engage in the provision of the **widest possible range of financial services**.

Moreover, for least cost provision of these services, bank-related entities must not be subject to any more onerous regulatory requirements than are generally applied to functions of those kind, whatever the nature of the institutional provider.

An appropriate balancing of these stability and efficiency objectives can be achieved through the holding company model described in this chapter.

By separately constituting the banking entity under the holding company, it can be quarantined from other subsidiaries in the group. With effective **firewalls** between the bank and other entities in the group, there is **no case for consolidation** of the bank and other subsidiaries of the holding company for bank capital adequacy 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.

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.

A subsidiary involved in a range of activities would be subject to the regulators who cover those functions, but the group would have an incentive to rationalise its structure so that subsidiaries are matched with regulators, avoiding the cost of multiple regulatory regimes. In this way, institutional form will tend to be brought into line with the nature of the functions performed and the appropriate regulatory agency. **Functional regulation will tend to be achieved through a process of self selection.**

At the same time, the structure of the group will be **highly flexible**, with changes able to be effected rapidly in response to internal innovation and external competitive dictates. 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.

On these grounds **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 to be conducted on a **non-consolidated basis**, with the Reserve Bank to be satisfied that appropriate **firewalls** exist between the bank and any other subsidiaries of the holding company;
- other subsidiaries in the group meeting regulatory standards and market practices, including capital adequacy where applicable, **consistent with the functions they perform**;
- a **lead regulator system** being used to exchange information between regulators involved with different entities in the group, where this is considered necessary to make a judgement about the group's overall prudential standing; and
- appropriate **disclosure** requirements being observed to ensure that customers are fully aware of the nature of their contractual relationship with the individual entity concerned.

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 clearly disclosed to the public.

The most compelling argument for the holding company model is that **it allows form to follow function, and be regulated accordingly**.

5.4 The Structure of Financial Supervision

5.4.1 Regulatory models

Many of the problems of the current regulatory regime arise from the profound changes that have occurred in the role and structure of financial institutions and markets.

In simplistic terms, this is commonly referred to as 'blurring of distinctions' or institutional convergence. The changes run much deeper than this, however, as outlined earlier in this submission.

Of equal importance is a blurring of regulatory **objectives** which have created asymmetries, discontinuities and overlaps in the incidence of regulation.

In a world in which institutional functions were clearly defined and distinctive (banks supplied traditional banking services, insurance companies provided insurance cover, etc), regulation could be targeted to institutional types, whatever its intended purposes.

In today's financial system, the dynamics of decomposition, convergence, financial innovation and shifts in the respective roles of intermediaries and markets, make it mandatory that regulation be reconfigured

5.4.2 The Institutional Versus Functional Approaches

A central question in any revised regulatory system is whether regulation is better based on **institutions** or on separate financial **functions**.

The present system of regulation is primarily based on institutional form. This is largely a product of history. When financial systems were less complex, institutional categories closely corresponded with defined types of financial functions.

In more recent decades, financial innovation (including those spawned by efforts to circumvent regulations) and technological developments have seen many financial services offered by institutions other than the traditional providers.

Different classes of financial institution are subject to different regulators as outlined in Section 5.4.9.

This diversity of regulators increases the difficulty of ensuring the **neutrality** of the regulatory framework.

Regulators generally try to maintain the equality of the burdens they impose on the financial institutions under their control. However, the very need for these efforts reduces the flexibility of the regulatory framework. Moreover, changes (whether to the explicit regulations or to their interpretation and application) will frequently need to be arranged through a number of regulators, thereby making the system slow to respond to changing circumstances.

This **inherent inflexibility of an institutionally based system of regulation** reduces the responsiveness and innovative capability of the financial system.

In addition to problems of overlapping jurisdictions and regulatory gaps arising from the existence of different regulatory bodies for different institutional types, there are further regulatory burdens occasioned by the use of the financial system by government **for other purposes**.

As an illustration of how complex the system has become, the regulatory regime covering two traditional banking products is outlined below.

Personal deposit accounts are subject to:

- Customer identification under the Financial Transactions Reports Act;
- Reporting of large cash transactions (and suspicious transactions) under the Financial Transactions Reports Act;
- Administration of tax file number procedures;
- Collection of Financial Institutions Duty (FID) and Debits Tax (DT);
- Administration of the code of operation for direct debit social security payments and pensioner accounts;
- Reserve Bank prudential requirements;
- Bills of Exchange Act and Cheque and Payments Order Act;
- Trade Practices Act;

- Privacy Act;
- Code of Banking Practice;
- EFT Code of Conduct; and
- Unclaimed Moneys legislation.

Personal lending is subject to:

- Reserve Bank prudential requirements;
- Collection of Financial Institutions Duty (FID);
- Stamp Duties legislation;
- Code of Banking Practice;
- Cash Transactions Reports Act;
- Trade Practices Act;
- Uniform Consumer Credit legislation (and the former Credit Acts in the individual States);
- Anti-discrimination laws;
- Stamp Duties legislation;
- Laws affecting the capacity to contract (eg. Mental health Act, Lunacy Act, Public Trustee Act);
- Privacy Act;
- Laws affecting recoveries (eg. The Bankruptcy Act); and
- the EFT Code of Conduct.

The range of requirements that can be imposed by a variety of regulators and government agencies raises the issue of where responsibility lies for ensuring that the burden does not become excessive. Moreover, many of the requirements involve a varying burden depending on the source of the service. These pressures tend to divert services to institutions that are not subject to all the requirements.

5.4.3 The Functional Approach

In order to minimise the costs of regulation, it should **bear evenly on all financial institutions** which perform the same functions so that there is no incentive for members of one class of institution to transform themselves into another type of institution to reduce the burden of regulation. It is also desirable that regulations do not bear so heavily on existing institutions that they provide an incentive for the creation of new institutions outside the regulatory net.

The impact of regulation on the competitiveness of a financial institution depends not only on the nature of the regulation but also on the regulation of other institutions **carrying out the same activities**.

These considerations lead to the suggestion that the best way to ensure neutrality is to impose regulations on functions rather than institutions. The basic assumptions of this approach are:

a) All financial products and services can be separated into **functions**.

b) Each financial institution is a **bundle of functions**, a bundle whose composition changes from time to time. This implies that all the business of a financial institutions can be divided into distinct functions.

c) Regulation is applied to functions and **not to institutions**. The burden borne by any institution would then depend on the composition of its bundle of functions.

The regulations applied to functions can take account of the risks involved in them. If this is done, the pattern of regulation applied to a particular institution will be the aggregation of risks that arise from the individual functions it performs.

This approach ensures institutional neutrality because all institutions carrying out the same functions bear the same regulatory burden.

Of course, this still leaves open the question of regulatory intensity. If a function is subject to excessively heavy regulation, it will not be carried out to the appropriate extent.

The current system of financial regulation includes some examples of functionally based regulation. A leading example is the consumer credit legislation. It applies to all consumer loans, regardless of the institution providing them.

Any approach to functional regulation should start with the six fundamental financial functions outlined in Section 2.4. These are:

- Payments Services;
- Pooling of Resources;
- Transfer of economic resources;
- Risk Management;
- Price Information; and
- Handling of incentive problems.

While these functions are extremely useful in understanding the basic features of financial transactions, they do not provide a satisfactory basis for regulation without some further refinement.

A possible solution would be to define **elementary functions**, which are financial activities that can be provided on a stand-alone basis and which cannot be further broken down. For example, traditional housing lending can be separated into credit evaluation, mortgage origination, mortgage insurance, mortgage administration and mortgage securitisation/loan funding.

Regulation could be based on elementary functions, in which case the functions would bear the same regulatory burden whatever the institution through which they are offered and the mix of functions offered in conjunction with them. Unfortunately, such a system of regulation could be very complex because there could be a large number of defined functions.

Elementary functions may be combined into clusters. All financial institutions consist of one or more clusters. A natural cluster exists when there is:

- jointness in the provision of the constituent elementary functions so that there are economies to be obtained by providing the functions in a combined operation. For example, there could be economies in combining the housing lending functions delineated above.

- jointness in consumers' demand for functions. Consumers may prefer one-stop shopping for some clusters of elementary functions.

It would seem reasonable to base regulations on natural clusters of functions. Initially, it would be necessary to determine the appropriate clusters. The likelihood is that this would bring us back closer to the six fundamental functions referred to earlier.

5.4.4 Problems with the Functional Approach

One major problem with the functional approach is to define the functions and to determine the regulations to be applied to each function so that neutrality is achieved. Neutrality requires that the regulation itself does not influence the formation of clusters on the unbundling of activities. The configuration of activities should be based on optimising efficiency and finding better ways to meet consumer wants, not on regulatory influences.

A second problem with the functional approach is that it takes no account of the risk determining interactions between functions when they are combined into clusters and institutions. For example, a diversified loan portfolio will have a lower risk than the sum of the default risks of the individual loans. Similarly, different risks arise when a natural cluster involves loan origination and loan funding with deposits of fixed nominal value (the typical activities of a deposit-taking intermediary) than when loans are originated and securitised for funding in wholesale markets (in this case the origination and funding functions are kept separate, rather than being part of a cluster)

Finally, and most importantly, the functional approach has difficulty dealing with **systemic risk**, which revolves around preventing failure of certain groups of **institutions**. Of necessity, control of systemic risk needs to have an **institutional focus**.

These problems surrounding a pure functional approach lead us to conclude that an alternative model is required. This model is the objective-based approach covered in the following section.

5.4.5 Objective-Based Regulation

Unless the objectives of regulation are clearly prescribed, 'regulatory failure' is almost guaranteed to occur.

The fundamental starting point in the specification of regulatory objectives is to establish and acknowledge that the **ultimate objective of regulation is to attain what is best for the end-users of the financial system**.

The importance of acknowledging the ultimate objective is to ensure that the **costs** of achieving regulatory objectives are brought to account. As those costs must be borne by users of the financial system, it is only through cost/benefit tests that the case for regulation can be established.

Under this objective-based approach, the ultimate objective can be decomposed into a set of objectives around which regulatory form can be designed.

Applying that analytical framework, regulation of the financial system can be categorised according to the following high-level objectives:

1) **Systemic Risk**

2) **Conduct of Business**

3) **Competition**

The **systemic risk** objective involves **prudential supervision** to ensure the soundness of the financial system. It therefore has an institutional focus.

The **conduct of business** objective involves product or **functional regulation** to protect users of the system from unfair dealing or errors of judgement resulting from inadequate or misleading information.

Competition objectives are not specific to the financial sector and are achieved through the general operation of competition policy under the provisions of the Trade Practices Act. Competition policy is covered in Section 5.5.

The foregoing classification of regulatory objectives is summarised in Table 5.3 below:

TABLE 5.3: OBJECTIVE-BASED REGULATION

Objective	Systemic Risk	Conduct of Business *	Competition
Type of Regulation	Prudential	Product	Mergers & Acquisitions
Target	Institutions	Functions	Markets

* Also commonly referred to as **consumer protection** objectives. However, as this can be interpreted to imply protection against loss, with attendant moral hazard concerns, the term **conduct of business** is preferred.

Just as the structure of the financial system has fundamentally changed, and is destined to change profoundly further in the years ahead, there is a need to restructure the regulatory system so that it is compatible with contemporary and future challenges.

The existing regulatory system involves a mismatch between:

- consumer preferences for convenient access to the widest range of financial services;

- outdated institutional definitions of financial services providers; and

- multiple regulatory bodies with overlapping jurisdictions and multiple objectives.

The **systemic risk** objective translates into prudential measures designed to avoid the uncontrolled failure of one or more key financial institutions whose collapse could induce a system-wide financial crisis.

The protection of users of the financial system involves **conduct of business** measures designed to ensure that individual consumers are in a position to make informed decisions, are not subject to malpractice, and are able to rely on the integrity of market processes.

The classification of regulations by objective, as outlined above, demonstrates that prudential supervision is a means to contain systemic risk. Under this objective, prudential supervision is concerned with preventing a problem in one institution triggering a chain reaction of systemic proportions.

Confusion of objectives can arise where prudential supervision is also directed at consumer protection objectives.

In practice the distinction is more complex than might appear from a neat compartmentation.

A crisis of confidence, of which bank runs are the classic example, can have dire systemic consequences.

Maintaining public confidence in an institutional group which lies at the heart of the financial system may therefore be a legitimate intermediate objective of prudential supervision directed at the ultimate objective of limiting systemic risk. It is for this reason that banks have been singled out for special oversight by prudential supervisors.

The critical point is that any special regulatory provisions that apply to banks should arise from the **systemic risk objective**.

Depositor protection provisions should be viewed in that light.

Protection of bank depositors should be seen as a legitimate component of prudential policy directed at systemic risk objectives.

As covered in chapter 6, the liquidity transformation process performed by banks means that a serious problem in one bank can quickly spread to other **solvent** banks if public confidence is undermined.

The continued viability of the banking system (as distinct from individual banks) therefore conforms with the economists' definition of a **public good** - the national interest benefits exceed the sum of the private interests of stakeholders.

Under the objective-based classification of regulation, depositor protection provisions as applied to Australian banks need to be seen to be driven by **systemic risk** objectives.

A careful distinction therefore needs to be made between prudential supervision for systemic risk reasons and the consumer protection rationale for financial regulation.

As outlined earlier, **conduct of business**, rather than consumer protection, is the preferred title for regulation designed to protect investors and borrowers in their financial dealings.

The Reserve Bank also is careful to avoid reference to 'consumer protection' but prefers the short-hand label of 'product regulation'.

Nowhere is financial regulation more confused and fragmented than that which seeks to protect consumers. This regulatory overlap is taken up in later in this Section.

In addition to the three objectives of financial regulation outlined earlier (viz systemic risk, conduct of business and competition) an essential characteristic of regulation is **competitive neutrality**.

Competition is the means to achieve economic efficiency. Regulation which impacts unevenly on providers of financial services will distort competitive market processes, thereby having deleterious effects on efficiency.

Designing regulations that achieve competitive neutrality between alternative providers of similar financial services represents a considerable challenge.

In an environment where market innovation and rapid changes in institutional structures and financial functions are a mark of a dynamic financial system, the principle of competitive neutrality dictates that, wherever possible, regulation should avoid an institutional bias. As a first principle, financial products and services that are close substitutes should be subject to the same rules and regulations **irrespective of their institutional source**.

Regulation that has a **systemic risk objective** will of necessity tend to focus on **institutions** whose failure could have systemic consequences.

All other financial regulation, however, should have the same impact on alternative providers of comparable products and services. It should be product-based, not institution-based.

The blurring of distinctions that have arisen from the diversification of institutions beyond their traditional boundaries is covered earlier in this submission.

The phenomenon of functional decomposition, whereby financing is being disaggregated into its basic, component parts, has also been elaborated earlier.

These developments provide powerful grounds for avoiding regulation that is specific to particular institutional entities, other than in those exceptional cases where this is dictated by **systemic risk considerations**.

It is clear from the foregoing analysis that, in addition to separating the objectives of systemic risk and conduct of business, a new regulatory model must be able to accommodate **dynamic change** in the financial system in a competitively neutral manner.

The nature of the dynamic change needs to be understood in order to create a robust regulatory framework.

Functional decomposition is a critical ingredient of the dynamic change that the regulatory framework must be able to accommodate.

For dynamic efficiency gains to be optimised, institutions must be given maximum flexibility to reconfigure, to use financial re-engineering to decompose activities into functions, to insource and outsource, to specialise and despecialise, and so on. The need for this **institutional flexibility** underpins the arguments in the next chapter on the regulation of financial conglomerates.

5.4.6 Systemic Risk

The systemic risk objective requires a system of prudential regulation that focuses on **institutions**, for it is institutions, not products or functions, that can become insolvent.

Prudential supervision for **systemic risk objectives** is concerned with preventing problems emerging in one institution that have the potential to spread more widely in the financial system.

It is for this reason that banking supervision is the linchpin of systemic risk management.

The unique characteristics of banks - maturity transformation, high leverage, opaque balance sheets, illiquid assets, and their interconnection through the payments system - mean that they are exposed to contagious disorders. **Contagion** refers to the potential for one bank's difficulties to cause runs on otherwise solvent institutions, threatening the stability of the entire banking system.

A banking crisis of this nature can have severely damaging effects on the economy, through destroying financial wealth, disrupting the payments system and impairing the flow of credit, especially to small business.

It is this **systemic risk** that justifies the special regulatory treatment of banks, involving both prudential supervision and depositor protection.

It needs to be stressed that, under this objective-based approach, the actions of the central bank in protecting depositors are directed at preventing banking runs that have systemic risk consequences.

As Martin Feldstein, the US economist and former Chairman of the Council of Economic Advisers, puts it:

> 'The banking system as a whole is a 'public good' that benefits the nation over and above the profits that it earns for banks' shareholders. Systemic risks to the banking system are risks to the nation as a whole'.

It is for this very reason that maintaining public confidence in the banking system is a fundamental role of the central bank. The depositor protection provisions are part of the mechanism by which public confidence is sustained.

This is not an argument for preventing **individual** banks from failure. It is entirely appropriate that poorly managed banks be subject to the disciples of the market, with loss of shareholder investment through failure being the ultimate penalty.

What is critically important is that mechanisms are in place to manage a failed bank's exit from the market without contagion effects on other banks. Depositor protection arrangements are part of these mechanisms and **have served Australia well**.

Given the potential for the payments system to be a mechanism for transmitting problems from one bank to another (refer Chapter 6), it is critically important that banking supervision have very close oversight over **settlement risk in the payments system.** It is for this reason that only prudentially supervised banks should be able to engage in the ultimate exchange of value in the payments system through conduct of exchange settlement accounts with the Reserve Bank.

It is clear from the above discussion **that prudential oversight of banks is central to the systemic risk objective of regulation**.

The question then arises as to whether any other class of institution involves sufficient risks to **the stability of the financial system as a whole** to be brought within this regulatory objective.

This is necessarily a matter of judgement.

On one view, interlinkages in the financial system warrant an extension of the concept of what constitutes a systemically important firm (refer 'Twin Peaks': A Regulatory Structure for the New Century by Michael Taylor).

A more intellectually credible approach is to distinguish between the nature of the promise which underpins the financial contract.

An obligation to pay an amount fixed in nominal terms **on demand,** regardless of the circumstances, is the most onerous in terms of the burden implicit in the promise.

When illiquid financial assets underpin the sum of the promises made, the risk attaching to the promises increases.

And when problems in one institution can cause customers of other institutions of the same type to seek to redeem their 'on demand promises' because they know that being first in the queue increases the prospect of being paid in full, all the ingredients of systemic risk are present.

On these grounds, systemic risk is uniquely associated with deposit-taking institutions, the overwhelmingly more important category of which is banks. The critically important distinguishing feature of banks among deposit-takers is their role in the payments system.

For these reasons, the systemic risk objective **at the institutional level** comes down to a focus on banks.

Beyond this regulation of the institution of banking, systemic risk control needs to focus on the smooth functioning of **markets** through the provision of appropriate **liquidity to the system as a whole**.

These characteristics of the stability objective argue powerfully for the Reserve Bank to have responsibility for systemic risk control, of which banking regulation is an integral component.

5.4.7 Other Objectives of Prudential Supervision

The complicating feature of classifying regulation according to the two fundamental objectives of systemic risk and consumer protection is that prudential supervision can serve both ends.

Prudential supervision of banks directed at containing systemic risk also helps to protect bank depositors. In that sense it has both systemic risk and consumer protection consequences, although the latter is essentially a by-product of the former.

Prudential supervision, however, need not be confined to institutions whose solvency has systemic risk consequences. The nature of the contractual promise can in some circumstances justify prudential supervision even though the insolvency of the institution concerned would not jeopardise systemic stability.

Prudential supervision of insurance companies is a classic case. The long-term nature of the contract, the difficulty involved for policy-holders in continuously monitoring the insurer's financial health and the potential for insurers to alter their risk profile after policy-holders have paid premiums, amount to a powerful justification for prudential regulation of insurers. In this instance the objective is **consumer (ie policy-holder) protection** not systemic risk.

To the extent that the Insurance and Superannuation Commission undertakes prudential supervision of life insurance, general insurance and some (defined benefit) superannuation funds, it does so for consumer protection reasons.

These functions should not be confused with the Reserve Bank's prudential supervision responsibilities, which are directed at systemic risk objectives.

5.4.8 Conduct of Business

Under the objective-based approach outlined earlier, all regulatory measures directed at protecting users of financial services come within the **conduct of business** objective.

This includes those forms of prudential regulation directed at protecting consumers as discussed in the preceding section.

It also embraces all other regulations which are specific to the financial sector and which govern the relationship between financial institutions and their customers.

These regulations include (inter alia):

- disclosure and documentary requirements in all their multiplicity of forms;
- rules governing advertising, marketing and sale of financial products;
- licensing of advisors;
- professional conduct;
- conflict of interest;
- investment policies; and
- trustee responsibilities.

It is in this territory of financial regulation that there is the greatest scope to address overlap and fragmentation in the interests of achieving desirable objectives **at least cost** to users of the financial system.

5.4.9 The Current Regulatory Structure

The present financial services regulatory regime is comprised of four primary regulatory bodies: the Reserve Bank of Australia (RBA), the Australian Financial Institutions Commission (AFIC, which in turn co-ordinates state-based regulators of building societies and credit unions), the Insurance and Superannuation Commission (ISC) and the Australian Securities Commission (ASC).

The regulatory field covered by these agencies is shown in Figure 5.5.

In addition to these financial services regulators, financial institutions are subject to an array of broader ‘consumer protection’ regulators such as the Australian Competition and Consumer Commission (ACCC), Federal and State Consumer Affairs Ministers (most notably, in administering the State-based consumer credit legislation), the Privacy Commission (under the Privacy Act) the Human Rights Commission and so on.

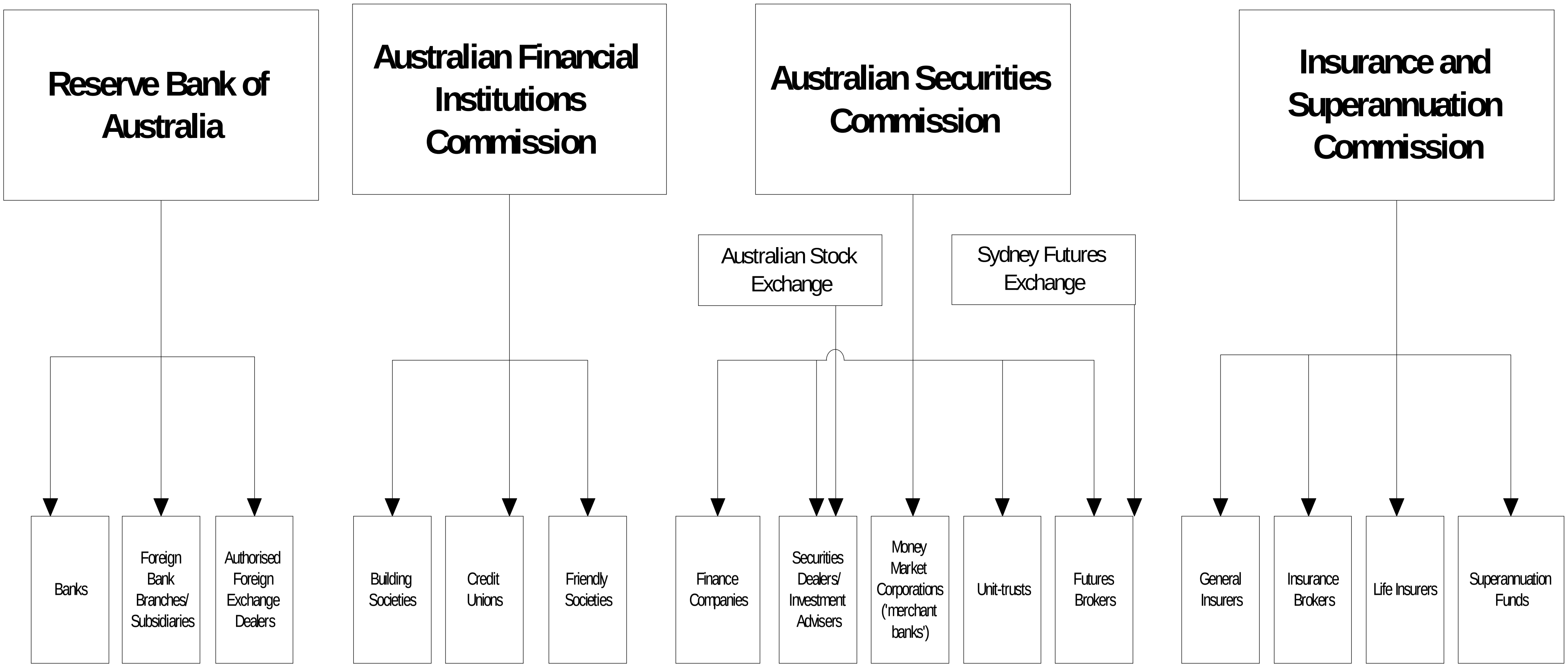
5.4.10 An Objective-Based Structure

Section 5.4.5 established a set of principles around which the structure of financial supervision should be organised. Those principles involve an **objective-based approach**, with the objectives of **systemic stability** and **conduct of business** (the latter being directed at investor/consumer protection) being defined as the appropriate twin objectives for financial regulation.

Moving from an institutionally-based arrangement of regulatory agencies to an objective-based model is no simple matter. However, given the far-reaching changes that are occurring in the financial system, it is imperative that we restructure the regulatory system and its supervisory bodies to create a regulatory model that can accommodate dynamic change in the interests of maximising economic efficiency.

One solution to this dilemma that has been advocated by some is to create a single **‘mega regulator’** to supersede the existing separate regulatory agencies. Within this single agency there would be specialised units or divisions organised around functional lines. This segmentation would be necessary to ensure that special expertise and experience in different financial functions were assigned to the regulation of those functions.

FIGURE 5.5: THE CURRENT REGULATORY STRUCTURE



The advantages of this model have been cited as:

i) its organisation along functional lines provides the flexibility to accommodate changing institutional structures, including financial conglomerates;

ii) its purview can extend to non-financial institutions where they engage in some financial services activities;

iii) regulatory ‘turf battles’ can be resolved within the agency;

iv) the scope for regulatory arbitrage and breaches of competitive neutrality are eliminated, as the same financial functions are treated in the same way, by the same regulator, irrespective of the institutional nature of the provider; and

v) while the focus would be on financial functions, there would be scope within a single regulatory authority to form a group-wide view of the activities of a particular institution by some form of aggregated functional regulation.

While these advantages are compelling, the crucial problem in practice is that **systemic stability involves a different perspective from that taken at a functional level.**

As Charles Goodhart, the eminent UK economist and monetary expert puts it:

> ‘So there remain two central functions of regulation within the financial sector, investor protection and systemic stability. An immediate, major question is whether these functions need to be undertaken jointly, or whether they can (and should) be separated. There are good reasons for trying to separate them. The focus of investor protection is micro; that of systemic stability is macro’.

Goodhart goes on to say

> ‘In my view, the difference in focus and function of investor protection and systemic stability is so large that the desideratum would be to have two main regulatory bodies, **and two only**, in each country’.

The distinction between macro and micro financial regulation can be linked back to the conceptual model that the financial system is all about **financial promises**. Financial regulation may be justified because failure can occur in the market for financial promises due to externalities.

Market failure at the **micro** level occurs where information asymmetries cause a promise to be accepted that would not have been if complete information had been received. Hence the case for regulating **disclosure**.

Market failure at the **macro** level occurs when the insolvency of one institution causes a run on otherwise solvent institutions, leading to their inability to adhere to their promises. Hence the case for intervention to deal with potential failure at the **systemic level.**

A single regulatory agency that sought to combine both the micro and macro regulatory functions is not the optimum model. Rather, it is appropriate to aim for rationalisation of regulatory agencies down to the minimum of two, covering the systemic and micro regulatory dimensions.

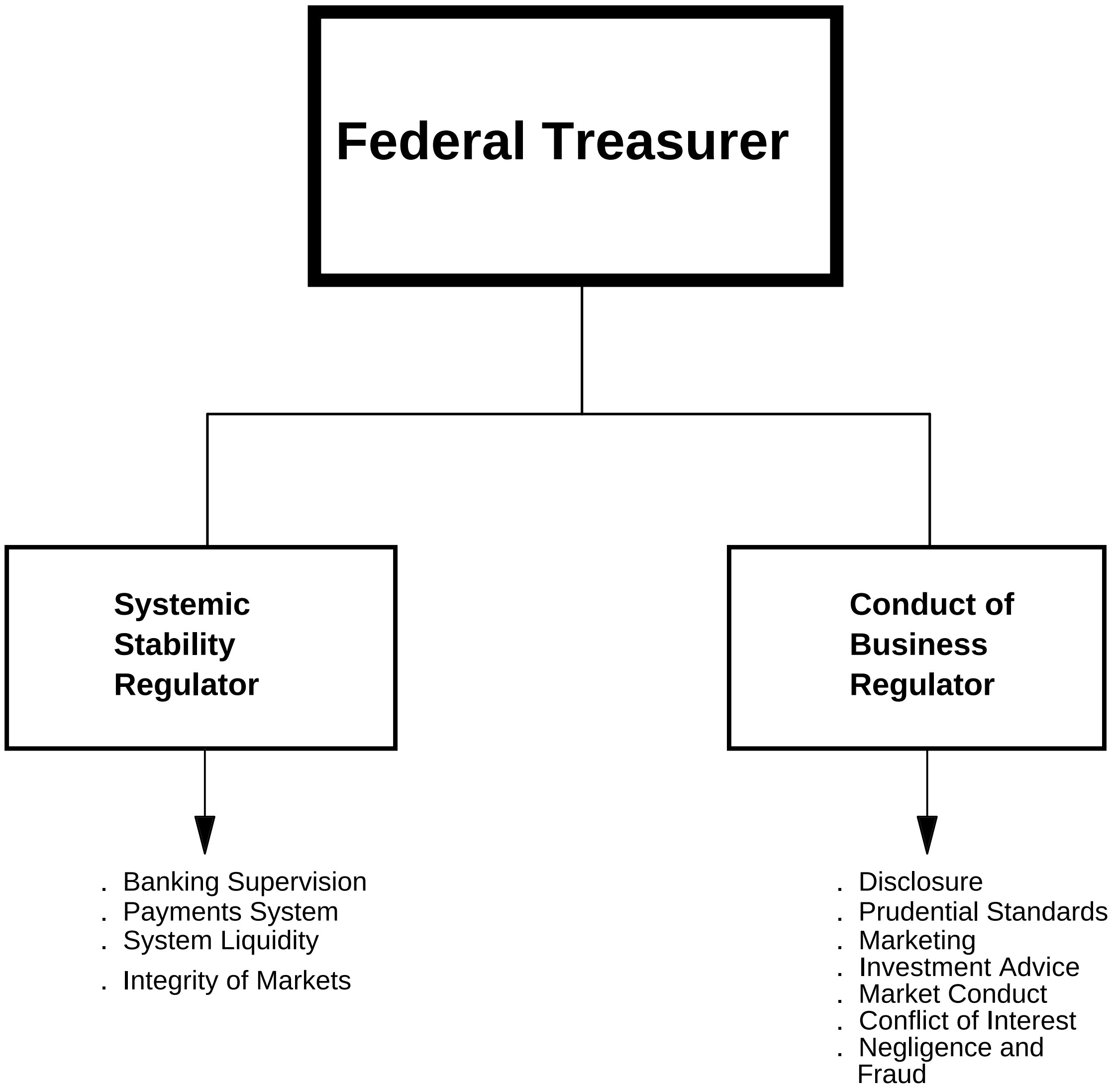
This conceptual model of just two regulatory bodies for the entire financial sector is the ideal this Inquiry should be seeking to make operationally implementable. It is depicted in Figure 5.6.

The twin regulator model also neatly resolves the institutional versus functional approaches - both approaches need to be adopted in parallel. Institutional regulation needs to be adopted for systemic stability. In the case of conduct of business regulation, a mixture of functional and institutional approaches are required. Hence both approaches are adopted, with institutional and functional regulation being assigned to the regulatory objective which they are best suited to achieve.

As David Llewellyn, an acknowledged expert on financial regulation, submitted to a financial system inquiry in South Africa:

> ‘The skill in regulation is in combining elements of functional and institutional regulation within the same framework.... However efficient functional regulation is, the user of financial services is put in jeopardy if the institutions with which he deals become unsafe’.

FIGURE 5.6: OBJECTIVE-BASED REGULATORY MODEL



5.4.11 The Systemic Stability Regulator

The point was made earlier that prudential supervision, which by definition is about the solvency of institutions, is undertaken for both systemic stability **and** investor protection objectives.

Each of the existing four regulator agencies undertakes prudential supervision to varying degrees.

Clearly the RBA has a major preoccupation with systemic stability. Its charter requires it to exercise its powers 'in such manner as in the opinion of the Board, will best contribute to the **stability** (emphasis added) of the currency of Australia; the maintenance of full employment in Australia; and the **economic prosperity and welfare** (emphasis added) of the people of Australia'.

The 'stability of the currency' refers to the inflation objective of the central bank through its administration of monetary policy. However, the objective does have some connotations of the stability of the financial system. More particularly, the RBA's responsibility for financial stability has been attributed to that part of its charter that extends to the 'economic prosperity and welfare of the people of Australia'.

The role of the RBA will be taken up shortly. Before that, however, the **prudential responsibilities** of the other regulatory agencies can be dealt with briefly.

Figure 5.5 shows the institutions and markets covered by each regulator. This classification needs to be extended to consider the underlying purpose of the regulation.

AFIC is primarily a prudential regulator. Its objective in this role, however, is to protect the interests of depositors in building societies and credit unions. Its purview is not systemic risk.

The ISC undertakes a mixture of prudential and product-based regulation of life and general insurance companies and superannuation funds but all in the interests of investor protection.

The ASC is primarily focussed on the efficient functioning of securities and capital **markets**, although it does have quasi-prudential responsibilities in the case of 'prescribed interest' collective investments, primarily unit trusts.

It is clear from the above review that, if one of the existing regulatory agencies were to become the systemic stability regulator, it would have to be **the Reserve Bank.**

The alternative is to create an entirely new regulatory agency and to transfer banking supervision to it as its core, although not only, responsibility.

There are a variety of approaches adopted internationally. Indeed within any generalised description there are characteristics unique to each country. However, with that caveat, it is possible to identify three alternative approaches.

Firstly there is the familiar model in which banking supervision (here regarded as synonymous with systemic stability) resides with the central bank. The second model is where banking supervision rests with a ministry such as Treasury or Finance. Thirdly, there is the option of a special regulatory agency with a degree of independence from the monetary authorities and government, such as a prudential supervision/banking commission.

There has been a lively international debate for some years about whether monetary policy and financial supervision should reside in the one institution.

It is not intended to traverse this territory in detail in this submission. However, the key arguments for and against these responsibilities being combined in the central bank may be summarised as follows:

Central Bank to be the Systemic Risk Regulator

1 The central bank cannot abrogate its **ultimate responsibility for the stability of the financial system**.

2 There will be a large measure of overlap between the areas of interest and information requirements of the central bank and an independent regulator. In countries where banking supervision is separated from the central bank, it is common for the central bank to devote considerable resources to banking system surveillance, thereby ‘shadowing’ the banking supervisor. Combining these functions therefore **avoids wasteful duplication**. This is a very powerful argument in designing a regulatory structure intended to achieve its objectives at **least cost**.

3 The central bank is **the source of liquidity** for the financial system. It therefore must play a crucial role in dealing with any systemic crisis or institutional solvency problem of major dimensions. As the banking regulator, it is well placed to respond quickly with **lender of last resort** assistance to the banking system or an individual bank.

4 The central bank is intimately concerned with the **integrity of the payments system**. Central bank liabilities are the source of ultimate exchange of value in the inter-bank settlement process that underpins any payments system. Oversight of the payments system is therefore an integral function of the central bank.

5 The central bank gains **valuable insights into financial market conditions and the state of the economy** through its banking supervision responsibilities. On this ground, the monetary policy and supervisory functions are complementary (but see the contra argument below).

The Separation of Systemic Stability Regulation from the Central Bank

1 The most commonly cited argument is the potential for **conflicts of interest** in combining the objectives of price stability and systemic stability. It is argued, for example, that a desirable tightening of monetary policy in the interests of price stability could be delayed or withheld if the prudential supervision arm were to judge that this could create severe difficulties for a fragile banking system. Conversely, the banking supervision arm could put pressure on the monetary policy arm to ease monetary policy to assist an ailing banking sector where this easing might not otherwise have been contemplated.

2 Supervision of banks (or other financial institutions) cannot (indeed should not) prevent failure of some institutions. Yet such failures can **weaken the credibility of the central bank**, and credibility is critical for any central bank **in its conduct of monetary policy**. Indeed, we have even seen the Reserve Bank blamed for the failure of some institutions (state banks and building societies) that it did not have responsibility to supervise.

3 Central bank **independence** could be compromised where government financing is needed in any large rescue of a major financial institution.

Where the balance of these proposition lies is necessarily a matter of judgement. It must be said, however, that the arguments in favour of separation are less than compelling.

The conflict of interest proposition is less than persuasive so long as monetary policy is conducted in a pre-emptive manner and strict inflation targets are pursued.

Likewise, the independence and credibility arguments are relevant only if supervision fails to achieve its intended objective. A regulatory structure based on risk of failure represents a negative approach to design criteria.

The fact that much of the supervisory regime would need to be **duplicated** if it were to be conducted outside the central bank adds a cost minimisation argument to the case for combining systemic risk regulation within the central bank.

On the balance of judgement, it is CBA's view that the complementarities between monetary policy and systemic stability, and the need to avoid creating duplicated functions, argue powerfully for **systemic stability regulatory responsibilities to reside with the Reserve Bank**.

5.4.12 Systemic Stability Regulatory Responsibilities

Having established that the Reserve Bank should carry responsibility for systemic stability, the question remains as to what should be the ambit of these responsibilities.

Clearly these responsibilities should cover:

- banking supervision;
- the payments system, both domestic and international (the latter involving the foreign exchange market); and
- vital financial markets

Without being definitive, the financial **markets** included above will encompass safety arrangements in those markets whose smooth functioning is regarded as fundamental to the maintenance of systemic stability.

The responsibilities outlined above could be regarded as **the minimum** needed to protect the financial system as a whole from disruption.

Some would extend these responsibilities much further, arguing that a wider range of institutions than banks could be systemically important. On this basis it is argued that 'there is now a strong case for bringing the prudential supervision of banking, securities, and insurance within the ambit of a single regulatory agency.' (Michael Taylor, 'Twin Peaks': A Regulatory Structure for the New Century).

The difficulty with this approach is that it tends to extend the ambit of responsibility to all prudential regulation.

As already covered at length, prudential regulation can be undertaken for investor protection as well as for system stability reasons**. It does not follow that all institutions that warrant prudential oversight for investor protection are also systemically important**.

Extending prudential supervision by the systemic stability regulator to a wide range of institutions would also raise significant **moral hazard** issues. It would be difficult to prevent a view being formed that all institutions subject to prudential oversight by the systemic stability regulator were equally safe.

For these reasons, **CBA is strongly opposed to prudential supervision by the Reserve Bank, or any regulatory agency that were to supplant the banking supervision functions of the RBA, being extended to non-bank financial intermediaries**.

As the composition and structure of the financial system changes over time, however, it would be logical to leave it to the judgement of the RBA as to whether any extension of its supervisory reach to additional institutional groups or markets would be required to carry out its systemic stability responsibilities.

5.4.13 The Market Conduct Regulator

The Market Conduct Regulator would embrace all responsibilities for the interface between consumers and financial institutions and markets.

This is the area of the current regulatory system where there is the greatest scope for rationalisation. There is much confusion and overlap in the current structure. More than this, there are regulatory processes outside of the field of the financial regulators which add new layers of regulation with associated costs and inefficiencies.

The appropriate starting point is to aim for the ultimate rationalisation by having just one ‘consumer protection’ regulator for the entire financial system.

A **Financial Services Commission** (the name being of no importance) could be established to subsume the roles of:

- AFIC
- ISC
- Parts of the ASC (excluding its Corporations Law functions)
- Consumer Affairs, where financial products are concerned
- ACCC, where consumer issues involve financial institutions
- Those (minor) activities of the RBA which are connected with ‘consumer issues’ - refer coverage in the RBA annual report of its involvement with consumer matters.

This ‘mega-regulator’ would undoubtedly have to be organised into separate divisions consistent with the need for special expertise and experience in regulating complex financial functions.

The most logical divisionalisation would be along **functional** lines to provide flexibility for changing institutional forms, and to achieve competitive neutrality of regulatory burdens on a functional rather than institutional basis.

In practice, however, the divisionalisation might look fairly similar to the way AFIC, ASC and ISC would look if they were to be simply merged in their current form.

Separate divisions therefore might be created for:

- Deposit-taking
- Superannuation
- Collective investments
- Life insurance
- General insurance
- Financial advice
- Financial markets

Alternatively, a more fundamental reorganisation of the merged entity could be around the nature of the promise that underpins financial functions. Under this model, divisions of the Financial Services Commission could be established to deal with:

- Capital guaranteed products
- Non-guaranteed products
- Financial protection products
- Asset protection products
- Credit products

Divisional organisation is essentially a matter of judgement, subject to the overriding requirement that the agency achieves its regulatory objectives in the most efficient, cost-effective, and competitively neutral manner - simplicity, uniformity and least-cost should be its mantra.

The Financial Services Commission would have three primary functions:

- Disclosure
- Investor Protection

- Advice

These functions are dealt with briefly below.

5.4.14 Disclosure

The case for regulatory intervention to protect consumers arises primarily form the information imbalances that exist between financial services providers and unsophisticated personal customers.

The appropriate response is to regulate disclosure of the information needed to reach an informed decision. **The objective is informed decision-making**.

Disclosure standards are worthwhile when the information so provided assists consumers to understand the nature of the contracts they are party to, and to make better informed decisions about the price and risk characteristics of the alternative financial services available to them. In this latter respect, disclosure needs to assist consumers to compare financial product offerings.

Disclosure requirements at the institutional level can also expose financial services providers to public scrutiny and competitive pressure from the market.

As with all regulation, however, **costs need to be balanced against perceived benefits**. Disclosure requirements that impose a cost burden on the provider but impart no useful information to the decision-maker represent a ‘dead-weight loss’ to users of the financial system.

Having all disclosure requirements specified and administered under the one regulatory umbrella agency would help to **standardise and simplify disclosure** in the interest of informed decision-making by consumers **at least cost**.

In the latter respect it must be stressed that the incidence of these costs falls on users of financial services. It is axiomatic that disclosure of information that does not lead to different financial decisions than would have been taken in its absence, involve costly impositions for no benefit.

Standardisation and simplification of the plethora of disclosure requirements in the interests of cost-efficiency should be a priority task for the proposed new regulatory agency.

A simple, uniform disclosure regime across all financial products, and one which is suitable for electronic interface with the customer, should be the ultimate objective.

While there may be a case for separate disclosure regimes for asset and liability products, the overriding principles should be the same. Hence, disclosure for both borrowing and lending products should be administered within the one agency. It follows that administration of the Uniform Credit Legislation should be transferred from State Consumer Affairs jurisdictions to the new Financial Services Commission.

5.4.15 Investor Protection

Apart from regulating disclosure in the interests of informed decision-making, there will be some cases where **prudential regulation** is justified in the interests of consumer protection (as distinct from systemic risk).

These come down to cases where search costs for consumers in gathering the necessary information are large, particularly where continuous monitoring would be needed, special expertise is required to evaluate the information, the promise on the part of the financial institution is of long duration (eg superannuation or life insurance cover), and institutional failure would have potentially serious consequences for unprotected investors.

In these circumstances it may be sensible for the community to delegate prudential oversight of certain institutions to a regulatory agency acting on the community's behalf.

The prudential supervision functions currently performed by the ISC and AFIC are of this type.

These responsibilities should be brought together under the proposed Financial Services Commission.

5.4.16 Financial Advice

Financial advice is another area where market failure can justify regulation.

Regulation of financial advisers is currently highly inconsistent and disparate.

Bringing the licensing and control of advisers within the one agency should facilitate greater consistency of treatment.

The objective should be competent advisers, dispensing advice that is appropriate to client needs, at a reasonable price to the user.

Avenues for redress in cases of fraud and negligence could also be administered by the one agency.

5.4.17 Recommendations

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.

The function of **Conduct of Business Regulator** (provisionally labelled the 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.

This objective-based approach to the structure of the regulatory system should provide for an optimum configuration that can achieve its regulatory objectives at least cost to the efficiency and flexibility of the financial system.

5.5 Competition

5.5.1 Efficiency through Competition

Competition policy, as administered under the Trade Practices Act (TPA), applies broadly across the economy rather than being specific to the financial sector.

The fundamental principle that underpins competition policy is that **competitive markets** promote economic efficiency. Competition policy is all about maximising the efficiency gains that accrue from the interplay of competitive forces. Competition is not an end in itself. It is the means to achieve **economic efficiency**.

The role of competition policy is therefore not to supplant market processes but to make them work better in achieving economic efficiency. It is about promoting competition, not impeding it.

Competition policy as administered under the Trade Practices Act, can be divided into two main parts: that directed at practices which inhibit competition in the marketplace and that dealing with unfair trading practices.

Both of these objectives should be pursued by seeking to make markets work more effectively. The two parts can therefore be viewed as complementary. Competitive conduct, of which merger policy is the centrepiece, is all about the **supply side** of the market, while unfair trading practices (more generally subsumed under the label of ‘consumer protection’) focuses on the **demand side**.

In this part of the submission only the competitive conduct dimension is covered.

5.5.2 The Role of the Inquiry

Reviewing the general application of competition and merger policy under the Trade Practices Act (TPA) is an exercise well beyond the confines of this Inquiry.

For that reason, this submission does not address the content of the revised merger guidelines released by the ACCC in July 1996. Nor does it pass judgement on the issues raised by the Industry Commission in its recent information paper on Merger Regulation. Those matters pertaining to the economy-wide application of competition policy are better addressed in other fora.

Where the Inquiry does have a vital role to play is in **raising understanding of the competitive environment in the financial services sector**.

The Inquiry’s analysis of competitive conditions and the increasing pace of change in the finance industry will have a marked influence on the quality of debate about issues such as merger policy and the pricing of financial services.

5.5.3 Competitive Conditions

As covered in Section 4 (Changing Industry Dynamics) the impact of technology is taking competition in the financial services industry to a new level of intensity.

New electronic means of interfacing with customers are allowing a broader range of financial institutions to offer a wide product array. The resulting 'convergence' between products sold by different institutions is providing customers with a wide choice of financial services' providers. The result is intensified competition for all forms of banking and financial services.

At the same time the process of functional decomposition is adding a new competitive dimension. As an understanding of this process is essential to making an informed judgement on competition and pricing issues, it is described in some depth in the next section.

5.5.4 Intensified Competition Through Functional Decomposition

The conventional model of a financial institution is one of a vertically integrated firm providing each of the sub-components of the products and services it offers.

Under the combined impact of information technology and new approaches to business management, an alternative model has emerged. This **deconstruction model** involves breaking up the provision of financial products into a sequence of value generating activities.

A classic example of this development is the emergence of mortgage originators. These niche firms have specialised in only part of the home lending business of traditional suppliers. By avoiding the costs involved with 'bricks and mortar' branch networks, and targeting a product which was cross-subsidising other parts of the business (primarily transaction banking services), the mortgage originators have been able to **'cherry pick' profitable business** from the traditional home lenders.

A further development already well advanced in some overseas countries is the potential to use a cluster of insourced and outsourced activities and processes to deliver a service to the customer. In this way much of the ‘back office’ processing can be contracted out to suppliers with superior economies of scale, while additional product and delivery channels can be made available to the customer via agency arrangements with institutions who have surplus capacity.

For existing institutions, this decomposition allows financial and managerial resources to be allocated to those activities where a comparative advantage is enjoyed. Where no such comparative advantage exists, activities can be outsourced to providers who can deliver the activity on a more cost effective basis.

This process leads to the disaggregation of monolithic organisations on the basis of individual 'make or buy' decisions. The decision process involves determining which functional components to supply internally, which to sub-contract out (outsourcing) and which to supply to others as a contract business (insourcing).

In effect, an **internal market** for decomposed functions is created within the institution.

Pressure to improve quality and reduce costs results from this process.

For **new entrants**, deconstruction allows them to specialise in particular products, processes and delivery channels, without attempting to provide either a full range of services or even the entire ‘production process’ involved with a particular activity.

Figure 5.7 shows how deconstruction of various financial activities can be presented as three dimensions:

- Customer channels.
- Products.
- Support services.

In the new competitive environment, unless a financial institution is competitive in each activity, it will be exposed to price competition from more efficient providers.

The consequences of this development are twofold. Firstly**, competition can only intensify** as entry to the market is facilitated by this clustering of insourced and outsourced activities. And secondly, the resultant potential for heightened 'cherry picking' **makes cross-subsidisation from profitable to unprofitable activities unsustainable**.

5.5.5 Pricing and Efficiency

Against this background of intensified competition at the functional level, pricing within the financial sector must be free to respond to competitive dynamics.

It is through market competition that customers will receive least-cost provision of financial services.

A legacy of the regulated environment remains in the approach to pricing of **transaction services.**

Political and community resistance to transaction fees that reflect the cost of the services provided has left the personal market with a distorted pricing structure.

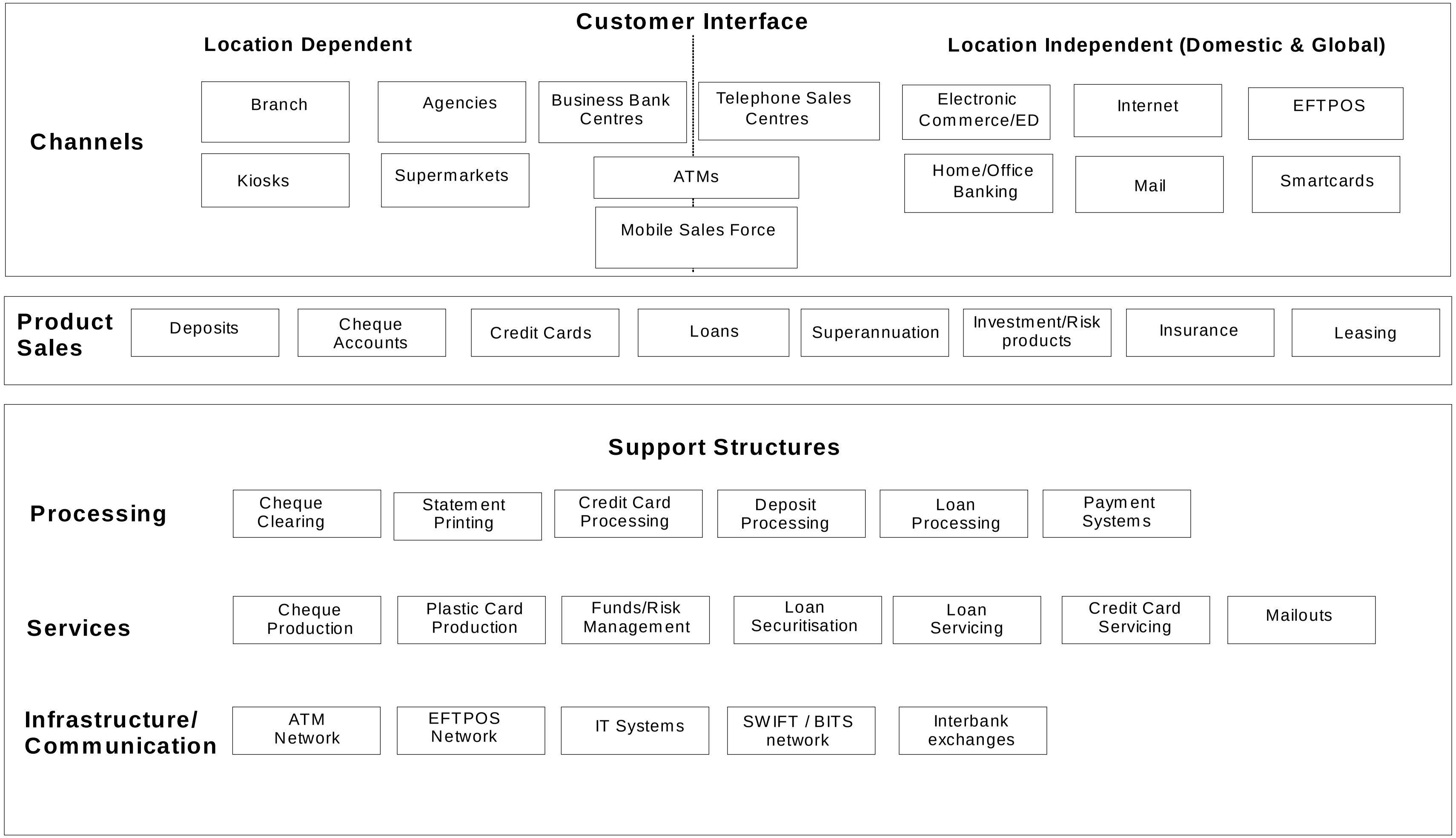
The failure of prices to reflect the underlying cost of these services is both inefficient and unsustainable.

As the example of the mortgage originators so powerfully demonstrates, once alternative providers can target discrete functions within a product or process value chain, the ability to 'cherry pick' profitable lines of business greatly intensifies. Existing providers of the entire value chain need to respond competitively or face the loss of their most worthwhile customers. More than this, it is those very customers that are supporting unprofitable activities through cross-subsidies.

Through this process the previously subsidised parts of the business are becoming increasingly non-viable. **Unless pricing of unprofitable activities can be adjusted to recover costs, the continued provision of the services becomes unsustainable.**

This Inquiry should therefore lend its support to a move to more commercially based pricing structures for all financial services, including transaction services.

Figure 5.7 The Decomposition of Banking



5.5.6 Competition Policy

The deconstruction process outlined above is also highly relevant to the application of competition policy under the Trade Practices Act.

The objective of the Trade Practices Act 1974 is (inter alia) to ‘enhance the welfare of Australians through the promotion of competition’.

The function of competition policy is not to regulate or replace market processes, but to create the environment within which the free operation of the market can best achieve economic efficiency.

Section 50 of the TPA is intended to protect the integrity of the competitive process. Section 50 prevents the accumulation of additional market power through mergers or acquisitions of competitors which would, or be likely to, **substantially lessen competition**.

Section 46 and Section 50 both operate ultimately **to prevent undesirable market conduct** on the supply-side, whether through the misuse of market power against competitors or the capacity for market power to be accumulated against competitors. Both provisions assume that such market power would be used to maximise profitability by imposing prices **independently of the market**.

As stated by the ACCC -

> ‘The primary reason for being concerned about mergers, especially between competitors, is that they increase the likelihood that the merged firm would have greater scope to set prices above the competitive level, or otherwise distort competitive outcomes, either alone or in co-ordination with other firms selling the same product.’

Market definition is critically important to the application of Section 50 because it influences measures of market concentration and perceptions of the extent of competition within the market. Both of these factors form the basis of subsequent investigation to identify whether or not a merger would ‘substantially lessen competition’ existing in the relevant market.

The definition of a particular market inevitably requires the exercise of judgment. A narrowly defined market will tend to overstate concentration and lead to misjudgments about the extent to which the merged firm might be able to set prices independently of other market participants. A broadly defined market might tend to understate the market power able to be exercised by the merged firm.

5.5.7 Defining The Market

The definition of the relevant market is a crucially important step in applying competition policy.

Definition of the market has a locational or geographic, a product, and a functional dimension. Within these parameters, the ACCC has formulated a set of guideline merger concentration thresholds (the 4-firm threshold test) below which mergers generally would not require assessment by the ACCC and would not breach Section 50.

Merger proposals resulting in market concentrations which breach the ACCC's thresholds attract ACCC scrutiny on the basis that they have **the potential to** 'substantially lessen competition' in the market.

The 4-firm threshold test applies if, after the merger:

(a) the merged entity would command a market share of **40%** or more, and the sum of market shares of the four largest competitors **is less than 75%**, or

(b) the merged entity would hold a market share of at least **15%** and the sum of the market shares of the four largest firms **exceeds 75%.**

In its recent review of the ACCC's merger guidelines, the IC recommended that a more liberal threshold test be used to identify mergers which have the potential to breach Section 50. Under the IC's proposal, the threshold test applies where the market shares of the **three** largest competitors would exceed **75%** or the merged entity would hold a market share greater than **50%**.

Were each merger proposal to be assessed on its merits, the setting of concentration thresholds at certain levels would not be of major concern.

A potential difficulty arises, however, in the way the thresholds are applied.

Once it is determined that a merger proposal breaches the thresholds in the market as defined by the ACCC, the **onus** of proving that a proposed merger will not substantially lessen competition **lies with the merging parties**.

It is for this reason that getting the market definition right is critically important.

In addition to adopting an appropriate market definition, the concept of **contestability** is vitally important.

Contestability refers to the ease by which new competitors can enter if profitable opportunities exist in a market. This **threat of entry** causes market incumbents to price in ways that do not create these opportunities. In this way the threat of entry is a competitive force in the market.

For this reason, market shares are not an accurate indicator of market power in markets which are contestable. Market shares are a **static** measure whereas contestability is a **dynamic** concept.

5.5.8 Increased Contestability

The deconstruction process outlined above has greatly intensified the contestability of all the dimensions of the financial services market. This process has made market entry feasible at a more disaggregated functional level, where pricing and cost conditions are conducive to doing so.

Resultant competitive pressures are forcing incumbent financial institutions to redouble their efforts to lift efficiency and cut costs. At the same time, this competitive process is forcing cuts in the price of products and services that were previously subsidising other parts of the business (eg home loans subsidising underpriced transaction services).

It is clear that the entire financial services market is in the throes of fundamental transformation under the impact of technological innovation and new competition. This is a dynamic process that is likely to increase in tempo, particularly under the influence of global competitive processes.

5.5.9 The ACCC Position

It is neither relevant nor appropriate to raise with this Inquiry matters of detail with respect to merger policy as applied by ACCC.

The Bank fully supports the need for a competitive market for all types of financial services.

The competitive process drives financial institutions to strive continuously for better ways to meet customer need at least cost.

The Bank therefore supports the role of ACCC in applying competition and merger policy.

The underlying philosophy of merger policy should be to promote and protect competition, not to impede the operation of the market.

As outlined earlier, the competitive process in the financial services market involves both the convergence of product offerings by different types of financial institutions and the capacity to deconstruct the supply chain.

These competitive processes are seriously at odds with the ACCC's (formerly TPC) guidelines on bank mergers issued in 1995.

The Bank fully supports a case-by-case approach to merger policy in the financial sector.

If in applying merger policy, however, the ACCC applies an excessively narrow definition of the market or overstates barriers to entry, it can impede the very competitive processes it is intended to protect.

Mergers may, or may not, have a role in the interplay of competitive dynamics and the fundamental change process that the financial sector is experiencing. Were mergers to be inappropriately restricted, one mechanism for competitive response by the industry to the forces of change would be impeded.

For this reason the ACCC should revisit its guidelines on bank mergers to take greater account of the competitive dynamics of the industry and the contestability of the relevant market.

5.5.10 Competition Tests Should Apply

The Bank is not advocating special dispensation for the finance industry from the rigour of the merger tests which apply under the Trade Practices Act (TPA). On the contrary, the Bank believes that all merger proposals in the financial sector should be assessed on their merits, within the same criteria as apply across the economy.

The underlying philosophy of the benefits of competition is no less applicable to the setting of merger policy in the financial services sector than in other industries.

The powers available to the ACCC to prevent mergers which are anti-competitive provide adequate protection to all stakeholders in the financial system. However, as noted earlier, 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.

5.5.11 No Pillars

The intensity of competitive pressures and the dynamics of change in the financial sector described elsewhere in this submission, in combination with the powers available to the ACCC under the TPA, provide adequate protection to all stakeholders against undesirable mergers.

In this respect, the 'six pillars policy' articulated by the Federal Government in 1991 does no more than duplicate the power granted to the ACCC to administer national competition policy. The 'six pillars policy' derives from the power available to the Federal Treasurer under Section 63 of the Banking Act and under Section 5(1) of the Insurance Acquisitions and Takeovers Act 1991 in relation to insurance companies.

It is not clear that such an arbitrary veto on mergers provides any useful addition to competition policy. If a merger would have undesirable effects on competition (and no offsetting public benefits), it will not receive ACCC approval under the tests specified in Sections 50 and 88 of the TPA.

If a particular merger proposal would not be opposed by the ACCC on competition grounds, it is difficult to see what other grounds a Treasurer would have for vetoing it.

It is conceivable, although unlikely, that there could be some **prudential** issue at stake. On that basis, it may be sensible to give the Treasurer power of veto where he is in receipt of a specific recommendation from the RBA opposing, or proposing, a particular merger **on prudential grounds**.

If this process were to be adopted, it should be exercised on a case-by-case basis, not through blanket opposition to a particular class of mergers.

5.5.12 Conclusions and Recommendations on Competition Policy

Vigorous competition is the best mechanism to ensure customers have a financial system that is innovative, low-cost and responsive to their needs.

The Bank strongly supports measures to promote competition and remove regulatory or other distortions in the financial system.

The pricing of retail banking transaction services has not fully adjusted to market realities in a deregulated environment.

Banks must be allowed to price all services on a fully commercial basis.

Cross-subsidies cannot be sustained in the current and future competitive environment.

If the cost of delivering services cannot be recovered from the users, continued provision of the service becomes non-viable.

In the interests of supporting continued access to financial services for a broad cross-section of the community, this Inquiry should endorse the principle of commercial pricing of all services, including retail transaction services.

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 Bank does believe, however, the ACCC guidelines on bank mergers are unduly narrow and fail to take account of competitive conditions in the financial sector.

Those **merger guidelines should therefore be revised**.

The powers available to the ACCC to prevent mergers which are anti-competitive provide adequate protection to all stakeholders in the financial system. The **‘six pillars policy’ should therefore be abolished**.

The Treasurer may, however, retain special override powers where he is in receipt of a specific recommendation from the RBA opposing or proposing a particular merger **on prudential grounds**.

In the event that ACCC approval were sought for a merger between any of the major nationally-operating participants in the finance industry, the Bank believes that a public benefits test should be applied.

5.6 Other Regulatory Issues

5.6.1 Introduction

The objectives of financial regulation have been addressed earlier. These were considered to be as follows:

- avoiding systemic risk.
- providing investor/consumer protection.
- ensuring competitive neutrality.
- maintaining efficiency of the market

Regulation inevitably involves a direct cost to the regulated institution and in many cases an indirect cost to the consumer of that institution’s products and services as these costs are passed on. In assessing the efficacy of regulatory requirements it is thus important to compare the costs of these arrangements with the benefits of the specific objectives being pursued.

Identified below are specific aspects of the current regulatory arrangements applicable to the financial services industry that the Bank considers are inconsistent with sound principles of regulation due to either one or more of the following:

- they act as an impediment to the efficient conduct of our business.
- they prevent the Bank from competing on an equal footing with other financial service providers.
- compliance costs are excessive relative to the benefits to customers.
- duplication or inconsistency exists in regulations.

5.6.2 Prudential Regulation

(a) Banks

(i) Capital Requirements

- **Internal Risk Models for Credit Risk**

Existing arrangements for assessing the adequacy of a bank's capital resources against its credit risk, force most banks to hold minimum levels of 'regulatory' capital in excess of the appropriate level of 'economic' capital - ie the amount of capital commensurate with the actual risk profile of their portfolio. This reflects the 'broad-brush' approach taken by the RBA to capital adequacy requirements.

While such an approach may have appeared appropriate at the time these arrangements were first introduced (1988), the application of sophisticated risk measurement technology for the pricing and managing of financial products provides the opportunity for prudential capital standards to incorporate banks' own risk-capital allocation models.

It is therefore recommended that the RBA adopt a more flexible approach to capital adequacy by having regard to internal models used by banks; this would be on the basis that the RBA has satisfied itself as to the integrity of a bank's model.

Some other central banks (notably the Federal Reserve) are becoming increasingly more willing to accept such arrangements. In these circumstances the RBA should use its influence with other central banks for convergence on this issue.

- **Netting**

An issue of major concern in the administration of existing capital adequacy requirements **is the need for clarification of the validity of 'netting' under Australian law**. To enable banks to treat exposures on a net basis, amendments will be required to the Banking Act, Corporations Law and Bankruptcy legislation. The process of analysing and debating the legal status of netting has been ongoing for an extensive period and requires immediate resolution if Australia is to be competitive and consistent with international jurisdictions.

Resolution of this issue is long overdue and it is recommended that as a matter of high priority **relevant organisations enact appropriate legislative amendments to facilitate netting of exposures with the same counterparty**.

- **Tier 3 Capital for Market Risk**

In announcing guidelines (which will become effective in December 1997) for Australian banks to include market risk within capital adequacy measures the Reserve Bank has indicated it will not allow the inclusion of 'Tier 3' capital instruments.

This is in contrast to BIS proposals which allow for the creation of a new tier of capital to support market risk. This capital can be in the form of subordinated debt with maturities as short as two years, subject to a 'lock-in' provision allowing banks to defer repayment where the capital ratio would fall below required levels.

The RBA's refusal to recognise Tier 3 capital will deny Australian banks the benefit of a form of capital available to foreign competitors and thereby hinder the international competitiveness of Australian banks.

To be consistent with other aspects of BIS capital arrangements, it is recommended the **RBA include Tier 3 capital resources when market risk is included in capital adequacy measures**.

(ii) Prime Asset Requirement

Existing prescriptive liquidity requirements are not considered necessary where a bank's internal risk management system ensures a liquidity level at least matching PAR is to be observed.

At the very least, the shrinking supply of Government debt on issue over coming years as the Budget moves into surplus would justify a **widening in the range of eligible PAR assets**. Reduced supply of Government debt could have a major impact on market volatility, thereby increasing the potential for substantial swings in banks' earnings. An expansion could include semi-government paper, short term-bank securities, and high quality corporate paper in eligible PAR assets.

Reflecting the above, **banks should be allowed to include holdings of an expanded array of highly liquid securities as eligible PAR assets**.

(iii) Non-Callable Deposits

Current arrangements to lodge the equivalent of 1% of AUD assets with the RBA discriminate against banks. Other deposit-taking institutions are not required to observe a similar requirement.

The payment of a below-market rate of interest on NCD balances - 5 percentage points below the T/Note tender yield - represents a significant earnings penalty to banks (and an ultimate cost to customers). The cost to CBA of this sub-commercial rate is around $40 million annually. As noted in recent comments by the RBA Governor, NCD requirements are ‘essentially a budget revenue raising measure’.

Removal of the NCD requirement, or payment of a market rate of interest, is recommended.

(iv) Funds Under Management

Reserve bank Prudential Statement C2 requires that where a bank is involved in funds management activities it must display in a prominent manner on any document inviting investment that such products are ‘subject to investment risk including possible delays in repayment and loss of income and principal invested’. Funds managers not associated with a bank are not required to make the same disclosures.

This places bank related funds management vehicles at a distinct disadvantage to other competitors. The concern is that in the minds of the public such statements will be interpreted to mean that investments with bank associated fund managers have greater levels of risk.

Disclosure provisions should be standardised for all institutional providers.

(v) Securitisation

Prudential Statement C2 imposes a range of stringent disclosure and capital requirements where Australian banks are involved in securitisation activities.

In practice these requirements work to the disadvantage of free standing domestically incorporated banks (such as CBA) compared with Australian banks or money market corporations which are subsidiaries of foreign bank or branches of foreign banks operating in Australia.

This is because of the less onerous requirements established by relevant host country supervisors of these banks in relation to the holding of capital against liquidity and/or credit enhancement facilities provided to support securitisation structures.

As a result, these groups are at a distinct pricing advantage in relation to their involvement in the Australian securitisation market.

It is recommended **prudential requirements governing banks' involvement in securitisation activities be harmonised with arrangements applying in main OECD countries.**

(b) General Insurance

The Insurance and Superannuation Commission has outlined proposals requiring general insurance companies to publicly disclose solvency ratios.

While not opposed to increased disclosure, the Bank considers that specific measure proposed by ISC is not appropriate for the intended purpose in that it neglects a range of relevant prudential factors. As currently proposed it is more likely to be confusing to policy holders and is tantamount to the ISC becoming a defacto rating agency; this would be in conflict with its supervisory role.

It is recommended that **further discussion take place between the ISC and insurers with a view to developing a more appropriate solvency measure**.

5.6.3 Consumer Protection

(a) Consumer Credit Code

The new Consumer Credit Code, which will apply to a large proportion of the Bank's lending, imposes technical, complicated procedures which do no more than cause unnecessary duplication in documentation at the stage of formation of the contract and in any subsequent variation. The legislation does not provide commensurate benefit to borrowers and is imposing significant costs on banks; such costs are necessarily ultimately borne by consumers.

The extent of the disclosure required is a major cause of the high cost of implementing and operating under the Code. The Bank's implementation costs are estimated at up to $30 million with ongoing additional costs of around $4 million per annum.

Many of the disclosures and other requirements of the Code are not considered necessary for the reasonable protection of consumers.

Also the legislation provides for a bank automatically to lose its right to be paid interest on specified loans as a result of non-compliance with what are strict regulatory requirements. Such a breach could be unintentional or technical in nature; there does not have to be any detriment to the borrower. A bank's interest in respect of a particular loan, or class of loans, could be substantially reduced, while the bank continues to bear the full interest cost on the deposits necessary to fund those loans.

Other intrusions contained in this legislation include the power to impose interest rate adjustments and to re-open contracts.

CBA supports the Australian Bankers' Association call for **a substantial simplification of the Code through removal of prescriptive disclosure requirements and the removal of civil penalties**. **Administration of the Code in respect of banks should be removed from the province of state authorities and be assumed by a Federal regulator**.

(b) Trade Practices Act

(i) Exclusive Dealing

The exclusive dealing provisions in the Trade Practices Act (s47) have unintended consequences by outlawing legitimate business practices, eg where combinations of services are provided by different legal entities in a group. The section prohibits, in absolute terms, the provisions of services, or discounts, on condition that the acquirer will acquire services from another person. This prohibition applies despite recommendations for reform going back to the Hilmer Report.

The growth of financial conglomerates strengthen the case for moving ahead with those reforms. Accordingly **the Bank recommends a general review be undertaken of all exclusive dealing prohibitions**. At the very least prohibitions should be made subject to the 'substantial effect on competition' tests.

(ii) Reputation Damage

Generally, the manner in which the Trade Practices Act is applied both in the restrictive trade practices and consumer protection provisions operates to prohibit much legitimate commercial activity, and has, in recent years been administered with an anti-business agenda. Minor, technical or doubtful infringements of legislation have been used to damage, or threaten to damage, business reputation and brand name, without any apparent purpose other than to harm the business.

The threat of prosecution for minor matters is a powerful weapon against business, because regardless of the seriousness of the matter or whether the prosecution is likely to succeed, reputation damage to the business will occur through associated publicity. In the case of banks, the protection of reputation against abuse of executive power is an important prudential matter, going to the confidence of the public in the banking and financial system.

It is submitted that the **Trade Practices Act should be amended to provide that a prosecution should not be instituted for a breach of any provisions of the Act without the consent of the relevant Minister** (ie an amendment to Section 163). Secondly, **consideration should be given to amendments to the Act to protect industry and business against damaging and prejudicial public statements being made by the Commission** without any alleged breaches of legislation having been admitted or proven against industry groups or specific businesses.

(iii) Misleading or Deceptive Conduct

The operation of Section 52 of the Trade Practices Act should be reviewed. The ability of this provision to give any aggrieved person a cause of action to go to court, has been the central cause of the growth of the litigation industry in Australia. Claims by defaulting borrowers from banks alleging misleading and deceptive conduct have increased dramatically in the last ten years. Very few of the cases have merit, and they do not ultimately succeed. However, the increased incidence of litigation imposes an undue and unproductive burden on the banking industry, and the public, which ultimately has to bear the costs.

Section 52 is not restricted to claims made in respect of an organisation's own products; it applies equally to claims made by other parties. However by virtue of Section 65A of the Trade Practices Act, no action can be taken against the media for any claim made in respect of say a bank's business activities.

In addition to these general concerns, there is also the issue of duplication of prohibitions against misleading and deceptive conduct contained in Section 52 of the TPA and the Corporations Law. Sections 995-1000 of the Corporations Law prohibit a range of misleading and deceptive conduct in relation to dealings in securities documentation. These provisions impose a positive duty of disclosure on persons responsible for providing information to investors to enable them to make informed decisions, and ensure market transparency.

Conversely, the Trade Practices Act does not impose a positive duty of disclosure. Instead it establishes a broad standard for business conduct. Contravention can occur without knowledge or fault on the part of the offender, notwithstanding the exercise of reasonable care.

Given that the Corporations Law imposes stringent disclosure obligations in relation to fundraising and takeover activities, defences are an essential protection for business. This ensures an appropriate balance is maintained between investor protection and the obligations imposed on business. However, this balance is undermined as investors can choose to bring an action under the Trade Practices Act, where equivalent defences are not available, in circumstances where Corporations Law defences would apply. Businesses are therefore exposed to liability because they cannot rely on statutory defences despite having taken all possible precautions.

The overlap and inconsistency between the two regimes gives rise to legal and commercial uncertainty, which ultimately results in increased costs to users of the financial system. Further, this situation is inconsistent with the international regulatory standard adopted in comparable jurisdictions in relation to fundraising and takeover, which more closely reflects our Corporations Law approach of rigorous liability combined with a due diligence defence.

In view of the above, **CBA supports recent Corporations Law Simplification proposals that conduct relating to fundraising, takeovers and securities dealings generally be regulated solely under the Corporations Law**, and that the applicability of the relevant provisions of the Trade Practices Act be specifically excluded.

(c) Product Disclosure

The purpose of product disclosure is to provide sufficient information to the consumer so that he/she can make an informed decision to purchase a product in the full knowledge of the risks, benefits, costs and caveats of the product. A number of issues arise in respect of the current disclosure arrangements governing major financial services products:

- **Product disclosure is institutionally focussed**

Product disclosure regulation is currently institutionally focussed i.e. disclosure is governed by the type of institution that offers the product. This has resulted in similar/same products with similar investment horizons/financial objectives, from a consumer's perspective, having different disclosure requirements and in some cases large differences in benefits.

- **Sales documents**

There are many differences in the requirements stipulated by the regulators regarding sales documents:

- Registration of sales documents - ASC prospectuses must be registered and approved prior to an offer being made to the public. ISC information brochures can be withdrawn after they have been issued.

- Form of sales documents - Adoption of new technology is at different speeds across the regulators. For example, the ASC is allowing the introduction of electronic prospectuses. To date, the ISC has not given any indication of allowing such offer documents. This example highlights the potential problems of institutionally focussed consumer protection regulation with different timing of its introduction and the potential development of different disclosure requirements for similar products.

- Repeated disclosure requirements - The current disclosure regimes require the same ‘text’ to be repeated at different points in the sales process (eg: references to investment performance and ‘free-look’ periods). In addition, some products cross multiple regulators which require that they satisfy a variety of disclosure regimes.

- Benefit illustrations - Currently these are only required for ISC regulated products.

- Disclosure of remuneration basis - Currently the ASC is requesting disclosure in the advice document in dollar terms. The ISC requires details of remuneration on a percentage basis.

- Penalties for non-disclosure - Penalties are similar across the ASC and ISC. However, the requirements for disclosure are more prescriptive for ISC regulated products than those regulated by the ASC.

- Variations in sales documents - Similar products under different regulatory regimes require different formats for the sales documents

It is recommended that product disclosure requirements 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 to make an informed decision. Reflecting where particular products may lie on the risk spectrum and the level of prudential supervision imposed, disclosure may be waived (say in the case of bank deposits) or be minimal.

Indicative disclosure elements would include:

- nature of the investment, including the price risk attaching to the principal sum;

- roles of parties to the investment;

- benefits;

- investment strategies;
- historical investment performance;
- fees and charges;
- remuneration of advisers;
- unit pricing arrangements; and
- complaints resolution.

(d) Provision of Financial Advice

The underlying rationale for the existence of regulations governing the provision of financial advice is supported - ie to protect consumers from inappropriate advice and to ensure that persons giving advice are competent to do so.

The financial services industry does not have a clear and consistent definition of what constitutes the giving of financial advice. In relation to the sale of life insurance products, the ISC provides some guidelines as to the type of information which must be provided to customers in association with the provision of advice. However, the ASC does not make it clear when advice is being given; it does require that any advice be given on the basis of knowing the 'customer's needs'.

The lack of a consistent set of arrangements applicable to the giving of advice across the full spectrum of financial products provides considerable confusion and uncertainty for both advisers and consumers.

Key areas of concern are -

- Letter of introduction

  The ISC requires a letter of introduction to be provided to all clients. The ASC does not. The letter of introduction provides the client with knowledge abut the adviser, the services offered, the products on which advice can be given and who is responsible for the adviser's actions. This causes a conflict of duty for advisers providing recommendations on both ASC and ISC regulated products.

- Documentation requirements

  The ISC has issued guidelines on the minimum client data that must be documented as the basis for advice. The ASC only stipulates that a 'reasonable basis' has to be documented.

- Confirmation of advice

  The ASC requires all advice to clients to be documented and confirmed in writing irrespective of whether the advice is implemented. The ISC only requires that advice to be implemented be confirmed in writing to the client no later than the commencement of the cooling off period. The ISC requires a 14 day 'free look' period. The ASC requires no 'free look' period.

- Disclosure

  Within the same client interview, financial advisers are frequently representing different legal entities at different parts of the interview impacting upon disclosure, accreditation and compliance requirements. This leads to consumer confusion and adds to advice complexity.

- Accreditation

  ASC regulated products require the adviser to hold a proper authority. ISC regulated products do not.

In light of these concerns, **it is recommended that a consistent definition of advice be applied across the full spectrum of financial products**. Advice may be defined as a recommendation expressed or implied; it would include any recommendation relating to an investment. Advice would not include an explanation of the features and benefits of an investment or financial product.

Where advice is given, a standard approach should be established for all financial products covering:

- level of advice;
- accreditation/competency of advisers;
- ongoing training; and
- customer education.

(e) Lending to the Farm Sector

Legislation in NSW and Qld place restrictions on the Bank in the event of a (primary producer) borrower's default, thereby increasing the risks associated with lending to the rural sector in those states. Such legislation is discriminatory insofar as it fails to recognise that a farm business enterprise is akin to any other business enterprise.

The NSW Farm Debt Mediation Act 1994 (FDMA), mandates a process for mediation of farm debts before a creditor can take possession of property or pursue other enforcement action.

In Bank's view, the FDMA enters the resolution process too late. It does not facilitate early identification by non-viable farmers of their plight.

FDMA often creates a strong expectation by farmers and their consultants of debt forgiveness by financiers. It is a slow, costly and bureaucratic process, which has the potential to force up the cost of rural credit. Some farmers (or their consultants) regard it as a tactic for stalling and defeating creditors.

The Bank supports replacement of FDMA with a more efficient framework aimed at early identification and resolution of problems, and voluntary, not mandatory, mediation.

Lenders face similar problems in relation to the Credit Act 1987 (Qld) which has potential to limit the recourse that a lender may have in respect of realisation action on farm machinery.

This legislation does, however, appear likely to soon be superseded by a Credit (Rural Finance) Act. A related Bill is currently before the Queensland Parliament as a rural-specific adjunct to the soon-to-be-introduced Consumer Credit Code. However the underlying difficulties associated with the existing Act are to be carried forward into the new legislation.

5.6.4 Other Issues

(a) Corporations Law

(i) Regulation of Securities and Futures

It has been of concern to the financial services industry for some time that there is a lack of clarity and consistency between the regulatory regimes imposed by Chapter 7 (Securities) and Chapter 8 (Futures) of the Corporations Law.

The Australian Securities Commission (ASC) indicated via recent initiatives, such as the Licensing Review, that they were considering an integration of Chapters 7 and 8 to resolve overlaps and inconsistencies between the regulation of those products. However, this direction is now inconsistent with the CASAC Draft Report on the Regulation of On-Exchange Derivatives (June 1996), which proposes that the current division between Chapters 7 and 8 of the Corporations Law continue, with Chapter 7 regulating securities, and Chapter 8 regulating derivatives (including futures).

Within the Report, there is some attempt to bring the two regimes into line by duplicating certain market manipulation prohibition and disclosure requirements. However, due to the breadth of the proposed definitions, and the stated intention to double-regulate products which classify as both securities and derivatives, the core problem of excessive and inconsistent regulation of products within the financial services industry remains unresolved.

The Bank supports the efforts by CASAC to clarify these issues but recommends closer industry involvement take place.

(ii) Prospectus Requirements

Inadequacies and inconsistencies in the laws governing prospectus disclosure and liability for that disclsoure have impeded the development of debt and equity capital markets in Australia. These disclosure problems discourage potential issuers from raising funds in the domestic market. This has been one of the major factors holding back development of the Australian capital market over recent years.

In contrast to the Australian situation, the equivalent market in the United States has been very successful. This is largely due to the definition of the market contained in Rule 144A of the Securities Act 1993 particularly that section related to the status of professional investors and the legal responsibilities of intermediaries dealing with these investors.

To facilitate capital raisings in the domestic wholesale market it is recommended that the application of the prospectus provisions of the Corporations Law (Parts 7.11 and 7.12) to prospectuses issued in the wholesale market be reviewed. In Particular:

- It should be made clear that the Corporations Law is the only code applying to such offerings, to the exclusion of other legislation (in particular the Trade Practices Act);
- Australian companies to be able to issue securities under a procedure equivalent to the Rule 144A arrangements applying in the US; and
- All offering documents issued by corporations should attract the ‘due diligence’ defence.

(b) Over the Counter and On Exchange Derivatives

Recent and impending initiatives involving the regulation of certain financial market activities and derivative products are of significant concern.

Proposals contained in the CASAC Regulation of the OTC Derivatives Market Discussion Paper (August 1995) and the CASAC Regulation of On-Exchange Derivatives Draft Report (June 1996) are being thrust upon the market in a hurried and unco-ordinated manner, with only sporadic consistency between these and other regulatory initiatives such as the ASC Licensing Review (August 1995) and ISC Circulars.

Further, the draft reports do not provide a justification for the degree of regulation being proposed. Regulatory objectives need to be clarified and regulation directed towards improving the current regime and rectifying identified problem areas.

The regulatory programs initiated to date appear to have been focussed single-mindedly on investor protection. Whilst the Bank supports the introduction of appropriate protection for the retail end of the market, this must be handled with minimum disruption to the efficiency of the wholesale market. The common defect of these initiatives is the lack of balance between investor protection and the equally important objectives of market efficiency, cost-effectiveness and consistency with other regulatory regimes, both in the global and domestic context.

Of particular concern is that the current CASAC recommendations do not give any consideration as to the impact on the Australian market's competitive position vis-a-vis offshore markets offering these products.

The derivatives market is essentially a wholesale market and **in developing operating and disclosure standards proper account should be taken of the nature of the users of these products.**

(c) Government Counterparties - Authority to Deal

Banks have been concerned for some years about the difficulty in determining whether various financial market transactions entered into with government departments, statutory authorities and even certain trustees, are within the powers of these bodies following the precedent set by the Hammersmith & Fulham case in the United Kingdom.

Whilst continuing representations by peak industry bodies have been successful in resolving the issues concerning most of the state local government owned entities, the problem remains largely unresolved for about fifteen Commonwealth authorities who are active in the markets from time to time.

These authorities will usually be authorised in general terms to enter into the transactions but the general power is often subject to limitations as to the purpose of the transaction and to compliance with various conditions or directions imposed by the relevant Minister.

Banks therefore face unnecessary risk in that transactions may be unenforceable because the relevant government authority may not have contracted for the required purpose or satisfied the relevant conditions or directions and have thus acted in excess of power.

For the markets to operate with maximum efficiency and integrity, commercial and legal certainty needs to be a feature of all transactions. The lack of this feature in the case of Commonwealth government entities transacting significant levels of business weakens the Australian financial markets' claim to being internationally competitive in this regard.

Protection must be available for banks and other parties dealing with Commonwealth authorities in circumstances where it is not feasible for them to carry out the enquiries necessary to ensure that all of the relevant legislative requirements have been satisfied.

The Bank's proposed solution to this problem is to ensure that all enabling legislation for government entities is amended to:

- **clarify the definitions of transactions which are able to be entered into by the use of standardised industry wording; and**

- **make it clear that a person dealing with the entity would be protected if that person had, at the time of contracting, no actual knowledge of lack of power of the authority to enter into that particular contract despite taking all reasonable steps to confirm its authority.**

(d) Directors of Corporate Groups

It is common practice for directors of a bank and senior officers of a bank to act as nominee directors of subsidiary companies of a bank.

Under current company law in Australia, there has been a long standing uncertainty as to whether the directors of a subsidiary must only act in the interests of that subsidiary or whether they can also take into account the interests of the holding company. Further, the question arises whether they can act entirely in accordance with the directions of the holding company (in circumstances where the holding company considers that a particular action is in the interests of the group).

With the increased use of subsidiary companies in banking groups and the growth of financial conglomerates, together with the increasingly onerous and complex duties imposed on directors of companies, it is desirable that the law relating to directors duties be reformed to reflect the reality of the present commercial environment of corporate groups. It is noted that New Zealand has already reformed company law relating to nominee directors.

The Bank recommends that relevant legislation be amended to enable directors of subsidiaries to act in accordance with directions from the ultimate parent company.

(e) Regulatory Intrusions into Pricing of Bank Products

(i) Deeming

'Deeming', whereby Department of Social Security and War Veteran's pensioners are regarded as earning a specified rate on their savings, was introduced by the Federal Government in 1991 to encourage pensioners to secure appropriate rates of return on their savings.

The system of deeming represents a quasi interest rate control that does not sit well with the present deregulated banking environment. Similarly, procedures whereby DSS alters the deeming rate in the light of changes in the general level of interest rates warrant review.

The Bank supports the objective of providing pensioners with a return on their savings consistent with that afforded to other retail customers and in keeping with appropriate market developments. Reflecting the recent easing in monetary policy the current deeming rates are at levels significantly above market rates for comparable at call deposit accounts. This is demonstrated in the ability of banks to raise funds in the wholesale market at around 7% for large amounts (common parcels of $5m) at very low administrative cost. Rates on offer for retail deposits are in the vicinity of 1.50-3.50% for at-call funds or 5.75-6.00% for a six month term deposit of up to $100,000. Clearly the current deemed rates of 5% for amounts up to $30,000 and 7% thereafter are severely out of alignment.

The arrangements entrench cross-subsidies and undermine the competitiveness of the banking sector. Other bank customers, such as homebuyers, existing mortgage holders and businesses, are forced to pay to meet the cost of this cross-subsidy.

Whilst there is no legislative requirement for banks to offer the deemed rates of interest, the overwhelming expectation of pensioners has been that their bank will pay interest in terms of the Government's deeming arrangements. The rate has a 'government sanctioned' quality which creates a raised expectation/demand on the part of pensioner customers for an account that pays those rates. Given the size of the funds now involved and their growth, this response can be expected to increase in significance over time. Since their introduction the balance of deemed accounts has grown to around $11 billion.

The severe repercussions of the current deeming arrangements on the prudent management of banks' balance sheets and the inequitable impost on other customers by the artificially high interest rate outcomes of the deeming arrangements, call for early and decisive action to place the deeming arrangement on a footing consistent with a market based financial system.

Reflecting the above concerns it is recommended the Government develop equitable basis for setting and adjusting deeming rates.

(ii) Fee Free Accounts

Reflecting strong Federal government suasion banks are required to provide customers with access to a basic banking service on a fee free basis. Much of the pressure for this has come from ill-informed debate as to the social responsibilities of banks in meeting customer needs.

Funding social services through internal cross-subsidies results in hidden costs, economic inefficiency, horizontal inequity and poor targeting of beneficiary groups. **In as much as banks may be required by government to provide a banking service which goes beyond that which might normally be provided, the costs of provision should be clearly recognised and funded through the budget process**.

(f) Government Imposed Regulatory Overheads

In addition to its direct operating expenses, the Bank is subject to a number of government imposed overheads in relation to which substantial costs are incurred. This has a direct and obvious flow on effect to the pricing of banking services to customers.

Major examples include:

(i) Financial Institutions Duty/Debits Tax (FID/DT)

These duties which are 'transactions'-based, are levied in all States and Territories, except Queensland. Arrangements are not uniform. While legislation provides for the recoupment of FID from customers, the significant costs of the development of necessary systems for monitoring, reporting and charging appropriate amounts must be borne by the Bank. In the year ended 30 June 1996, the Bank paid around $350 million to the various State governments in FID/DT. **These taxes on financial transactions are distortive, regressive and inefficient and should be abolished.**

(ii) Financial Transaction Reports Act (FTRA)

The Bank is required to report to the Australian Transaction Reports and Analysis Centre details of all cash transactions with customers of $10,000 and over. There is an additional obligation to report transactions which are considered ‘suspicious’. Scope of the Act extends beyond money laundering to suspicious breaches of taxation and social security law.

There are very significant indirect and ongoing monitoring and staffing costs associated with adhering to responsibilities under the FTRA (estimated annual costs $6 million).

The requirement for banks to be suspicious of their customers and form views on whether their transactions are suspect is contrary to a proper commercial relationship and to the privacy of customers’ banking transactions.

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.