Introduction

1. The Commonwealth Treasurer, Mr Peter Costello, announced on 30 May 1996 the establishment of an Inquiry into the Australian Financial System ("the Inquiry"), to report to him by 31 March 1997.

2. The Inquiry will report on the effects of financial deregulation in the 1980s, identify the factors likely to drive further change in the financial system and make recommendations on the regulatory arrangements affecting the operation of the financial system, including prudential and other regulations made by the Reserve Bank of Australia ("RBA") and other regulatory authorities.

3. The Victorian Government strongly supports the Inquiry and its terms of reference. This Submission focuses primarily on the key issue of the structure of the arrangements for both the effective national prudential supervision of financial institutions and the regulation of the products they provide. The Submission also comments on issues surrounding Financial Institutions Duty, Bank Accounts Debits Tax, Stamp duties and taxation reform.

4. In preparing Victoria's Submission the Department of Treasury and Finance has received and drawn on submissions prepared by the Victorian Financial Institutions Commission ("VicFic"), the State Revenue Office, the Departments of Premier and Cabinet and State Development and the Office of Fair Trading which reports to the Attorney General.

Summary of Recommendations

5. Victoria recommends that the regulatory and prudential supervision framework be largely retained in its current form subject to:

   - the States and Territories (the "States") transferring to the Commonwealth responsibility for the supervision of all State based non bank financial institutions ("NBFIs"). Transfer of this responsibility, in Victoria's case, is subject to the Commonwealth agreeing to or accepting the preconditions outlined later in this Submission.

     The conditions include an ongoing commitment and guarantee from the Commonwealth that the supervision of NBFIs will meet the same high standards which have been set by VicFic under the State based arrangements;

   - consideration being given to transferring responsibility for the supervision of unit trusts providing superannuation products established under the Corporations Law to the Insurance and Superannuation Commission (the "ISC"); and

   - the Council of Financial Supervisors being retained and strengthened with a primary focus on institutional and financial system stability and a secondary focus on competitive neutrality in the supervision or regulation of similar products.

6. Victoria acknowledges that the taxes it imposes on financial transactions, specifically Financial Institutions Duty, Bank Accounts Debit Tax and Stamp duties are narrow and inefficient and place the Australian financial system at a competitive disadvantage. The vertical fiscal imbalance between the States and Commonwealth however, leaves the States with no option other than to levy these taxes. The reality is that these taxes can only be eliminated in the context of overall tax reform.

Observations on Post Campbell Committee Events and Financial Deregulation

7. The deregulation of the financial system commenced in 1983 following the release of the Campbell Report in 1981 recommending extensive financial deregulation. Deregulation was a result of pressures which had built up in the Australian regulatory framework and the overseas trend towards deregulation. Deregulation which included the removal of quantitative lending and interest rate controls on banks, the floating of the Australian dollar, the removal of the restriction of Australians purchasing shares and real estate overseas and the entry of new banks, significantly changed the Australian financial system.

8. Deregulation resulted in a more competitive but also more volatile Australian financial system with increased volatility in exchange rates and interest rates. Banks became more competitive in the lending area and took back some of the market share they had lost to NBFIs. Deregulation has also seen a growth in the insurance/funds management sector, again largely at the expense of NBFIs.

9. The Campbell Committee warned there was a need to increase prudential supervision to counter the effects of financial deregulation. It was recognised by the Campbell Committee that the deregulation of many of the controls on the financial system, the banks in particular, provided greater autonomy and that this autonomy brought greater risks to individual institutions and the financial system.

10. There was a lag in timing between the Campbell Committee’s recommendation to increase the level of supervision and the actual development and implementation of new prudential standards. This lag reflected both the speed with which institutions availed themselves of the benefits of deregulation and the difficulty supervisors and regulators have in foreseeing and quickly responding to extensive changes in the nature of the products, institutions and markets they are regulating. The prudential supervision that emerged focused largely on the major financial institutions and the main stream products they were delivering to the market.

11. Victoria was seriously affected by the failure of financial institutions in the late 1980s and 1990. The circumstances surrounding the collapse of specific Victorian financial institutions is now on the public record, through the Fergus Ryan Report on the Victorian Economic Development Corporation, the Habersberger Report on the Farrow Group of Building Societies and the Tricontinental Royal Commission. Relevant extracts from these documents can be supplied to the Inquiry on request. Victoria however, was not the only State affected by the collapse or failure of

financial institutions. The State Bank of South Australia collapsed and the losses of the major banks in the early 1990s had a significant effect on the economy nationally.

12. It is important that any changes to the current supervisory arrangements take account of the lead time necessary to develop and implement new prudential standards and bed down any new supervisory structures. Depending on the recommendations of the Inquiry for the structural arrangements for supervision and regulation, it may be appropriate for there to be a further review or examination of the adequacy of the specific form and approaches adopted to prudential supervision or product regulation in the context of those recommendations.

Changes in the Financial System

13. A number of important changes are currently occurring in the Australian financial system. These include:

- the emergence of new suppliers of traditional products, for example mortgage originators offering housing loans. It is estimated that mortgage originators such as Aussie Home Loans have captured up to 10% of the new home loan market in the past few years;

- technological developments which have facilitated the emergence of new delivery systems such as EFTPOS, stored value cards and home-banking (via a computer terminal or telephone) and the likely emergence of new 'players' in the financial system in the near future, for example Microsoft and Intuit are both currently developing (in conjunction with a number of U.S. banks) an electronic banking service to be offered to the public.

  The technological developments are also expected to enable "real time" settlement of exchange settlement accounts with the RBA. Real time settlement will reduce the potential for systemic risk - and may eventually lead to a greater number of participants being admitted to the payments system increasing competitiveness with less overall risk to the system;

- the growth in managed funds and superannuation relative to the assets of deposit taking institutions. Fund managers now control approximately 39 per cent of the finance sector's assets, compared with 26 per cent in 1980; and

- the convergence of institutions, for example banks offering life insurance and superannuation products and a number of life insurance companies are now offering housing loans. This has resulted in the emergence of financial conglomerates which offer virtually all types of financial products within a single group structure.

14. The changes outlined above have led to a reassessment of the current regulatory structure. Some commentators believe that financial institutions such as banks and life insurance companies and the products they offer have now (or soon will) become

so similar that the current institutional approach to prudential regulation, with different regulatory authorities applying different rules and regulations to institutions which offer essentially the same products, is inequitable, outdated and inefficient.

15. It has been suggested that the existing supervisory authorities should be combined under one mega regulator and that supervision should be focused on products or functions and not on the institutions providing the products (although in theory a mega regulator can adopt either a product or institutional approach or an approach which is both institutional and product based). Some commentators have also argued that building societies and credit unions, which are deposit taking institutions, should be supervised by the RBA or some other national body responsible for the supervision of all deposit taking institutions.

16. Any changes to the supervisory and regulatory arrangements must take into account the objectives of supervision and regulation and the current, as well as anticipated, structure of the financial system. After reviewing the current arrangements, the objectives of supervision and the structure of the financial system, Victoria does not believe the changes to the financial system are of sufficient magnitude to justify the establishment of a mega supervisor at this time. Victoria believes that the anticipated changes to the financial system can be accommodated by strengthening the role of the Council of Financial Supervisors. Victoria does however believe that subject to certain preconditions there is scope to transfer responsibility for the supervision of State based NBFIs to the Commonwealth.

Objectives and Forms of Supervision and Regulation

17. In assessing the appropriate institutional structure and approach to supervision it is important to distinguish between the terms supervision and regulation, the different objectives of supervision and regulation and how those objectives are met.

18. The term regulation, often associated with competition and product regulation entails the establishment of rules or behaviour and formal business requirements. Supervision however, concerns establishing prudential standards, monitoring compliance with those standards and developing early warning systems to detect difficulties within an institution or industry.

19. There are three principle objectives behind the supervision and regulation of financial institutions and the products they provide. These objectives are briefly outlined below.

Competition

20. The Commonwealth's framework for competition policy which is aimed at ensuring that markets are free and competitive is set out in the Trade Practices Act which is administered by the Australian Competition and Consumer Commission ("ACCC"). The ACCC is responsible for monitoring and enforcing competitive conduct rules in all markets including the financial market. It seeks to ensure that market participants

operate efficiently and that the conditions for the creation of barriers to open and fair competition are kept to a minimum. The ACCC's regulatory activity encompasses but is certainly not limited to financial markets.

Product Regulation

21. Product regulation is directed towards ensuring that investors and borrowers (particularly in the retail market) are treated fairly and equitably by financial institutions. Product regulation establishes rules and standards covering the terms and conditions of specific products, disclosure of information to customers, dispute resolution etc. Examples of this type of regulation can be found in the Uniform Credit Code, the terms of reference of the Banking Ombudsman, the prospectus provisions of the Corporations Law covering unit trusts and some of the activities of the ACCC. Uniform product regulation also facilitates the objective of competition in that it helps to ensure that similar products are regulated on a similar basis no matter which type of institution is offering the product.

22. The main justification for product regulation is that information asymmetries exist between the depositor or investors and the financial institution which cannot be overcome by the individual without incurring high transaction costs. Information asymmetries in financial markets are generally considered to be minimised most efficiently through some degree of regulation and supervision. Hence in economic terms it is the lessening of this market imperfection and potential market failure that is the rationale for product regulation.

23. This form of regulation focuses on consumer/investor protection issues and does not address risk management of financial institutions or the financial system. This form of regulation is broad, extending beyond the financial markets and cannot expect to adequately address risk in the financial system.

Prudential Supervision

24. Prudential supervision aims to ensure that institutions and the financial system more generally remain solvent, viable and stable. This form of supervision is, by definition, institution based and has focused on deposit taking institutions and insurance companies.

25. Deposit taking financial institutions' susceptibility to systemic risk distinguishes them from other financial institutions and providers of financial services. Although deposit taking institutions carry a degree of risk accepting deposits repayable at call or at a future date and transforming these short dated liquid liabilities into long term illiquid assets, they are perceived as a safe haven for the savings of average Australians.

26. Deposit taking institutions also participate in the payments system through exchange settlement accounts overseen by the RBA. These exchange settlement accounts facilitate the settlement of financial transactions which in turn facilitate the trade in goods and services in the economy.

27. Given the asset/liability mismatch within deposit taking institutions and their role in the payments system, prudential supervision involves establishing and monitoring compliance with prudential standards covering such things as minimum capital, liquidity ratios and large exposure requirements and risk management systems.

28. Financial system stability or the avoidance of systemic risk is seen to be a requisite for and to reinforce confidence in the broader economy. System stability seeks to avoid what is commonly seen as contagion risk where the failure of a single institution spreads to other institutions or the system as a whole. A financial "meltdown" would obviously have serious consequences for the national economy.

29. The collapse of the Farrow Group of Building Societies had a significant impact on Victorian investors and institutions and the Victorian economy. A number of Victorian based building societies, credit societies and regional banks suffered potentially serious "runs" following the collapse of the Societies. The collapse also had the potential to have a flow on effect to the broader financial system. In the absence of industry based liquidity support schemes the situation was only controlled following the establishment of a Government backed liquidity support scheme.

Risk Allocation and Regulation/Supervision

30. In general, the framework for regulation and supervision adopted has depended on the allocation of risk between the investor/customer and the institution providing the product or service. The greater the allocation of risk to the investor/consumer, the greater the emphasis on product regulation and disclosure. The greater the retention of risk by the institution, the greater the emphasis on prudential supervision.

31. For some products little risk is borne by the consumer or investor such as with bank deposits, capital guaranteed products and traditional insurance contracts to cover defined future events, while for other products such as unit trusts, the risk is borne by the consumer. Risk allocation is not necessarily so clear cut however, as what appear to be functionally similar products are in fact offered to consumers with different allocations of risk between the institution and the investor/consumer. An investment in an investment linked product with an insurance company will carry a different risk allocation than an investment in a capital guaranteed product.

32. In addition to different allocations of risk between investors and institutions, institutions providing similar products will carry different levels of risk. This spectrum of risk between institutions providing similar products is recognised by the rating agencies in the ratings that they assign to individual institutions and products.

33. The spectrum of risk inherent in different products and institutions should continue to influence the focus of product and prudential supervision arrangements. A system of regulation and supervision that does not recognise the spectrum of risk inherent in

different institutions and products and the need for different levels and intensity of supervision will be incomplete.

Structure of the Financial System

34. Tables 1 and 2 below sourced from the RBA Bulletin April 1996, show the control of assets in the financial system as at June 1980 prior to deregulation and at June 1995.

35. Table 1 below shows the control of assets between banks, other financial intermediaries and fund managers and insurers. Financial intermediaries which include building societies, credit unions and finance companies are institutions which borrow and lend money. Insurers and fund managers provide products which protect customers against the risk of some future event occurring and manage funds on behalf of others. The table shows that banks have marginally increased their asset share since deregulation, while fund managers and insurers have increased their ownership or assets under management by 15% at the expense of other financial intermediaries.

TABLE 1
Australian Financial System Assets

	June 1980 %	June 1995 %
Banks	42	46
Non Bank Financial Intermediaries	32	15
Total Intermediaries	74	61
Fund Managers and insurers	26	39

Source : Reserve Bank of Australia Bulletin April 1996
“Recent Trends in the Financial System”, p38

36. Table 2 below shows that both banking and insurance groups have increased their asset share at the expense of other players in the system since 1980. The table also shows that the banking groups continue to control over half the financial systems assets. The assets controlled by the State Bank of NSW are included in the Insurance Groups.

TABLE 2
Australian Financial System Assets

	June 1980 %	June 1995 %
Insurance Groups	18	23
Banking Groups	53	56
Other	29	21

Source : Reserve Bank of Australia Bulletin April 1996
“Recent Trends in the Financial System”, p42

37. The increase in fund managers and insurers share in the financial system's assets reflects a decline in the flow of household savings into banks. In the 1970s, 42% of household savings flowed to banks and 20% to life offices and superannuation funds. In the 1990s, these numbers are 27% to banks and 55% to life offices and superannuation funds (Source: RBA Annual Report 1996). This may suggest that banks are losing dominance of the financial system. However, banks also play a significant role in the funds management and insurance sector (holding 25% of assets in this sector) of the financial system through subsidiaries. Hence the decline in the flow of savings to banks has not resulted in the lessening of the banking groups control of financial system assets.

38. Table 3 below shows the control of assets in managed funds in the financial sector.

TABLE 3
Assets of Fund Managers In Australia

	June 1990 %	**June 1995** %
Insurance Groups	45	39
Banking Groups	21	25
Other	34	36

Source : Reserve Bank of Australia Bulletin April 1996
"Recent Trends in the Structure of the Financial System", p42

39. Approximately 70 per cent of the financial system's assets are now managed by the 30 largest conglomerates. It is important to note however, that financial conglomerates provide their products through separate legal entities. Among the 30 largest conglomerates 11 include a bank accounting for more than 75% of the groups total assets and 4 include a life insurance company which has more than 75% of group total assets. Typically the bank or insurance company has acted as the holding company for the remainder of the groups assets. It is likely however that as the dominant form of activity declines conglomerates will seek to have all their business held by a holding company. Currently holding companies are being required to broadly diversify their shareholding.

40. Attachment 1 sets out, in more detail, the institutional share of assets in the financial system.

Current Supervisory Arrangements

41. The current supervisory arrangements reflect the products provided by the institutions and the allocation of risks between the institutions and their customers.

42. Currently there are three main prudential regulators in Australia:

– the RBA has supervisory responsibility for Australian banks. This is in addition to the RBA's responsibility to manage monetary policy. As indicated above, banks represent 46 % of the financial system's assets excluding their insurance and fund management subsidiaries or 56% of the financial system's assets including these subsidiaries. Banks are the dominant participants in the Australian payment system accessed through exchange settlement accounts with the RBA and hold their liabilities predominantly in the form of fixed or at call deposits. Given the promise made to depositors and the dominant role banks continue to play in the financial system, the RBA imposes a range of prudential standards on banks designed to manage the risks inherent in the business of banking and the potential for a failure to have flow on effects to the national economy;

– the ISC supervises insurance companies (both life and general) and superannuation funds. Life companies whose business can be largely characterised as funds management provide insurance and superannuation products through statutory funds. Life companies hold 39% of the assets of managed funds. Life companies are required to hold capital adequacy reserves to ensure statutory funds can fund future business plans and withstand large financial shocks and solvency reserves for individual statutory funds. The level of reserves held by the individual statutory funds depends on risk allocation, that is, whether the products are "capital guaranteed" or investment linked. The ISC also supervises general insurers which are required to meet minimum solvency standards.

  Superannuation funds represent the long term retirement savings of Australians and must be managed by the trustees of these funds to meet the liability profile and the risk and return expectations of the members of the fund. The assets of Australia's superannuation funds currently stand at $244 billion and are expected to grow significantly and continue to increase in terms of market share. This responsibility represents a significant moral hazard to the Commonwealth as Australians are compelled to invest in superannuation funds and these funds are preserved in the system until the superannuant reaches a minimum age.

  To meet this responsibility the Commonwealth has enacted the Superannuation (Industry) Supervision Act (the "SIS Act"). The SIS Act focuses on and codifies the common law duties of trustees and requires trustees to develop long term investment strategies for their investment portfolios. The major Victorian public sector superannuation authorities are exempt from the SIS Act and are supervised by the State in accordance with an agreement between Victoria and the Commonwealth; and

– under the Financial Institutions Scheme, the Australian Financial Institutions Commission ("AFIC") sets prudential standards under which the state-based supervisory authorities ("SSAs") monitor compliance by building societies and credit unions (and friendly societies from 1 January 1997). VicFic is the SSA in Victoria. Building societies and credit unions only represent 3 % of the finance sector's assets. Friendly societies which are predominantly based in Victoria represent 0.8 % of the finance sector's assets. There are also plans to bring responsibility for prudential standards to apply to trustee companies under AFIC and the SSAs. Trustee companies manage common funds which are pooled investment products and managed estates of deceased persons.

43. Each of these authorities has some product regulatory functions, in particular the regulation of the superannuation industry may be characterised as both product and prudential regulation. The primary focus of the RBA is prudential regulation to ensure the stability and viability of the financial institutions which they supervise. The RBA and to a lesser extent AFIC\SSAs, which supervise bodies with access to exchange settlement accounts in the payments system, are concerned with system stability and the avoidance of systemic risk.

44. The Australian Securities Commission ("the ASC") is primarily concerned with the enforcement of the Corporations Law and the integrity of capital markets. Although it performs product regulatory functions in respect of at least 420 public unit trusts with around $46 billion under management, it is not strictly a prudential supervisor as is the RBA, AFIC or the ISC in respect of some of its activities. This reflects the fact that the return provided by a unit trust is determined by the performance of the investment portfolio of the unit trust. Generally the ASC focuses on regulation via disclosure and the principle of "caveat emptor" applies.

45. Each of these four bodies is a member of the Council of Financial Supervisors, a non-statutory body which was established in 1992 to discuss issues of common interest and to help avoid regulatory overlap and unnecessary inconsistencies in the approach of different regulators. An issue of particular importance to the Council of Financial Supervisors, and one of the main reasons for its establishment, involves the supervision of financial conglomerates. The Council of Financial Supervisors has recently established guidelines to address this area and is seeking legislative authority to enable greater formal co-operation and information exchange among its four bodies.

Arguments for a Mega Supervisor

46. The development of financial conglomerates, the growing belief that products need to be supervised in a competitively neutral manner irrespective of the institution providing the product and economies of scale are the major reasons advanced for the establishment of a mega supervisor or regulator. Each of these arguments is considered below.

Competitive Neutrality and Product Regulation

47. A supervisory approach based on product regulation suggests that prudential requirements would be attributed at the product level. This would see similar products offered by different institutions supervised in a way which is competitively neutral. Under this approach mortgage originators, which raise funds in the wholesale market or under the prospectus requirements of the Corporations Law, and banks which extend housing loans, would meet the same prudential standards. Either

mortgage originators would be required to meet the prudential standards imposed on banks, designed to protect the banks, their depositors and stability in the financial system or the banks would be released from meeting these standards.

48. In Victoria's view this is a flawed approach given the current structure of the financial sector and the existence of banks and insurance companies which remain the dominant players in this sector. These institutions provide specialist products and an industry focused approach to supervision has developed around those products. The often quoted phrase is that it is institutions not products that fail and threaten the financial system. The approach misses the fundamental point that in the case of deposit taking institutions which participate in the payments system and carry a significant asset/liability mismatch, institutional prudential supervision is the only effective means of addressing the risk within those institutions and ensuring system stability.

49. In the case outlined above involving competition between mortgage insurers and banks, it is open to the banks to establish off balance sheet securitisation vehicles which raise funds in the wholesale market and either acquire housing mortgages from the bank or originate new mortgages. If banks took this step they would not have to hold capital against the credit risk inherent in these loans and competitive neutrality would be restored.

50. Prudential regulation should be designed to reflect the risk allocation of products or services in any particular market. While there is a need for regulators not to inhibit innovation and competition in financial markets and for functionally similar products to be regulated as similarly as possible, these goals should not be construed as a need to replace institutionally based prudential regulation with product regulation.

51. There is a necessary trade off between competitive neutrality and the promotion of fully effective and efficient markets and system stability in the financial markets. Perfect competitive neutrality between products in financial markets should however be the benchmark that a system of institution based prudential supervision must strive to meet wherever possible.

Conglomerates

52. Conglomerates provide a wide range of products and increase the complexity of supervision and regulation. The emergence of conglomerates raises the issues of whether supervision should focus on the product or the institution and whether there should be one or more supervisors.

53. The approach to the supervision of conglomerates depends to a large extent on the corporate structure under which they provide their products and services, this in turn is often a function of the importance which is placed on banks and the potential for a bank failure to generate systemic risk.

54. Where banking, insurance and funds management products are provided under one corporate structure the risks faced by the institution will become more complex and

interrelated. In this situation it would be necessary for one supervisor to be responsible for overseeing all the operations and products of the institution if they were carried on a single balance sheet. If however, conglomerates are required to provide banking, funds management and insurance products through different legal entities, the argument for a mega supervisor is less important. In these circumstance each of the institutions comprising the conglomerate can be supervised on a discrete institutional basis provided appropriate arrangements are established to coordinate the supervision of the conglomerate as a whole on the basis of a dominant business activity test.

55. In Australia conglomerates are required to conduct their banking, insurance and funds management activities in separate legal entities so as to prevent the risks of one operation affecting the viability of another operation. The legal structure of conglomerates therefore reduces the need for a mega supervisor to manage the risks posed by conglomerates.

Economies of Scale

56. VicFic and the other SSAs have operated successfully as a mega regulator at a State level and achieved economies of scale.   While the mix of responsibilities varies around the States, VicFic is responsible for the prudential supervision and product and corporate regulation of a range of State based non bank financial institutions. These institutions are however relatively small and their operations are largely localised to the State in which they are incorporated.

57. At a national level however, there seems little benefit and limited economies of scale arising from incorporating the ACCC and the ASC into a mega regulator. Each of these authorities has a different perspective and a different focus from that of the RBA and the ISC. Also the regulatory activity of these authorities encompass more than just the financial markets.

58. The proposal to combine the ISC and the RBA is not supported by Victoria. The RBA is a prudential regulator. The ISC is responsible for both prudential and product regulation. The products of the banks, the insurance companies and superannuation funds carry significantly different risk allocations between the provider and consumer and differing approaches and skill sets are needed for supervisors and regulators in the existing areas of responsibility of the RBA and the ISC. The skill sets of regulators encompassing both areas of RBA and ISC regulation would need to be extremely broad to focus on deposit taking institutions, insurance products, funds management products and superannuation products. The supervision of banks and insurance companies is therefore still best accommodated by retaining the two specialist supervisory bodies.

59. The blurring of financial products and institutions means that the spectrum of risk in financial markets is becoming less easy to recognise. If the functions of the ISC and the RBA were combined there would potentially be a further blurring as to the promises made by institutions and the allocation of risks in the products being offered.

60. Finally, the merger of the RBA and the ISC may lead to the creation of a new supervisory body separate from the RBA and the separation of monetary policy and the prudential supervision of banks. While there are a number of countries which have separated these roles, this is not seen as a desirable outcome. The RBA has traditionally provided a lender of last resort facility to Australian banks. The RBA would have more difficulty in assessing the position of a bank requesting liquidity support if the RBA was not also the supervisor. Furthermore the supervision of banks and insurance companies and superannuation funds by a single supervisor may lead to an expectation that the lender of last resort facility has been extended to insurance companies and superannuation funds.

Recommendations for Supervisory Regulatory Framework

61. In Victoria's view the appropriate regulatory framework at a national level is the lead regulator model similar to the approach that the Council of Financial Supervisors has begun to adopt.

62. Victoria views the Council of Financial Supervisors and the lead regulator model as an effective base for addressing the issues of competitive neutrality in regulation and the supervision of financial conglomerates over the medium term. If in the longer term the forces leading to convergence particularly between banks and life insurance companies intensify, the lead regulator model should form a sound platform for the establishment of a mega regulator combining the supervisory responsibilities of the RBA and ISC.

63. Victoria recommends that the regulatory framework be largely retained in its current form. Victoria does recommend however that:

- the States transfer to the Commonwealth responsibility for the incorporation and supervision of State based NBFIs. There are however preconditions to this transfer of responsibility and those preconditions are outlined at paragraph 70 below. The preconditions recognise the need for supervisory requirements which reflect the differing industry sectors and structures.

  The rationale for transferring responsibility to the Commonwealth rests on building societies and credit unions performing similar functions to banks and friendly societies performing similar functions to life insurance companies. The institutions are subject to similar prudential standards and some of the institutions, particularly the industrial credit unions and the larger friendly societies operate nationally. Finally State based NBFIs only represent around 3.8% of the financial system's assets and, from a national perspective, it would be more efficient for these institutions to be supervised by nationally based supervisory bodies. There are potentially further economies of scale and cost savings if State based NBFIs are subject to national supervisory arrangements;

- consideration is given to transferring the supervision of unit trusts providing superannuation products established under the ASC to the ISC. This would remove the requirement for these trusts to comply with the prospectus provisions of the Corporations Law. The ISC would set more appropriate requirements covering the form of the trust, the contents of the disclosure documents and any relevant solvency requirements.

- the Council of Financial Supervisors should be retained and strengthened and follow closely the developments taking place overseas which promote the co-operation between supervisors in different member countries.

  Each supervisor should generally retain its current responsibilities. Where financial conglomerates operate in several product areas of the financial system, one supervisor should be appointed as lead regulator to oversee the position of the conglomerate from an overall risk and prudential perspective and initiate any action required for prudential purposes. The question of which regulator should lead the supervision of a particular financial conglomerate should be determined through a dominant business activity test.

  The Council of Financial Supervisors could be strengthened by meeting more regularly and possibly having its role and responsibilities enshrined in legislation. The Inquiry may see the benefit in the establishment of an independent secretariat to support a formalised role for the Council of Financial Supervisors.

  The Council of Financial Supervisors should closely monitor the developments occurring overseas. The factors which are likely to drive change in the Australian financial system and lead to the convergence of financial institutions are also driving change at the international level. In recognition of these changes and the rise of financial conglomerates the Bank of International Settlements, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors are now seeking to promote multilateral co-operation between supervisors in member countries. In 1995 the three international supervisory bodies of bank, securities and insurance supervisors (the "Tripartite Group") released a report on the types of problems financial conglomerates pose for supervisors and the ways in which these problems may be overcome. In particular, the Council of Financial Supervisors should address the problem of contagion within a conglomerate.

  The Council of Financial Supervisors is already monitoring and drawing upon developments occurring overseas. The 1995 Annual Report for the Council of Financial Supervisors stated that the Tripartite Group is to draw up proposals for improving co-operation and the exchange of information between bank, insurance and securities supervisors, and to work towards developing the principles for the future supervision of financial conglomerates.

State Based Non Bank Financial Institutions

64. The States are currently responsible for supervising a range of State based NBFIs which include building societies, credit unions, friendly societies, cooperative housing societies and trustee companies. In Victoria, VicFic is responsible for supervising all of these institutions with the exception of trustee companies which are supervised by the Office of Fair Trading. As indicated above, it is planned that the supervision of both friendly societies and trustee companies will be transferred to AFIC and VicFic.

65. Tables 4 and 5 below provide a breakdown of Victoria's NBFIs.

TABLE 4
Number of Societies and Total Industry Assets as at 31 March 1996 (1).

	Number of Societies	Total Assets ($M)
Credit Unions	71	2,642
Building Societies	5	1,249
Friendly Societies	65	6,662
Trustee Company Common Funds	13	1,721
Co-operative Housing Societies	736 (or 53 'groups')	838
Total	890	13,112

TABLE 5
Asset Distribution as at 31 March 1996 (1)

Assets ($M)	Number of Societies					
	CHS Groups	Credit Unions	Building Societies	Common Funds	Friendly Societies	Total
0-1	18	8	1	-	24	51
1-10	24	22	-	2	23	71
10-50	7	28	-	4	10	49
50-100	3	5	-	1	1	10
100-500	1	8	3	6	2	20
> 500	-	-	1	-	5	6
Total	53	71	5	13	65	207

(1) CHS figures are as at 30 April 1995 (the latest available data).

66. Although Victoria supports transferring responsibility for the regulation and supervision of State based NBFIs to the Commonwealth, transfer is subject to a number of preconditions. These preconditions arise from differences between State based NBFIs and banks and insurance companies, the approach to supervision required by these differences and the non supervisory functions which VicFic is required to perform.

67. The features distinguishing building societies and credit unions from banks and the smaller friendly societies from life insurance companies include:

- size;
- regional focus;
- ownership structure;
- legislative environment; and
- the existence of State based credit union contingency fund and national industry based liquidity support schemes.

68. VicFic's approach to prudential supervision, detailed in Attachment 2 focuses on analysis of regular financial reporting, on-site inspections (routine and special) and general supervision (approvals, exemptions, policy development etc). VicFic's approach to supervision differs from that taken by the RBA and possibly the ISC. While the RBA receives and analyses regular financial reports it does not conduct regular on site inspections. Although the RBA has commenced reviews of discrete areas of a bank's business it generally relies on the reports it receives from the external auditors of the banks and the discussions it holds with key managers within the banks.

69. The major non-supervisory functions of VicFic are detailed below:

– There are some 300 separate discretions or powers under the legislation which have to be routinely exercised by VicFic. These include such things as the issue of directors' licences, applications for statutory approvals, approval of the acquisition of subsidiaries and the raising of funds, proposals for the raising of subordinated debt, applications for exemption from the provisions of the legislation, scrutiny of disclosure documents, approvals of auditors and actuaries, approvals of mergers and transfers of engagements, rule changes, registrations of new societies and liquidations.

– VicFic administers and manages the Credit Union Contingency Fund (basically established to provide protection to depositors of credit unions). AFIC is responsible for administering and managing the national industry based liquidity support funds.

– Maintenance of public records and registers and dealing with freedom of information requests.

– Dealing with requests from societies and their advisers for advice and assistance on relevant legislation and the prudential standards.

– VicFic receives complaints about societies from members. VicFic determines whether the complaint involves a breach of the legislation or the rules of the society and if it does takes appropriate action.

Conditions for the Transfer of State Based NBFIs to the Commonwealth

70. Victoria supports responsibility for the supervision of building societies and credit unions being transferred to the Commonwealth subject to:

- the Commonwealth accepting responsibility for all State based NBFIs currently supervised by VicFic and trustee companies. This would involve the Commonwealth taking responsibility for the supervision of friendly societies, cooperative housing societies and trustee companies as well as building societies and credit unions.

  Building societies and credit unions would be supervised by the RBA. Friendly societies provide their investment products through benefit funds which are not dissimilar to the statutory funds managed by life insurance companies and would logically be supervised by the ISC. Trustee companies have similar funds management products in the form of common funds and could also be placed under the ISC. Housing cooperatives which do not take deposits and raise their funds in the wholesale market would most likely fall under the RBA and be supervised by its regional office.

  In assuming responsibility for the supervision of the cooperative housing societies the RBA would need to recognise that the State of Victoria has guarantees and indemnities of $277 million to these societies and that it has an ongoing exposure to these societies;

  In addition to assuming responsibility for the prudential supervision of these bodies, the Commonwealth would also be assuming responsibility for their corporate regulation. This would involve all State based legislation being repealed and being enacted as Commonwealth legislation;

- the Commonwealth accepting that it will have a dual role of setting regulatory standards and supervising compliance with those standards by NBFIs. This includes recognition of the impact that the failure of one of these institutions can have on a localised area within a State if the institutions are not rigorously supervised and a requirement by the Commonwealth that the RBA and the ISC retain the same rigorous approach to supervision and the conduct of on site inspections as is currently in place in Victoria.

- the RBA continues to manage the industry based Contingency Reserve Fund for credit unions;

- the RBA continues to manage the industry based liquidity support schemes established for building societies and credit unions or accepts it has a responsibility to act as lender of last resort;

- the SSAs and their staff are merged with the regional offices of the RBA or the ISC; and

- the Commonwealth providing an ongoing commitment and guarantee that the supervision of State based NBFIs will meet the same high standards which have been set by VicFic under the State based arrangements.

State Taxation Imposts on Financial Institutions

71. The vertical fiscal imbalance between the States and the Commonwealth has resulted in the States maintaining a range of narrow-based and inefficient taxes. These are usually riddled with different exemptions or thresholds, have multiple rate structures and high collection costs. Four of these main State taxes which impact on the way financial markets operate are Financial Institutions Duty ("FID"), Bank Accounts Debits Tax ("Debits Tax"), Marketable Securities Duty ("Share Duty") and Loan Securities (or Mortgage) Duty.

72. Attachment 3 sets out details on these taxes and how these four taxes operate. The discussion below evaluates the merits of these taxes and the effort that Victoria is taking to reform these taxes in a way which is designed to mitigate any harmful impacts on financial markets. However, it is concluded that the amount of effort that Victoria can exercise unilaterally to repair these taxes is limited by the current parlous state of Commonwealth-State financial relations and the need for tax reform at a national level.

FID and Debits Tax

Background

73. Victoria recognises that Australia is the only nation in the world to explicitly tax financial transactions and that this puts the Australian financial system at a competitive disadvantage in the global financial market. FID and Debits Tax however, raise significant revenue for Victoria and some other States. In the absence of broader national reform to address the vertical imbalance and the revenue raising powers of the States, Victoria will be forced to rely on inequitable and inefficient taxes such as FID and Debits Tax for some time.

74. FID was a national growth tax to the end of the 1980s. However, a 1990s decline in real growth in FID revenues was triggered by:

   - a doubling of the maximum duty ceiling on single transaction from $600 to $1200 (referred to as "the cap"); and

   - a doubling of the primary rate of duty from 0.03 per cent to 0.06 per cent.

75. As a result, business began to utilise various tax avoidance mechanisms more aggressively than had been the case in the past:

   - by aggregating electronic and physical transactions to take advantage of the cap;

- through schemes exploiting the lower (secondary) rate of tax of 0.005 per cent on short-term dealings; and

- by the movement of funds to FID-free Queensland.

76. For most of the past 10 years Debits Tax, like FID, was a national growth tax. However, more recent relative stability in the real growth of Debits Tax revenue has also been influenced by:

- rate increases;

- movement out of cheque accounts;

- changes in the value of withdrawals including through EFTPOS;

- movement of funds to Queensland; and

- business use of single debit and multiple credit systems.

Pressures Impacting FID and BAD

77. In the current era of banking practices, it is widely recognised that FID and Debits Tax are fundamentally flawed and in need of reform. Introduced in the 1980s for a regulated, localised and paper-based banking system, the legislation now has particular difficulty in dealing with key issues posed by modern electronic payment arrangements. Further, a broad cross section of industry claims that the taxes impede efficient use and development of electronic technology and thus add to business compliance costs.

78. Technological developments are substantially changing the way business is conducted in the financial sector. For example, between 1991 and 1995, the proportion of gross payments exchanged between banks in the form of cheques and other paper debits declined from 59% to 39%[1]. Cheques still remain important for making retail payments- with around 4 million cheques being processed each business day in recent years. However, electronic payments are growing rapidly, both in the wholesale sector (up from 40% to 64% in value exchanged by banks between 1991 to 1994), and through debit cards, particularly at EFTPOS terminals[2]. There were 3.2 million debit and credit card transactions in 1994/95 totalling $320 million per day in value. ATMs grew from 4,956 to 6,175 between 1991 to 1995[3].

79. Some of the major current tax difficulties are listed below.

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1 Australian Payment Clearing Association
2 Ibid
3 Australian Payment System Council, Annual Report 1994/95, pp 45 and 70.

- Growth of electronic payment systems is expected to gradually erode the financial transactions tax base both nationally and especially for smaller jurisdictions.

- Corporates are encouraged to trade among themselves, including netting of debits and credits outside the traditional tax paying banking sector.

- Non-recognition of electronic aggregation for duty ceiling purposes may deter the adoption of new technology and more secure business practices, while at the same time distorting business and consumer behaviour.

- The relocation of banking activity to FID-free Queensland which is eroding Victoria's tax base.

- Globalisation of financial markets - including through technological applications - has the longer-term potential to replicate these avoidance effects on an international scale, leading to an erosion of the national tax base.

- An increasing range of complex financial products leads to difficult-to-identify, opaque transactions and greater funds mobility.

- Inter-jurisdictional disharmony on FID in relation to tax bases and double taxation add to business compliance costs.

- There is a limited future for the current Debits Tax regime due to:

  - its narrow base;

  - decline in cheque payments due to substitution by electronic transfers;

  - a lower Queensland rate; and

  - regressive rate structure.

- All this produces tax base erosion as well as vertical and horizontal inequities between FID customers, types of accounts and jurisdictions.

- With no Debits Tax payable on withdrawals from accounts without cheque facilities, customers are encouraged to hold inefficient multiple accounts, and or agree to complex fund transfer arrangements, with cheque facilities then separated from other accounts.

80. Provided they obtain community acceptance, stored-value cards (SVCs or smart cards) are in future likely to substantially displace EFTPOS and related electronic billing, owing to SVC cost advantages over debit cards. Relative to EFTPOS, a reduced number of bank account verifications are required when substantial values are stored on the smartcard for use in higher value, lower volume payments. Any associated move by employers to load value directly to an employee's SVC (by crediting the

issuer’s float account) is likely to substantially erode the national transactions tax base by avoiding credit and debit transactions on the employee’s own bank account.

Evaluation of the future for FID and Debits Tax

81. In March 1996, Coopers & Lybrand completed a report for the Australian Bankers’ Association (ABA) titled *FID and Debits Tax: Constraints on Australia’s Future in a Global Financial Market***.** Its sole recommendation was that FID and Debits Tax be abolished by the year 2000, with necessarily complex reform unable to remedy perceived deficiencies. No suggestions were made on how around $2 billion in national revenue could be replaced. Some of the reasons given were:

- Financial transaction taxes are unique to Australia, which will be at an internationally competitive disadvantage in a global, borderless electronic market for banking services, particularly in the Asia-Pacific Region. Victoria will be unable to maximise opportunities to develop as a regional financial centre;

- To avoid the taxes, mobile capital and transactional banking - particularly but not only by large business and high income individuals - will be driven to low cost centres off-shore or in Queensland; or result in electronic netting of trade receipts by companies. All this will create a very unstable revenue base;

- The taxes are economically distorting, penalising the use of efficient electronic technology; and impede development of new products such as multiple-purpose or sweep accounts. The taxes will be unable to cope with electronic transactions [including Electronic Data Interchange (EDI)], stored value cards, smart phones and Internet banking. Electronic banking will make it difficult, if taxes are payable at all, to trace the jurisdiction in which they are legally payable; and

- “State governments have failed in their attempts to reform these taxes and address the problems posed by electronic banking. It is time for governments to concede that reform is not feasible....”(Report, p2).

82. The Victorian Government agrees with many of the conclusions of the Coopers & Lybrand study. However, while these taxes fail many of the conventional tests of what a “good” tax should be, the reality is that they will not be abolished in the absence of fundamental tax reform, commencing at the national level. Such national tax reform must be based on broader structural reform to Commonwealth-State relations which provides more autonomy to the States in revenue raising and reduces the States’ reliance on Federal grants. In the meantime, while FID and Debits Tax are fundamentally flawed, the State cannot afford to abolish them unilaterally and forgo $570 million in revenue.

83. In the absence of national tax reform, there is no benefit to be gained from abolishing FID and Debits Tax and substituting the loss with more revenue from one or more of

the other narrow-based, dysfunctional taxes on which the State is forced to rely due to the imbalance of fiscal powers between the Commonwealth and the States.

Reform of FID and Debits Tax

84. While on the one hand continuing to push for national tax reform and the abolition of FID and Debits Tax is a first-best solution, Victoria has no choice but to work in conjunction with industry in the meantime to mitigate and alleviate some of the more harmful effects on FID and Debits Tax.

85. While the history of financial transactions tax reform has been frustratingly slow, steps are being undertaken to pursue reform. Steps being taken to reform these taxes include:

- a Committee of State and Commonwealth Treasury officials is currently reviewing debits tax for the Heads of Treasury; and

- a National Consultative Forum of revenue office and industry representatives has jointly agreed to further investigate a range of implementable FID reform options.

Conclusion

86. National tax reform coupled with a fairer distribution of revenue raising powers between the States and the Commonwealth may allow the States to dispense with inefficient taxes such as FID and Debits Tax. The Victorian Government considers this to be a vital objective to improve the competitiveness of the national economy. Meanwhile, in the short to medium term FID and Debits Tax revenues are expected to hold up and Victoria is continuing to work co-operatively with other jurisdictions and the finance industry to mitigate some of the more harmful effects of the taxes.

Marketable and Loan Securities (or Mortgage) Duty

87. The share and loan security duty are taxes on the transfer of instruments covering equity and loan capital respectively which result in an exchange of rights to financial assets. The problems with these taxes arise from the non-uniformity of rates between instruments, multiplicity of rates for some instruments and narrowness of the base due to threshold exemptions and exclusions. Thus, these taxes are generally regarded by the business community as inefficient, regressive and discriminatory.

88. The duty on these financial instruments are part of a poorly integrated array of taxes which the State is forced to use to raise revenue. These have been criticised as being *non-neutral* in terms of their impact on different methods of financing business capital acquisitions. Since share and mortgage duty apply only to specific forms of equity or borrowing instruments respectively, they interfere with the efficiency of the financial markets in ways which encourage industry to engage in complicated, and in some cases un-productive, arrangements to avoid duty.

89. For example, stamp duty applies to shares in a company or units in a unit trust but not to a whole range of derivative instruments such as options, swaps and futures. These financial instruments are used to protect the loss in the value of the securities which

are sensitive to movements in the underlying share price, interest rate or exchange rate. Where the untaxed derivative instruments are used to create synthetic portfolios as a proxy for share transactions in funds management, trading activity on the exchanges is consequently reduced affecting the revenue of brokers and clearing houses. Share duty is also avoided as a result.

90. Similarly, loan security or mortgage duty applies to specific forms of borrowings such as bills of exchange, some debentures, mortgages, unsecured notes and bank overdrafts. A large part of the duty is collected from households who pay this in addition to the duty already paid on the conveyancing when they finance part of their purchase with bank loans. In this respect, the duty penalises those who finance the purchase with bank loans and favours those who possess the required capital to finance the purchase without the need for borrowings.

91. Non-neutrality also emerges in loan security duty as a result of excluding a range of loan instruments such as government securities and bill finance. These exclusions need not necessarily result from deliberate exemptions but could arise from innovation in financial markets resulting in new products being marketed. For example, bank bills are part of the assets banks are required to maintain for the sake of liquidity. However, where these instruments are used to raise finance for businesses, they can be offered at a lower price compared to traditional loan instruments such as overdrafts. Part of the reason is that bank bills do not have to be supported by statutory deposits with the RBA, thus avoiding the regulatory cost of funds which apply to other forms of lending. By further avoiding stamp duty, there is incentive for banks to take advantage of such untaxed instruments in order to compete for new businesses.

92. It has been noted that the loan security duty was designed for the business and commercial practices of the 19th and 20th centuries and is out of place in the, sophisticated and speedy financial markets of modern day. In a global environment for finance, equity and loan markets are highly mobile and State taxation authorities are constantly trying to keep pace to protect the revenue base.

93. Essentially the conclusion is the same as for FID and Debits Tax. Admittedly, market securities duty and loan securities duty are both blunt instruments for raising revenue but there is little choice in the matter and State governments have to continued to rely on these inefficient means for raising revenue for lack of better alternatives and in the absence of reform at the national level.

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