SUBMISSION TO THE INQUIRY INTO THE

AUSTRALIAN FINANCIAL SYSTEM

From

Deborah Ralston
Director
Centre for Australian Financial Institutions
Faculty of Commerce,
University of Southern Queensland
TOOWOOMBA, QUEENSLAND 4350
Ph: (076) 312402
Fax: (076) 311527

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1. EXECUTIVE SUMMARY

1.1 Objectives of Financial Regulation

The key objectives of financial regulation are:

* ∗ stability and confidence in the financial system;

* ∗ the protection of depositors;

* ∗ efficiency in terms of allocative, operational and dynamic efficiency; and,

* ∗ competitive neutrality.

It is the contention of this submission that while existing legislation has enhanced the stability and efficiency of credit unions and building societies, thereby protecting the depositors of these institutions, competitive neutrality has not been achieved. As a consequence, cooperative societies have born a greater net regulatory burden than their competitors.

1.2 Regulation and Performance of Cooperative Societies

Both permanent building societies (PBSs) and credit unions (CUs) have shown strong and consistent performance over recent years. Balance sheets of CUs and PBSs indicate a broadening in lending activity, but a continued reliance on retail deposits which still comprise around 95% of total liabilities for both groups. The introduction of the FI Code in 1992 has strengthened the capital backing of CUs and PBSs, which have capital adequacy ratios of around 14% and 13% respectively, well in excess of the regulatory requirement of 8% and also that of the banking sector which stood at just over 11% in June 1996 (RBA, 1996). Profitability in cooperative societies has been strong with net interest margins consistently exceeding that of the banking sector over recent years.

1.3 Impact of the FI Code on Cooperative Societies

While CUs and PBSs have diversified loan portfolios to include non-traditional assets, both groups continue to demonstrate a very high degree of efficiency in their traditional lending spheres, that is personal loans and housing loans respectively. It is also evident that the experience of CUs in the area of unsecured lending has ensured a better performance in the newer lending areas. Across the board, PBSs generally demonstrate a more conservative approach to risk.

Overall, the impact of the FI Code has been to enhance the mean-variance efficiency of NSW CUs and Queensland PBSs portfolio allocation. In both cases, the efficient frontier of optimal portfolios available to institutions has moved to the left, indicating less risk at each level of return. This efficiency gain has come from expanding the range of assets available to institutions.

Neither capital, liquidity nor commercial loan restrictions bind the optimal portfolio available to institutions, but the requirement for CUs to maintain 60% of all assets as loans does impede portfolio allocation.

Recommendations
* *That the existing prudential requirements concerning liquidity and capital should be retained. These prudential measures have reduced the risk of cooperative societies without impeding the optimal portfolios of institutions.*
* *That in the interest of both allocative and dynamic efficiency regulation should not attempt to specialise or 'niche' financial institutions, and that once prudential requirements are met, institutions should be allowed maximum flexibility to define their own role, according to market demand and their own philosophy.*

While existing regulation under the FI Code has produced benefits to cooperative societies, it is imperative that the costs to institutions of this or any subsequent regulation be minimised to contain the net regulatory burden of both industries.

Clearly there are opportunities to reduce the costs of the existing scheme and therefore the net regulatory burden faced by cooperative societies through a reduction in direct, compliance and opportunity costs. This net regulatory burden has been imposed through:

- direct costs: state and federal levies have been paid to support a federal system which is too complex, prone to duplication and conflict on policy interpretation;
- compliance costs: societies have made a considerable investment in the FI Scheme through the establishment of new systems and reporting procedures; and,
- opportunity costs: the net regulatory burden faced by societies has been higher than necessary through failure to ensure lower cost of funds by addressing the level of perceived risk for the industry.

Recommendations

∗ *That cooperative society regulation be rationalised to ensure a more efficient and truly national scheme.*

∗ *That any new regulation imposed on this sector should be sympathetic with existing systems in order to minimise any additional compliance costs.*

∗ *That compliance costs for societies be reduced by ensuring that reporting to regulatory bodies conforms as far as is possible with normal financial reporting requirements.*

∗ *That supervisory resources be more efficiently utilised and the system made less intrusive by application of an early warning model or risk measure.*

∗ *That all depository institutions be regulated by the same body in order to ensure a 'level playing field' in terms of the cost of funding.*

1.4 Implications for Regulatory Structure

Under the rationale of protecting the public interest, specific areas where intervention would continue to be required in the name of efficiency, soundness and fair dealing are where any institution 1) accepts direct deposits from the public, 2) makes loans to the public or buys such loans or similar securities, or 3) where an institution sells loans or third party securities to other financial institutions or investors. (This would obviously require the establishment of "firewalls" in many financial conglomerates to annexe such entities.) A system of renewable licensing for such institutions, a uniform application of reserve capital and liquidity requirements, administered by a single regulatory agency, and appropriate disclosure and enhanced self-regulatory procedures would remove much of the existing inequities across institutions, and safeguard the interests of the financial system.

Recommendations

∗ *That given the lack of distinction in either structure, functions or roles between bank and non-bank depository institutions, both groups should be regulated by the same agency.*

∗ *That in the public interest and for the sake of competitive neutrality the prudential safety net should extend the same controls on capital, liquidity and credit standards across all firms engaged in:*

　　∗ *accepting deposits from the public;*

　　∗ *making loans to the public or buying such loans or similar securities; or,*

　　∗ *selling such loans or third party securities to other financial institutions or investors.*

2.   OBJECTIVES OF PRUDENTIAL REGULATION

The primary objective of financial regulation is the protection of depositors. Depositor protection underlies the pre-eminent concern for safety and stability of the financial system. However, in seeking a stable financial system which promotes public confidence in its institutions, efficiency must not be sacrificed. Indeed, there is an implicit trade-off between these two objectives.

Competitive neutrality is also a critical requisite for an efficient financial system. Lack of neutrality will bias the operations of the economy and lead to a less than optimal outcome in terms of economic growth.

2.1 Stability and Confidence

Financial institutions differ from other forms of business in that the failure of one institution can be contagious. It can thereby undermine the stability of the financial system and lead to a lack of confidence in its financial institutions. When individuals lose confidence in financial institutions savings are 'leaked' from the financial system and the potential for economic growth is reduced.

Recent incidents of institutional failure also emphasise the very real cost to taxpayers that can occur when governments intervene to protect depositors. For example, the final cost to taxpayers of the collapse of the US savings and loans industry was $US90 billion, while the cost of the Farrow building society group collapse in Victoria is likely to exceed $A1,000 million (Fogarty, 1996; Habersberger Report, 1994).

A healthy financial system with an effective prudential safety net is therefore an essential prerequisite to the well being of the economy and economic growth.

2.2 Efficiency

Efficiency in the financial system was the central issue and key objective in the deregulation of the financial sector.   Three different forms of financial market efficiency have been categorised by the OECD (Bisignano, 1991, p.279) as:

> *"Allocative efficiency*: whereby the removal of regulations and price distortions permits savings to be directed into the highest-yielding (risk-adjusted) forms of investment;
>
> *Operational efficiency*: whereby increased competition reduces costs of financial intermediation and other services; and,
>
> *Dynamic efficiency*: whereby deregulation and increased competition help to generate an improved range of financial products and services through innovations, permitting capital markets to adapt to changing customer needs in a flexible way."

Given that regulation is one of the major constraints on management decision-making in financial institutions, it is entirely possible that regulation can impede the efficiency of institutions in each of these three key respects. Institutions will not demonstrate allocative efficiency if regulation hinders the mean-variance efficiency of portfolio allocation. Operational efficiency will be jeopardised if the costs of regulation are such that institutions are unable to deliver services at minimum cost. Further, dynamic efficiency will be at risk if institutions find themselves prevented from participating in innovative activities that would otherwise yield a return to the institution. The history of financial institution regulation abounds with such examples.

2.3 Competitive Neutrality

In the financial services industry, costs of regulation fall on specific activities and financial instruments which often have a high price elasticity of demand. As markets have become increasingly competitive, squeezing margins and placing a premium on low-cost business methods, institutions facing an unequal regulatory burden find their ability to compete seriously impeded.

This issue of competitive neutrality, that is the *ability for market participants to compete on equal terms and conditions so that there is an equality of opportunity* was addressed by both the Campbell and Martin Inquiries (1991, p. 66). The Campbell Committee (1981, para. 1.24) *stressed the need for consistency in the regulatory and taxation burdens imposed on different intermediaries.* With the blurring in the role of financial and non-financial firms which offer financial services, the need to ensure competitive neutrality becomes even more essential.

One means of assessing the extent of competitive neutrality within a financial system is to consider the net regulatory burden faced by different suppliers of services. The net regulatory burden is the private costs of regulation to the institution, less the net private benefits that accrue from regulation.

It is the contention of this submission that cooperative societies face an unequal regulatory burden compared with their bank and non-bank competitors. While the Financial Institutions Code (1992) has delivered many benefits to the industry in terms of improved efficiency and stability, not all of these benefits have been realised. The evidence suggests that cooperative societies still pay a premium for retail deposits, and the direct and compliance costs to individual institutions have been high. This has left the industry with a negative net regulatory burden.

Banks, on the other hand, receive substantial tangible benefits to offset their regulatory costs. As part of the banking system, with a perceived 'government guarantee', these

institutions have a high risk rating for low cost wholesale funds and are also able to attract retail funds without the risk premium demanded by cooperative society depositors. Consequently, it is argued that bank competitors have a positive net regulatory cost.

Competitors which currently lie outside regulated financial markets, such as mortgage originators, have no prudential regulatory burden or benefit and therefore have a zero net regulatory burden.

3. REGULATION OF COOPERATIVE SOCIETIES IN AUSTRALIA

This section reviews the history, structure, conduct, performance and regulation of cooperative societies in Australia. 'Cooperative societies' is a generic term encompassing both permanent building societies (PBSs) and credit unions (CUs). It highlights their most significant shared feature, that being the cooperative movement on which they are philosophically based.

Although these institutions share a common heritage, and a common national legislation, they function as quite separate industries and differ in a number of key respects. PBSs have been involved primarily with home lending, and CUs with consumer finance, with both groups facing increasing competition for their traditional markets in the post-deregulation period.

Up until 1992, as state-based non-bank depository institutions, cooperative societies were governed by a range of state legislation. The failure of Pyramid Building Society and differences in the extent and degree of regulation across PBSs and CUs lead to widespread concern about the soundness of these institutions, and the consequences for stability and the efficiency of the financial system. Although these concerns and the need for uniform national legislation were considered in some detail by the Campbell Committee in 1981, regulation did not move to a national level until the introduction of the Financial Institutions Code (FI Code) on 1st July, 1992.

3.1 History and Industry Structure of Cooperative Societies

Cooperative societies were patterned on the British cooperative principal, distinguished from other types of financial institution by four main features. First, they tended to be locally or work-place based, second, they were instituted as non-profit organisations, third, they were dedicated to providing a limited range of financial

services to members, and fourth, their distinctive organisational structure was founded in the democratic principles of mutual ownership.

The pressures of a more competitive deregulated financial system, however, have eroded each of these four distinctive features to varying degrees. First, both PBSs and CUs have sought to widen their formerly narrow membership bases, through amalgamations and mergers, to allow them to gain advantages such as greater economies of scale and access to new technology. Some CUs with common bonds of association have combined, and the industry generally has *achieved such a high degree of interstate and industry wide co-operation that ....*(they appear as)*.... the branches of an integrated system* (Crapp & Skully, 1985, p. 16). PBSs have also merged to gain wider geographic spread, and under the FI Code can now trade inter-state.

Second, the emphasis on profitability has changed. Cooperative societies have traditionally functioned on a non-profit basis, providing services at cost to members. Profitability was never a necessary or desirable objective within a mutual structure, where members seek minimum borrowing rates and maximum deposit rates. In the post-deregulation period, however, prudential concerns for a more secure capital base, the need to fund expansion, and the pressures of performance benchmarking across the financial sector have lead cooperative societies to seek higher levels of profitability in order to maximise reserves and demonstrate a better return on assets.

Third, cooperative societies have expanded their services and product range beyond traditional activities. Personal loans, once the mainstay of CUs, have fallen to just on one third of assets in that sector, while owner-occupied housing loans account for an ever declining share of PBSs assets. In addition to home loans and personal loans, cooperative societies now provide a spectrum of services including a wide range of insurance, travel agency, sharebroking, financial advice, and cash management trusts. Cooperative societies have diversified in order to include higher return activities, to increase non-interest income and thereby reduce reliance on interest income, and as a competitive strategy to provide 'one-stop' financial services for the retail sector.

And finally, the necessity to raise capital by way of permanent shares has changed the organisational structure of some cooperative societies and threatened their mutual status. Whereas 84% of all PBSs in 1985 were mutuals with no issued capital, by 1996 less than a half retained this structure (Council of Financial Supervisors, 1993, p. 11 updated). Listed PBSs preserved the essence of mutual ownership on flotation, by according only one vote per shareholding, rather than one vote per share as is usually the case. Although only PBSs can issue shares under the FI Code, there have been moves on behalf of CUs to seek the same opportunity in the light of the repeal of Section 23G of the Income Tax Assessment Act (1936) (Senate Standing Committee, 1993).

Regulation has had a major impact on the history of cooperative societies. Prior to the onset of deregulation in the early 1980s, non-bank institutions generally were the beneficiaries of more liberal legislation than their bank counterparts. While the banking sector's share of total assets of all financial institutions[1] declined from 67.0% in 1955 to 43.7% in 1983, PBSs and CUs increased their collective share from 3.5% to 9% (RBA Bulletin, various). Since 1983, deregulation of the banking sector and increased competition have adversely affected cooperative societies, with collective assets in 1996 accounting for only around 3% of financial institutions' assets. Increased competition has led to major rationalisation within each industry. It should be noted, however, that these figures understate the significant role of credit cooperatives in the retail market, given that around 30% of Australians are members of CUs or PBSs (Council of Financial Supervisors, 1994, p.11).

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[1]   All financial institutions not including the Reserve Bank, general insurance, intra-group financiers, and housing co-operatives.

Table 3-1: Number, Assets and Financial Market Share (%) of Cooperative Societies 1983-1995

	CREDIT UNIONS			*BUILDING SOCIETIES*			*TOTAL*	
Year	*Number*	*Assets $b*	*%*	*Number*	*Asset $b*	*%*	*Assets $b*	*%*
1983	549	3.2	1.6	88	15.2	7.4	18.4	9.0
1984	531	4.3	1.8	75	17.7	7.6	22.0	9.4
1985	493	5.4	1.9	71	18.5	6.6	23.9	8.6
1986	453	6.6	1.9	68	20.1	5.8	26.7	7.7
1987	434	7.3	1.7	62	18.3	4.3	25.6	6.0
1988	419	7.5	1.5	58	21.5	4.2	29.0	5.7
1989	403	7.7	1.3	53	24.2	4.0	31.9	5.3
1990	386	8.7	1.3	52	23.0	3.4	31.7	4.7
1991	367	9.0	1.3	48	21.9	3.1	30.9	4.4
1992	352	9.9	1.4	32	21.6	3.0	31.5	4.4
1993	332	11.2	1.5	31	12.1	1.6	23.3	3.1
1994	308	12.5	1.5	28	12.0	1.5	24.5	3.0
1995	293	14.0	1.6	28	13.5	1.6	27.5	3.2
1996	285	15.3	na	25	12.7	na	28.0	na

Source: RBA Bulletin various, ABS Cat No 5618; ABS Cat No 5632

As Table 3-1 indicates, by 1996 both industries had similar assets, but while there were 25 PBSs, there were 285 CUs, indicating an average size of PBSs approximately ten times that of the average CUs.

3.1.1   Credit Unions

Although a number of small organisations which were the forerunners of CUs existed before World War II, CUs did not develop a significant role in the economy until the post-war consumer credit boom. In 1945 there were three registered CUs, but by 1954 there were sixty-four, fifty-nine of which were based in NSW. The reason for this concentration lies in a regulatory requirement of the NSW Cooperative Act (1923) which restricted CUs to specific geographic locations. New South Wales clearly retains a dominant role in the industry with 144 of the 288 CUs in operation as at June 1995.

The reduction in total number of CUs since 1983 has almost exclusively been brought about by mergers, often enforced by regulatory authorities. Enforced regulatory merger is a form of *de facto* failure. It is clearly in the public and regulators' interests

to identify signs of financial distress and to take remedial action in order to promote the goals of efficiency and stability within the financial system.

Other reasons for merger of CUs include:

- operational economies, particularly the necessity to take advantage of technological developments;
- legislative incentives, for instance some regulation specified a certain asset size for some forms of lending;
- the need to broaden bonds of association; and,
- interstate mergers of related CUs. (Crapp and Skully, 1985, p.160)

3.1.2   Building Societies

PBSs have had a long and occasionally controversial history in Australia. Their rapid growth was central to the Victorian land boom of the 1880s, and the first legislation governing PBSs, the Building Societies Act of 1874, allowed them a very broad agenda to *buy and sell or mortgage freehold or leasehold estate* (O'Brien, 1993, p.92). In Victoria, PBSs dominated the home loan market, increasing their market share of total deposits from 6% to a peak of 11% of all Victorian institutions, from 1885 to 1888. This rapid expansion in credit fuelled a speculative property wave, and culminated in the failure of a number of major societies in the 1890s[2]. Indeed, the failure of Premier Permanent Building Society in 1889, was described as *the most disastrous that had ever taken place in Melbourne* (Boehm, 1971, p. 258).

The legacy of these failures was a long lasting distrust in the public mind, and subsequently PBSs grew very slowly until the mid-1960s, accounting for only 1% of total financial institution assets in 1964 (Boehm, 1971, p.92). It was only during the 1960s and 1970s, that direct controls on the banking system offered PBSs a

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[2]   In 1888, 74 Victorian societies advanced $4,381,000, but by 1893, advances fell to $96 (Boehm, 1971).

competitive opportunity, leading to more rapid growth and an increase in financial sector assets to 7.4% in 1983.

Major structural readjustment took place in the post-deregulation period, with a total of 46 building society exits since 1985. These moves were primarily due to mergers of smaller institutions, the conversion of thirteen societies to banks, and two liquidations. In particular, it was these latter incidents, that is the failure of the Farrow Group and Swan Building Society, which seriously undermined public confidence in the industry and precipitated demands for a review of industry regulation.

3.2   Portfolio Management

The aggregate balance sheets for CUs and PBSs in 1995 are shown below. Examination of these balance sheets reveals evidence of the origins of societies and also demonstrates a broadening in operations and, in the case of PBSs, changes in capital structure.

3.2.1 Credit Union Portfolios

The aggregate balance sheet for Australian CUs is show in Table 3-2.

Table 3-2: Australian Credit Unions Aggregate Balance Sheet at June 1995

Liabilities	%	$000	Assets	%	$000
Deposits:			**Loans:**		
At Call	35.8	5 065 890	Personal	33.8	4 783 374
Notice of Withdrawal	4.5	634 900	Housing	38.0	5 382 843
Fixed Term	46.9	6 631 546	Commercial	3.1	437 011
Borrowings:			Revolving Credit	3.8	533 731
Bank	0.2	29 039	Cash on Hand	0.6	80 215
SSPs	0.4	58 336	Liquid Assets	15.9	2 245 539
Total Provisions	1.5	210 306	Other Assets	2.6	366 619
Term Subordinated Debt	0.0	200	Fixed Assets	2.2	318 590
Other Liabilities	1.4	201 522			
Total liabilities	**90.7**	**12 831 739**			
Capital:					
Permanent Share Capital	0.0	2 540			
Asset Revaluation Reserve	0.2	24 370			
Other Shareholders Equity	0.0	2 524			
General Reserve	4.3	612 562			
Retained Profit	4.8	674 187			
Total Capital	**9.3**	**1 316 183**			
Total liab. + equity	**100.0**	**14 147 922**	**Total Assets**	**100.0**	**14 147 922**

Source: Compiled from AFIC Data Base

Loans account for almost 80% of all credit union assets. In 1995, the aggregate balance sheet of CUs shows considerable diversification across various forms of lending. Housing loans, for example, at one third of total assets are almost equal to the value of personal lending. Commercial loans and revolving credit, each at approximately 4% of assets, have become significant components. While commercial

loans and revolving credit together account for less than 10% of the portfolio, the spread across these assets indicates an ability to increase volume and further diversify.

Over 70% of the liquid portfolio is comprised of deposits with special service providers. The remaining liquidity is held in various short term deposits with banks, bank bills and both state and commonwealth government securities.

CUs continue to maintain a funding base which is comprised almost entirely of members deposits, with retail deposits accounting for 96% of liabilities. The fact that almost half of retail deposits are fixed term suggests that CUs would be paying a relatively high rate of return on these funds.

The major source of capital remains retained profit and reserves, giving a capital to assets ratio of 9%. Although the inability of CUs to issue permanent share capital under existing legislation, together with the imposition of full company taxation on credit union profits, could impede their ability to sustain capital adequacy levels in the future, the current risk-weighted capital adequacy level of the industry at March 1996 was 14.3% (AFIC, 1996). This is a level well above the 8% required by regulation and also well above that of other depository institutions.

3.2.2 Building Society Portfolios

The aggregate balance sheet for Australian building societies is shown in Table 3-43.

Table 3-3: Building Societies Aggregate Balance Sheet at June 1995

Liabilities	*%*	*$000*	*Assets*	*%*	*$000*
Deposits:			**Loans:**		
At Call	35.0	4 723 237	Personal	1.4	190 170
Notice of Withdrawal	0.9	118 396	Housing	76.7	10 359 857
Fixed Term	49.0	6 620 279	Commercial	3.8	510 884
Borrowings:			Revolving Credit	0.7	86 582
Bank	1.7	225 491	Cash on Hand	0.5	72 561
SSPs			Liquid Assets	13.0	1 758 189
Total Provisions	0.7	99 077	Other Assets	2.4	318 017
Term Subordinated Debt	0.1	18 877	Fixed Assets	1.5	203 758
Other Liabilities	5.7	769 933			
Total liabilities	**93.1**	**12 575 290**			
Capital:					
Permanent Share Capital	1.6	210 747			
Share Premium Account	0.6	84 092			
Asset Revaluation Reserve	0.3	39 519			
Other Shareholders Equity	0.5	62 780			
General Reserve	1.3	172 420			
Retained Profit	2.6	355 170			
Total Capital	**6.9**	**924 728**			
Total liab. + equity	**100.0**	**13 500 018**	Total Assets	**100.0**	**13 500 018**

Source: Compiled from AFIC Data Base

In aggregate PBSs retain a loan portfolio which remains dominated by mortgage lending. Housing loans comprise almost 80% of total assets, and 94% of total loans. In addition, loans which are classified as commercial are primarily mortgage loans, used for investment and development purposes. The liquid asset portfolio is comprised of around two-thirds bank bills, and one fifth bank deposits. The remaining liquid assets are government securities.

Retail deposits remain an important source of funding for PBSs, comprising 94% of all liabilities. The subordinated debt listed on the balance sheet is used to supplement capital adequacy.

The range of capital sources listed in the balance sheet reflects the diversity of PBS structures. While retained earnings and reserves account for around two-thirds of capital, just over 20% of capital is now sourced from permanent share issue.   While the industry demonstrates a capital to asset ratio of 6.6%, for capital adequacy purposes subordinated debt is also taken into account. The risk-weighted capital adequacy ratio for the industry was 13.2% in March 1996, well above the mandatory requirement of 8% (AFIC, 1996).

3.3   Operations and Performance

The operations and performance of cooperative societies can be seen from the following analysis of operating margins.

3.3.1 Credit Unions

Operating margins for Australian CUs are shown in Table 3-4.

Table 3-4: Australian Credit Unions - Operating Margins

Item[3] / Year ended June	1989	1995
Total assets ($000)	7 660 614	14 147 922
Interest received ($000)	1 199 607	1 239 726
Interest paid ($000)	711 160	570 599
Net interest earned ($000)	488 447	669 127
Interest rate margin %	6.4	4.7
Non-interest expense ($000)	460 959	676 941
Cost to income %	85.0	86.0
Operating profit before tax ($000)	105 993	110 801
Return on assets %	1.1	0.8
Taxation ($000)	1 815	24 762
Tax/net income %	2.2	22.4
Capital reserves	534 627	1 313 644
Reserves / total assets%	7.0	9.3
Other income ($000)	55 959	118 616
% other income / total income	4.5	8.7

Source: AFIC Database, ABS Cat No 5618.0

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[3]   The interest margin is calculated here as interest income less interest expense over total assets. Cost to income ratio is non-interest expense to operating income (net interest income plus non-interest income) and, return on assets margin is operating profit before tax to total assets.

Total assets of CUs have doubled over this 6 year period. While interest margins have dropped slightly, so too have costs. The proportion of non-interest or other income to total income has also more than doubled from 4.5% to 8.7%.

A number of significant regulatory changes are also reflected in these operating margins. One of the major changes has been the increase in taxation, as CUs have been taxed at the corporate rate since 1993, thereby leading to an increase in the tax to total income of 2.2% to 22.4%. There has also been a substantial increase in the capital-to-assets ratio from 7.0% to 9.3%, reflecting the impact of capital adequacy provisions in the FI Code.

3.3.2 Building Societies

Operating margins for Australian PBSs are shown in Table 3-5.

Table 3-5: Operating Margins of Building Societies

Item[4]/ Year ended June	1989	1995
Total assets ($000)	23 998 261	13 500 018
Interest received ($000)	3 029 947	1 111 822
Interest paid ($000)	2 348 657	627 508
Net interest earned ($000)	681 290	484 314
Interest rate margin %	2.8	3.6
Non-interest expense ($000)	657 116	408 185
Cost to income %	89.0	75.6
Operating profit before tax ($000)	82 350	131 662
Return on assets %	0.3	1.0
Taxation ($000)	62 888	41 006
Tax/net income %	25.9	31.2
Capital reserves ($000)	1 270 984	924 728
Reserves / total assets %	5.3	6.9
Other income ($000)	58 176	55 533
% other income / total income	1.9	4.8

Source: Compiled from AFIC Data Base, ABS Cat No. 5632.0

The decline in total assets between 1989 and 1995 reflects the fact that 30 PBSs left the industry over this period.

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[4]   See footnote 3.

Return on assets improved considerably over the six year period from 0.3% to 1.0%. This increase in profitability can be attributed to both a higher net interest margin and a reduction in costs. The cost-to-income ratio decreased from 89% to 75.6%. Non-interest income to total income has increased very substantially from 1.9% in 1989 to 4.8% in 1995.

3.4   Regulation

Prior to the introduction of the FI Code in 1992, cooperative societies were governed by a range of state regulations, and also a number of federal acts such as the Financial Corporations Act (1974) and Taxation Acts. The specific state Acts applying to cooperative societies prior to 1992 are listed in **Error! Reference source not found.**.

Table 3-6: State-Based Regulation of Cooperative Societies

State	*Credit Union Legislation*	*Building Society Legislation*
ACT	Cooperative Societies Ordinance (1939)	Cooperative Societies Ordinance (1981)
New South Wales	Credit Union Act (1969)	Permanent Building Societies (Co-operation) Amendment Act (1986)
Northern Territory	Credit Union Act (1982)	Northern Territory Building Society Act (1981)
Queensland	Credit Societies Act (1986)	Queensland Building Societies Act (1986)
South Australia	Credit Unions Act (1976)	Building Societies Act (1975)
Tasmania	Cooperative Industrial Societies Act (1928)	Building Societies Act (1876) (Amended 1982)
Victoria	Co-operation Act (1981)	Victorian Building Societies Act (1986)
Western Australia	Credit Union Act (1979)	Building Societies Act (1976) (Amended 1984)

Source: Crapp and Skully (1985), p. 43 (Amended), King and Elstone (1987)

There were very significant differences between the key aspects of each of these state Acts. Not only were there variations with respect to requirements such as liquidity, reserves and lending, but also in the *degree of regulation* in each state (Crapp and Skully, 1985, p.44). For example, while membership of CUs in most states was restricted to people who share a 'common bond of association', Tasmania and ACT had no such provision.

3.4.1 Financial Institutions Code

In June 1990, the Farrow Group which included Pyramid Building Society went into liquidation in Victoria. Although under no obligation to provide financial backing to PBSs, the then Premier of Victoria, Mr John Cain, guaranteed repayments to depositors. While it was very clear from this incident that a vacuum existed in regulation of PBSs, it was also equally clear that the Reserve Bank had no intention of intervening in the area. As a consequence of these perceived deficiencies and in recognition of the need for national legislation, a Heads of Agreement document was drawn up among the states at the 1990 Special Premiers' Conference. This led subsequently to the 1991 Financial Institutions Agreement, which established an Implementation Task Force to develop national legislation.

The Task Force drew on the output of three recent reviews into non-bank regulation. The most formal of these was the Committee of Inquiry into Non-Bank Financial Institutions and Related Financial Processes in the State of Queensland, which was announced on 26th April, 1990 and which delivered its report in November of the same year. According to Queensland Treasurer De Lacy, the philosophy behind the Report from this Committee, known as the Brady Report (1990, p.5), was that:

> *the supervision system .. required should instil confidence in the public -- in other words, protect depositors -- but also provide flexibility for institutions to compete efficiently in a changing financial market.*

The legislative product of the Implementation Task Force was introduced to the Queensland Parliament in December, 1991, and passed with amendments in March, 1992. This was subsequently adopted under template legislation in each state of Australia and came into force on July 1, 1992.

3.4.1.1 Key Regulatory Provisions of the FI Code

From July 1, 1992, regulation of all societies was specified by the Financial Institutions Code (1992) which introduced a uniform set of regulatory requirements for PBSs and CUs across all states. The FI Code essentially strengthened prudential controls on liquidity and capital, and paved the way for societies to expand into new forms of lending from which they had previously been precluded. Table 3-7 summarises the major portfolio constraints on cooperative societies under the FI Code.

Table 3-7: Regulatory Provisions under the FI Code

Liquidity	7% prime assets to total liabilities
Capital	8% of risk-weighted assets
Lending (Primary Objects)	Credit Unions: < 10% of total assets in commercial loans, > 60% of total assets loans to members Building Societies: > 50% of total assets in home lending

Under the liquidity guidelines of the FI Code, all cooperative societies are required to maintain at least 7% of total liabilities in the form of *prime liquid assets*[5]. Prime liquid assets are assets held in the societies' own name which are unencumbered by pledges, are readily transferable, and are valued at market value. These assets include treasury notes, government securities, bank deposits and bills, loans to authorised money market dealers against government securities, state securities, and prescribed deposits with special service providers (SSP).

Capital adequacy requirements of the FI Code apply equally to PBSs and CUs. Cooperative societies are required to maintain a minimum of 8% of capital to total risk-weighted assets. Capital is defined as permanent paid-up share capital, non-

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[5]   The prime liquid asset requirement was initially 10% for building societies and 7% for credit unions. This was changed in early 1995 to bring both groups into line at 7%.

repayable share premium account, general reserves, retained earnings (less any goodwill or future income tax benefit), general provision for doubtful debts, asset revaluation reserves, convertible notes, subordinated debt, redeemable preference shares, hybrid capital instruments, and minority interests in subsidiaries.   Risk-weightings are applied to each class of assets, and are based on the nature of counter-party risk. In brief, cash and government securities with maturities less than 12 months attract a risk-weighting of 0%, other government securities and loans to authorised money market dealers are 10% risk-weighted, deposits with SSPs and banks are 20% risk-weighted, housing loans are 50% risk-weighted, and all other assets including commercial loans, personal loans, and revolving credit are 100% risk-weighted.

Under the FI Code the restrictions applying to lending differ for PBSs and CUs and are stated as *Prime Objects*. For CUs the prime objects requirements are that commercial loans should not exceed 10% of total assets, and that loans to members must be greater than 60% of total assets. For PBSs the prime objects requirement is that housing loans should comprise at least 50% of total assets.

3.5 Summary

As these figures attest, both PBSs and CUs have shown strong and consistent performance over recent years. Balance sheets of the CUs and PBSs indicate a broadening in lending activity, but a continued reliance on retail deposits which still comprise around 95% of total liabilities for both groups. The introduction of the FI Code in 1992 has strengthened the capital backing of CUs and PBSs, which have capital adequacy ratios of around 14% and 13% respectively, well in excess of the regulatory requirement of 8% and also that of the banking sector which stood at 11.2% in June 1996 (RBA, 1996).

The continued viability and strength of the industries is also demonstrated in Figure 3-1, which shows the net interest margin of cooperative societies compared with that of banks over the years 1989 to 1995. In each period the societies have demonstrated a higher net interest margin than the major banks.

Figure 3-1: Net Interest Margin Credit Unions, Building Societies and Major Banks 1989 - 1995
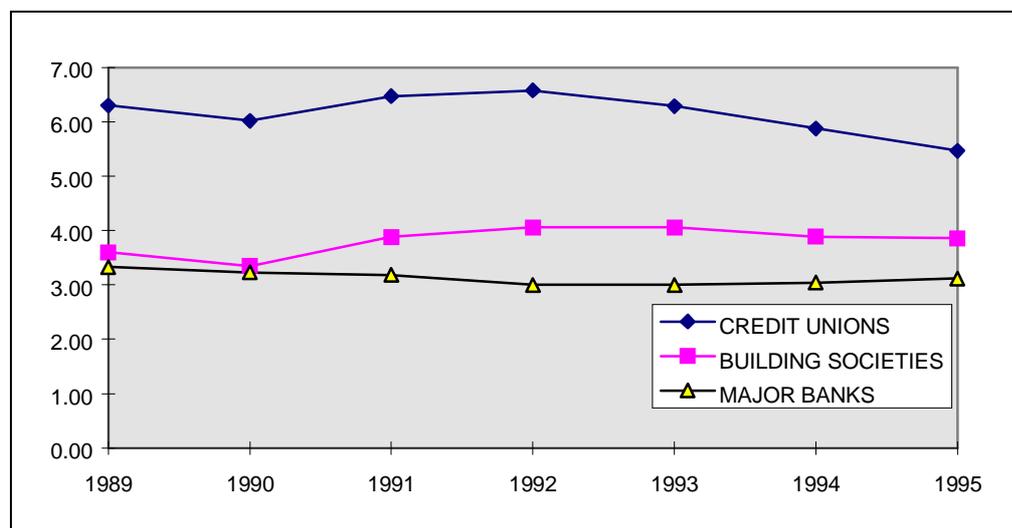
Source: KPMG Financial Institutions Performance Survey, various

4. IMPACT OF THE FI CODE ON COOPERATIVE SOCIETIES

This section examines the impact of the FI Code on portfolio allocation in cooperative societies to assess the effectiveness of this legislation in terms of allocative efficiency and risk. Two separate samples of institutions are used for this purpose: NSW CUs and Queensland PBSs. The samples are constructed from regulators' reports drawn from the 35 reporting periods between September 1987 to December 1995. The length of this period allows institutional portfolio performance to be studied across the full interest rate cycle.

The portfolio and debt behaviour of these financial institutions can be modelled with reference to the key asset and liabilities of their aggregate balance sheets, such that:

$$(c + l + pl + hl + cl + rc) - (cd + nd + td) = E \qquad (1)$$

$$(Total\ Assets) \quad - \quad (Total\ Liabilities) = Equity$$

where assets in the portfolio are:

c = cash on hand

l = prime liquid assets,

pl = personal loans,

hl = housing / real estate loans,

cl = commercial loans, and,

rc = revolving credit.

and liabilities are:

cd = deposits at call,

nd = NOW (notice of withdrawal) deposits, and,

td = term deposits.

Dividing equation (1) by equity provides a weighting of the relative contribution to the total portfolio of each class of asset and liability, such that:

$$\text{and} \sum_{i=1} w_i = 1.0 = w_e \quad \text{or} \qquad i'w \qquad (2)$$

where w represents the weightings of assets and liabilities in the portfolio, that is the choice set.

Following (2), weights can then be ascribed to each major component of the balance sheet as a percentage of equity (ie $w_c = c/e$), and a rate of return calculated for each, ie

$$w_c r_c + w_l r_l + w_{pl} r_{pl} + w_{hl} r_{hl} + w_{cl} r_{cl} + w_{rc} r_{rc} + w_{cd} r_{cd} + w_{nd} r_{nd} + w_{td} r_{td} = \pi \qquad (3)$$

Asset weights are non-negative ($w_c,\, w_l,\, w_{pl}\,,\; w_{hl}\,,\; w_{cl}\,,\; w_{rc} \geq 0$), the weights of liabilities are non-positive ($w_{cd}\,,\; w_{nd},\; w_{td},\; \leq 0$). Given this particular set of assets and liabilities, the maximum return available to societies at any given level of risk is represented by the efficient frontier generated from the combined yield and costs of these assets and liabilities.

The rate of return (interest paid) for each of the assets and liabilities is extracted from the societies' quarterly reports. The returns are calculated as *ex post* or actual returns (costs), by dividing the total quarterly returns (costs) on each asset (liability) by the value of the average assets (liabilities) for the quarter. That is, for asset (liability) x, the rate of return (cost) (r_i) in each quarter is:

$$\frac{total\ interest\ income\ (expense)\ x}{average\ \$\ value\ of\ x}$$

This method of calculating returns (costs) has two main advantages over using an *ex ante* time series. First, credit risk, which arises through delinquency or default on loan assets, is implicit in the model and will be reflected in a reduced rate of return. Second, the *ex post* return reflects the average return (cost) across the portfolio, allowing for the fact that loans and borrowings are contracted at different times, and at different interest rates. An *ex post* approach thus gives a weighted average return (cost) on the portfolio, while an *ex ante* approach to calculating return (cost) would reflect only the marginal return (cost). Consequently, both credit and market risk are implicit in the observed returns. Risk for each asset and liability is estimated by

deriving the standard deviation of returns for each across the quarters. These risk measures are then used to estimate the covariance matrix.

For the purposes of examining the efficient portfolio allocation of these institutions, and the impact of regulation on portfolio choice, the covariance matrix is input to the EXCEL Solver package to estimate the efficient frontier.

By this method, the impact of regulation on the portfolio allocation of institutions can be modelled by adding to the unconstrained portfolio the three main forms of constraint on portfolio decision-making, that is capital and liquidity requirements, and portfolio restrictions.

4.1 *The Impact of the FI Code on NSW Credit Unions*

NSW CUs are a superior sample because of the accuracy of the data and the large number of institutions in the sample. The sample data obtained from the NSW Financial Institutions Commission (FINCOM) comprise 35 quarters of regulatory reports, over the period June 1987 to December 1995, a total of 5858 observations. The mean returns (costs) for each class of asset (liability) over this period were calculated. These are plotted as shown in Figure 4-1.

Figure 4-1: Risk and Return for NSW Credit Union Asset and Liabilities 1987-1995
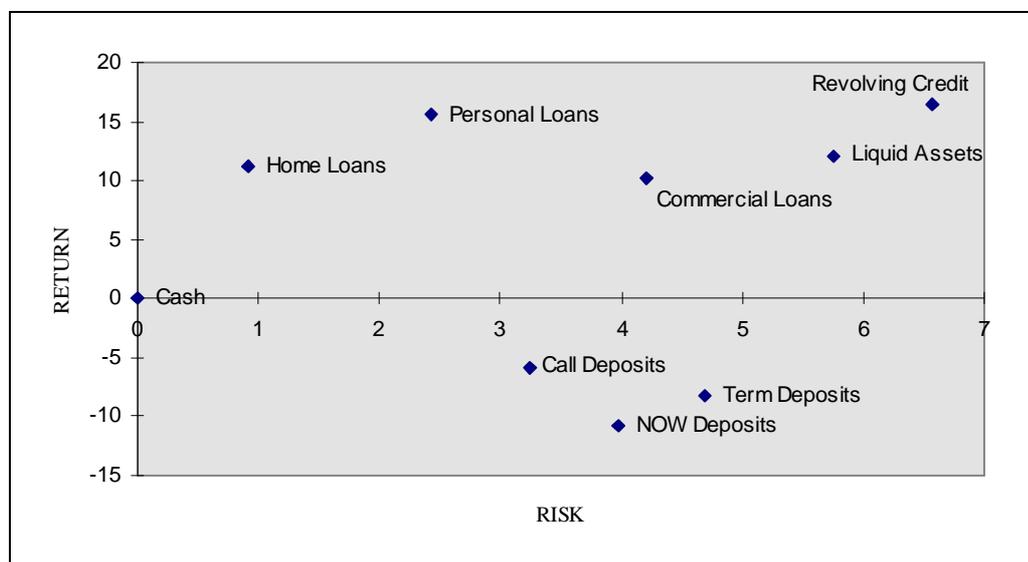
Of all the loan assets, personal loans have shown a high and consistent mean return for CUs over the entire period, with only a moderate degree of risk. This experience and skill in unsecured lending has also obviously contributed to the high return achieved on revolving credit, which is a post-1992 inclusion to the portfolio, albeit at a considerably higher level of risk. Returns on commercial loans, on the other hand, are relatively low, given the risk level involved. The relatively high return and risk of the liquid asset portfolio indicates a risk-accepting approach.

Both the cost and variance in liability interest rates increase with the duration of the deposit. The shortest term liabilities, call deposits for example, are the lowest cost form of funding with the least variance, while term deposits are the highest cost, highest risk source of funds.

4.1.1   Co-variance Matrix

The following covariance matrix is derived from the mean returns and covariances for each class of asset and liability in NSW credit union portfolios.

Table 4-1: Covariance Matrix for NSW Credit Unions

	c	l	pl	hl	cl	rc	cd	nd	td
Cash on Hand *(c)*	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Prime Liquid Assets *(l)*	0.00	20.19	9.02	0.54	-2.16	0.24	9.42	12.46	15.55
Personal Loans *(pl)*	0.00	9.02	4.79	0.42	0.18	0.36	4.53	5.65	7.27
Housing Loans *(hl)*	0.00	0.54	0.42	1.06	-1.21	1.91	0.43	0.29	0.82
Commercial Loans *(cl)*	0.00	-2.16	0.18	-1.21	16.30	2.66	-0.17	0.00	-1.32
Revolving Credit *(rc)*	0.00	0.24	0.36	1.91	2.66	7.09	1.03	0.69	1.45
Call Deposits *(cd)*	0.00	9.42	4.53	0.43	-0.17	1.03	4.77	5.79	7.43
NOW Deposits *(nd)*	0.00	12.46	5.65	0.29	0.00	0.69	5.79	8.57	9.66
Term Deposits *(td)*	0.00	15.55	7.27	0.82	-1.32	1.45	7.43	9.66	12.41

This covariance matrix indicates a positive relationship between returns on most assets and liabilities in the portfolio. One exception is commercial loans which appears to be negatively related to market rates on liquids, housing loans, call and term deposits, and shows no correlation with NOW deposits. Commercial loans do show some correlation with personal loans and revolving credit, however, suggesting that the interest rates charged on these products are set in relation to competitive forces, rather than changes in prevailing market rates.

4.1.2 Unconstrained Efficient Frontier

The unconstrained efficient frontier was constructed for NSW CUs. Composition of portfolios in the unconstrained efficient frontier are shown in Table 4-1.

Table 4-1: Unconstrained Efficient Portfolio for NSW Credit Unions

Net Return Equ(12)	Risk $\sqrt{var(r_e)}$ Equ(13)	Weights of items in efficient balance sheet								
		Assets						Liabilities		
		c	l	pl	hl	cl	rc	cd	nd	td
5%	0.08	1.04	0.47	0.36	0.00	0.00	0.14	-0.42	-0.10	-0.49
10%	0.15	1.07	0.94	0.72	0.00	0.00	0.28	-0.83	-0.20	-0.98
15%	0.23	1.11	1.41	1.08	0.00	0.00	0.42	-1.25	-0.30	-1.47
20%	0.30	1.14	1.89	1.44	0.00	0.00	0.55	-1.66	-0.40	-1.96
25%	0.38	1.18	2.36	1.80	0.00	0.00	0.69	-2.08	-0.50	-2.45
30%	0.45	1.21	2.83	2.16	0.00	0.00	0.83	-2.49	-0.60	-2.94
35%	0.53	1.25	3.30	2.52	0.00	0.00	0.97	-2.91	-0.70	-3.43
40%	0.61	1.28	3.77	2.88	0.00	0.00	1.11	-3.33	-0.80	-3.92
45%	0.68	1.32	4.24	3.24	0.00	0.00	1.25	-3.74	-0.90	-4.41
50%	0.76	1.36	4.72	3.60	0.00	0.00	1.39	-4.16	-1.00	-4.90

The most efficient portfolios at all levels of return are those composed of personal loans and revolving credit. Housing loans and commercial loans are not included at any level indicating that the risk-return profile of these assets is inferior to that of other asset categories.

4.1.3   Regulation Constrained Efficient Frontier - NSW Credit Union Act

Of all the state Acts, the NSW Credit Union Act (1969) appears to have been the most similar to the FI Code. The key regulatory requirements of this the FI Code are outlined in Table 4-2.

Table 4-2: Regulatory Provisions under the NSW Credit Union Act (1969)

Liquidity	7% liquid assets[6] to share capital and deposits
Capital	5% of mean balance sheet assets
Lending	Unsecured: $10,000 max. for not more than 5 yrs Secured: $10,000 or 1% of assets whichever is greater for not more than 20 yrs

Under the Credit Union Act, liquidity was specified as being a minimum of 7% of share capital and deposits (total assets). CUs were required to maintain capital at a minimum of 5% of mean balance sheet assets.

While home lending was not specifically excluded under the Act, lending restrictions limited the value of secured lending to a ceiling of $10,000 or 1% of assets. Despite these restrictions, CUs in NSW did undertake some home lending, although the interest income was not recorded separately from personal loans. There were, however, no provision to allow CUs in NSW to be involved in either commercial loans or revolving credit.

These regulatory constraints on portfolio allocation were applied to the efficient frontier developed in the previous section.

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[6]   Unlike the FI Code, the NSW Credit Union Act includes cash in its definition of liquid assets.

Under the Credit Union Act, the most efficient portfolio at each level of risk is shown in Table 4-3. With the restriction on revolving credit, home lending has been included in portfolios, and neither capital nor liquidity constraints were binding on the portfolio allocation of societies. Interestingly, however, the most efficient portfolio under the NSW CUs Act contains less cash and liquid assets than before the liquidity constraint was imposed.

Table 4-3: Portfolio Allocation at different levels of return for NSW Credit Unions under the NSW Credit Union Act

Net Return Equ(12)	Risk $\sqrt{var(r_e)}$ Equ(13)	Weights of items in efficient balance sheet								
		Assets						Liabilities		
		c	l	pl	hl	cl	rc	cd	nd	td
5%	0.23	0.80	0.19	0.31	0.21	0.00	0.00	-0.21	0.00	-0.31
10%	0.46	0.59	0.39	0.62	0.42	0.00	0.00	-0.41	0.00	-0.61
15%	0.70	0.39	0.58	0.93	0.63	0.00	0.00	-0.62	0.00	-0.92
20%	0.93	0.19	0.78	1.24	0.85	0.00	0.00	-0.83	0.00	-1.23
25%	1.16	0.00	0.98	1.56	1.05	0.00	0.00	-1.06	0.00	-1.53
30%	1.41	0.00	1.26	1.97	1.18	0.00	0.00	-1.57	-0.08	-1.76
35%	1.67	0.00	1.55	2.37	1.32	0.00	0.00	-2.08	-0.17	-1.99
40%	1.94	0.00	1.84	2.77	1.45	0.00	0.00	-2.58	-0.25	-2.22
45%	2.22	0.00	2.12	3.17	1.59	0.00	0.00	-3.09	-0.34	-2.46
50%	2.50	0.00	2.41	3.57	1.72	0.00	0.00	-3.59	-0.43	-2.69

The major constraint on efficient portfolio allocation was the elimination of some higher risk lending activities from the portfolio. To compensate for the lower return consequently available, societies have increased the level of risk across the portfolio.

4.1.4   **Regulation Constrained Efficient Frontier - Financial Institutions Code**

The regulatory constraints on portfolio allocation under the FI Code, described in section 3.4.1.1, were applied to the unconstrained portfolio.

The capital constraint under the F I Code requires that risk-weighted assets should not exceed 8% of capital. This constraint was found to be non-binding on the portfolio allocation of NSW CUs. Similarly, the requirement for prime liquid assets to equal at least 7% of total liabilities was also not binding on the optimal portfolio allocation.

Under the FI Code, the optimal portfolio at each level of risk is well diversified and includes all assets with the exception of commercial loans, as shown in Table 4-4.

Table 4-4: Portfolio Allocation at different levels of return for NSW Credit Unions under the FI Code

| Net Return Equ(12)	Risk $\sqrt{var(r_e)}$ Equ(13)	Weights of items in efficient balance sheet								
		Assets						*Liabilities*		
		c	l	pl	hl	cl	rc	cd	nd	td
5%	1.59	0.56	0.03	0.00	0.76	0.13	0.00	0.00	0.00	-0.47
10%	0.47	0.46	0.22	0.55	0.41	0.03	0.02	-0.21	0.00	-0.47
15%	0.57	0.46	0.54	0.99	0.33	0.00	0.18	-0.55	0.00	-0.94
20%	0.67	0.44	0.89	1.36	0.32	0.00	0.30	-0.90	-0.03	-1.38
25%	0.78	0.41	1.24	1.73	0.32	0.00	0.43	-1.25	-0.09	-1.79
30%	0.88	0.39	1.59	2.11	0.31	0.00	0.55	-1.59	-0.15	-2.21
35%	0.98	0.37	1.94	2.48	0.30	0.00	0.67	-1.94	-0.21	-2.62
40%	1.08	0.35	2.29	2.86	0.30	0.00	0.79	-2.28	-0.27	-3.04
45%	1.19	0.32	2.64	3.23	0.29	0.00	0.92	-2.62	-0.33	-3.45
50%	1.29	0.30	2.99	3.61	0.29	0.00	1.04	-2.97	-0.39	-3.87

The portfolio requirement that CUs cannot maintain more than 10% of loans in the form of commercial loans was not binding on portfolios at any level of return. The requirement that 60% of total assets must be held as loans, did constrain the portfolio at the 5% level. The impact of this requirement was quite significant and greatly increased the risk of the portfolio at this level of return.

4.1.5 NSW Credit Unions - Summary

Overall, the impact of the FI Code has been to enhance the mean-variance efficiency of NSW CUs portfolio allocation. As can be seen from Figure 4-2, the efficient frontier has moved to the left, closer to that of the unconstrained frontier. This indicates that CU portfolios will carry less risk at each level of return. This efficiency gain has come from expanding the range of assets available to the institution.

Neither capital, liquidity nor commercial loan restrictions bind the optimal portfolio available to institutions, but the requirement for CUs to maintain 60% of all assets as loans does impede portfolio allocation. This is particularly noticeable at the 5% level of return.

Figure 4-2: Unconstrained and Regulation Constrained Efficient Frontiers
**of NSW Credit Unions**
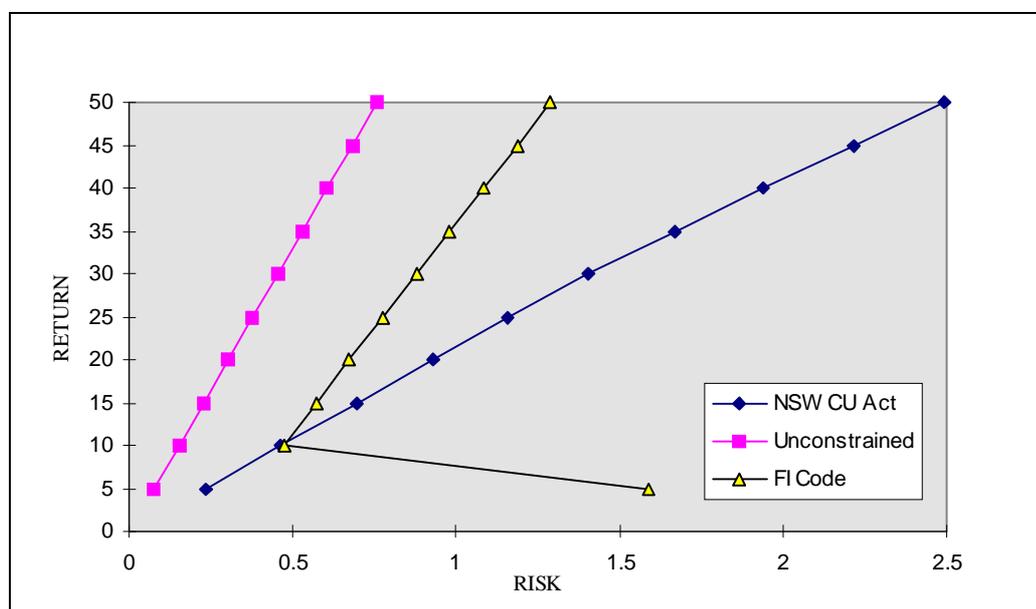
4.2 The Impact of the FI Code on Queensland Building Societies

Queensland PBSs were used to examine the impact of the FI Code on PBSs because Queensland has the greatest proportion of continuing societies over the period. Quarterly report data was made available from the Queensland Office of Financial Supervision (QOFS) archives. The sample consists of nine or ten societies in each of the 35 quarters examined, and comprises 194 observations.

The mean return and risk characteristics of different classes of assets and liabilities for Queensland PBSs are presented in Figure 4-3.

Figure 4-3: Risk and Return for Queensland Building Societies Assets and Liabilities 1987 - 1995
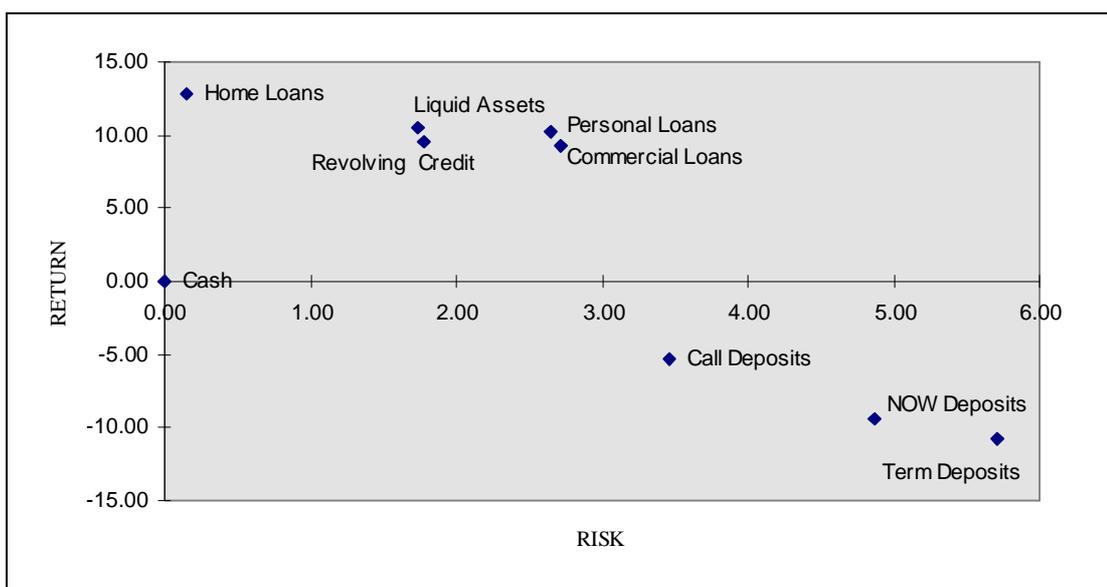
Queensland PBSs achieve a very high return on home loans, for minimal risk. This attests to the expertise of the industry in mortgage lending which has developed through experience and specialisation. Relatively low returns have been achieved in the post-1992 unsecured lending assets of personal loans, and revolving credit. Societies also appear to have accepted relatively low levels of risk in these assets, suggesting a very conservative approach to unsecured lending.

The liquid asset portfolio also indicates a relatively low risk approach, suggesting that over all PBSs adopt a risk-averse approach to portfolio management.

4.2.1   Co-variance Matrix

The following covariance matrix is derived from the mean returns and covariances for each class of asset and liability in Queensland PBSs portfolios.

Table 4-5: Covariance Matrix for Qld Building Societies

	c	*l*	*pl*	*hl*	*cl*	*rc*	*cd*	*nd*	*td*
Cash on Hand *(c)*	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Prime Liquid Assets *(l)*	0.00	10.27	-12.58	8.58	-11.49	-13.39	6.22	-9.00	13.23
Personal Loans *(pl)*	0.00	-12.58	26.12	-12.01	23.97	26.03	-9.58	14.91	-17.69
Housing Loans *(hl)*	0.00	8.58	-12.01	8.27	-10.62	-12.23	5.81	-8.07	11.89
Commercial Loans *(cl)*	0.00	-11.49	23.97	-10.62	25.65	25.91	-8.96	13.73	-16.48
Revolving Credit *(rc)*	0.00	-13.39	26.03	-12.23	25.91	30.03	-9.89	14.85	-18.30
Call Deposits *(cd)*	0.00	6.22	-9.58	5.81	-8.96	-9.89	4.46	-6.57	8.61
NOW Deposits *(nd)*	0.00	-9.00	14.91	-8.07	13.73	14.85	-6.57	11.91	-12.36
Term Deposits *(td)*	0.00	13.23	-17.69	11.89	-16.48	-18.30	8.61	-12.36	18.22

The covariance matrix for Queensland PBSs' returns indicates a strong potential for efficiency gains through portfolio diversification. As can be seen from in Table 4-5, the post-1992 assets of personal loans, revolving credit and commercial loans have a negative covariance with the main pre-1992 assets of liquid assets and home loans.

4.2.2   Unconstrained Efficient Frontier

The unconstrained efficient frontier was constructed for NSW CUs. Composition of portfolios in the unconstrained efficient frontier are shown in Table 4-6.

Table 4-6: The Unconstrained Portfolio Allocation at different levels of return for Queensland Building Societies

Net Return Equ(12)	Risk $\sqrt{var(r_e)}$ Equ(13)	Weights of items in efficient balance sheet								
		Assets						Liabilities		
		c	l	pl	hl	cl	rc	cd	nd	td
5%	0.44	0.61	0.23	0.05	0.52	0.00	0.08	0.00	0.00	-0.48
10%	0.88	0.22	0.46	0.09	1.03	0.00	0.16	0.00	0.00	-0.96
15%	1.59	0.00	0.08	0.14	2.24	0.00	0.03	0.00	0.00	-1.49
20%	3.28	0.00	0.00	0.00	4.50	0.00	0.00	0.00	-0.34	-3.16
25%	5.06	0.00	0.00	0.00	6.76	0.00	0.00	0.00	-0.80	-4.96
30%	6.87	0.00	0.00	0.00	9.01	0.00	0.00	0.00	-1.25	-6.76
35%	8.68	0.00	0.00	0.00	11.27	0.00	0.00	0.00	-1.71	-8.56
40%	10.50	0.00	0.00	0.00	13.53	0.00	0.00	0.00	-2.16	-10.36
45%	12.32	0.00	0.00	0.00	15.78	0.00	0.00	0.00	-2.62	-12.17
50%	14.15	0.00	0.00	0.00	18.04	0.00	0.00	0.00	-3.07	-13.97

The unconstrained efficient frontier is almost entirely comprised of home loans, demonstrating the superior risk-return performance of this set of assets. Concentration on these assets, to the exclusion of others, however, results in an undiversified, and consequently high risk portfolio.

4.2.3 Regulation Constrained Efficient Frontier - Queensland Building Societies Act

The key regulatory requirements which impact on the portfolio allocation of societies under the Queensland Building Societies Act (1986) are outlined in Table 4-7.

Table 4-7: Regulatory Provision under the Queensland Building Societies Act (1986)

Liquidity	7.5% of paid up capital and deposits
Reserves	0.25% of total liabilities at start of previous financial year in a Reserve Fund. Monthly contingency reserve fund payments 0.25% p.a. funds also required.
Lending	75% of valuation (100% if loan insured). All loans for residential.

Liquidity constraints under the Act required that societies maintain 7.5% of paid up capital and deposits as liquid funds. Under state legislation, reserves were required to be maintained at 0.25% of the total liabilities of the previous period.

Lending in Queensland PBSs was restricted to residential or housing loans. Revolving credit, personal and commercial loans were not part of the portfolio for these institutions.

Table 4-8 shows the optimal portfolio allocation for PBSs under this Act.

Table 4-8: Portfolio Allocation at different levels of return for Queensland Building Societies under the Qld Building Societies Act

Net Return Equ(12)	Risk $\sqrt{var(r_e)}$ Equ(13)	Weights of items in efficient balance sheet								
		Assets						Liabilities		
		c	l	pl	hl	cl	rc	cd	nd	td
5%	0.51	0.82	0.25	0.00	0.72	0.00	0.00	-0.31	0.00	-0.47
10%	1.02	0.63	0.49	0.00	1.43	0.00	0.00	-0.61	0.00	-0.94
15%	1.52	0.45	0.74	0.00	2.15	0.00	0.00	-0.92	0.00	-1.41
20%	2.03	0.26	0.99	0.00	2.86	0.00	0.00	-1.23	0.00	-1.88
25%	2.54	0.08	1.23	0.00	3.58	0.00	0.00	-1.53	0.00	-2.35
30%	3.05	0.00	1.44	0.00	4.32	0.00	0.00	-2.04	0.00	-2.72
35%	3.57	0.00	1.61	0.00	5.09	0.00	0.00	-2.68	0.00	-3.02
40%	4.09	0.00	1.78	0.00	5.86	0.00	0.00	-3.32	0.00	-3.33
45%	4.63	0.00	1.96	0.00	6.63	0.00	0.00	-3.96	0.00	-3.63
50%	5.16	0.00	2.13	0.00	7.40	0.00	0.00	-4.60	0.00	-3.93

The capital constraint under this Act was found to be non-binding on portfolio allocation at each level of return. The liquidity constraint, however, was binding, and improved the efficiency of the portfolio by ensuring some diversification at each level of return, thereby reducing risk at each level above a 10% return. Below 15% return, the liquidity constraint increased the risk of the portfolio, as societies increased the proportion of loan assets to compensate for reduced return on liquids.

4.2.4   Regulation Constrained Efficient Frontier -FI Code

The regulatory constraints on portfolio allocation under the FI Code, as described in section 3.4.1.1, were applied to the unconstrained portfolio. The resultant portfolio allocation is shown in Table 4-9.

Table 4-9: Portfolio Allocation at different levels of return for Queensland Building Societies under the FI Code

| Net Return Equ(12)	Risk $\sqrt{var(r_e)}$ Equ(13)	Weights of items in efficient balance sheet								
		Assets						Liabilities		
		c	l	pl	hl	cl	rc	cd	nd	td
5%	0.53	0.67	0.03	0.02	0.75	0.00	0.03	0.00	0.00	-0.50
10%	1.09	0.16	0.03	0.37	0.71	0.00	0.15	0.00	0.00	-0.42
15%	1.39	0.00	0.44	0.34	1.69	0.00	0.00	-0.23	0.00	-1.24
20%	1.87	0.00	0.14	0.45	2.47	0.00	0.00	-0.85	0.00	-1.22
25%	2.19	0.00	1.06	0.07	2.99	0.00	0.38	-1.68	0.00	-1.83
30%	2.67	0.00	1.24	0.05	3.69	0.00	0.45	-2.36	0.00	-2.08
35%	3.17	0.00	1.42	0.04	4.39	0.00	0.51	-3.04	0.00	-2.32
40%	3.67	0.00	1.60	0.02	5.09	0.00	0.58	-3.72	0.00	-2.57
45%	4.18	0.00	1.78	0.00	5.79	0.00	0.65	-4.40	0.00	-2.82
50%	4.68	0.00	1.94	0.00	6.48	0.00	0.71	-5.08	0.00	-3.05

The capital constraint under the Financial Institutions Code requires that risk-weighted assets should not exceed 8% of capital. This constraint was found to be non-binding on the portfolio allocation of Queensland PBSs. The requirement for prime liquid assets to equal at least 7% of total liabilities was also not binding on the optimal portfolio allocation except at levels of return below 15%.

The prime objects requirement for societies to retain at least 50% of assets in home loans does not constrain the portfolio.

4.2.5   Queensland Building Societies - Summary

As Figure 4-4 indicates, Queensland PBSs have benefited from the introduction of the FI Code in terms of mean-variance efficiency. The efficient frontier under this regulation has shifted further to the left, demonstrating a higher rate of return for each level of risk. The unconstrained efficient frontier indicates the danger of over-specialisation in the loan portfolio. Although PBSs are very efficient home lenders, this concentration of assets leaves societies exposed to considerable risk. These benefits of portfolio diversification allowed under the FI Code will increase as societies develop greater expertise in the new areas of lending.

Figure 4-4: Unconstrained and Regulation Constrained Efficient Frontiers for Queensland Building Societies
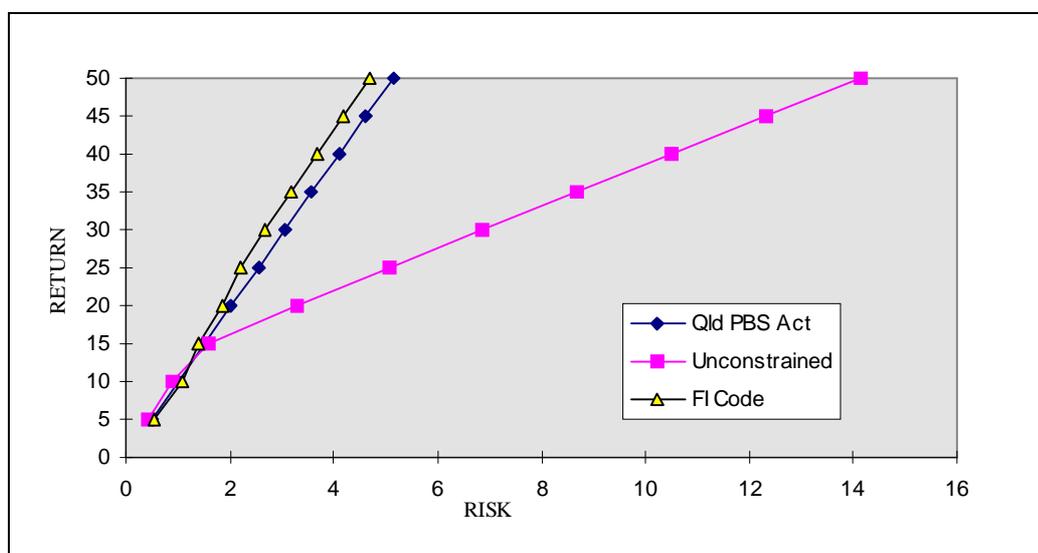
4.2.6 Conclusion

While CUs and PBSs have diversified loan portfolios to include non-traditional assets, both groups continue to demonstrate a very high degree of efficiency in their traditional lending spheres, that is personal loans and housing loans respectively. It is also evident that the experience of CUs in the area of unsecured lending has ensured a better performance in the newer lending areas. Across the board, PBSs generally demonstrate a more conservative approach to risk.

As this analysis demonstrates, regulation which seeks to define the role of industry through portfolio specialisation will clearly hinder both the allocative or mean-variance efficiency of the portfolio and will inevitably increase the risk of the industry. In the case of both CUs and PBSs the performance of institutions has been enhanced by additional portfolio diversification. The major constraints on efficiency under different regulatory regimes lies in portfolio elimination and in regulation which seeks to define the role of institutions.

Recommendations

∗   *That the existing prudential requirements concerning liquidity and capital should be retained. These prudential measures have reduced the risk of cooperative societies without impeding the optimal portfolios of institutions.*

∗   *That in the interest of both allocative and dynamic efficiency regulation should not attempt to specialise or 'niche' financial institutions, and that once prudential requirements are met, institutions should be allowed maximum flexibility to define their own role, according to market demand and their own philosophy.*

4.3   Costs of Regulation in Cooperative Societies

Costs of financial institutions regulation comprise direct regulatory body levies, compliance costs and opportunity costs. The issue of costs within the FI Scheme is addressed here from the point of view of net private costs to financial institutions. It should be noted that such costs are also incurred by parties other than the institutions themselves. Regulatory costs of the FI Code have also been addressed in two separate reports commissioned by industry bodies, the Beetham Report (1994) and the Waterhouse Report (1994).

At the institutional level there are three main areas of cost with regard to the introduction of the FI Code. These are:

- direct costs;
- compliance costs; and,
- net opportunity costs.

4.3.1 Direct Costs

The main direct cost of regulation faced by cooperative societies is that of regulatory body levies payable to state supervisory authorities and AFIC. The federal structure of the Financial Institutions Code played an essential role in obtaining cooperation and agreement for a national regulatory system.   The successful establishment and implementation of the scheme was in no small part due to the close links that developed between different sectors of the industry, state government authorities, and regulators. With supervisory authorities established in each state, each governed by its own Board of Directors, and reporting to a State Government Minister, industry participants and state authorities could feel ownership of the scheme. Indeed, without this federal structure it is difficult to imagine that a national system could have evolved.

It has become evident, however, that the FI Scheme is something of a "Rolls Royce" regulatory model. The complexity of the structure imposes higher than necessary costs on the industry, in terms of direct levies to state and national regulatory agencies,

duplication, and in the intangible costs that occur through conflicting interpretation of legislation by state and national bodies. This complexity is well demonstrated by Figure 4-5. With each state supervisory authority reporting to a Board and a Minister, the potential for duplication and conflict in policy interpretation is evident. This large and complex system oversees an industry of only $28 billion, which is at odds with the simpler structures which supervise the much larger banking and insurance industries.

Figure 4-5: Structure of the Australian Financial Institutions Commission
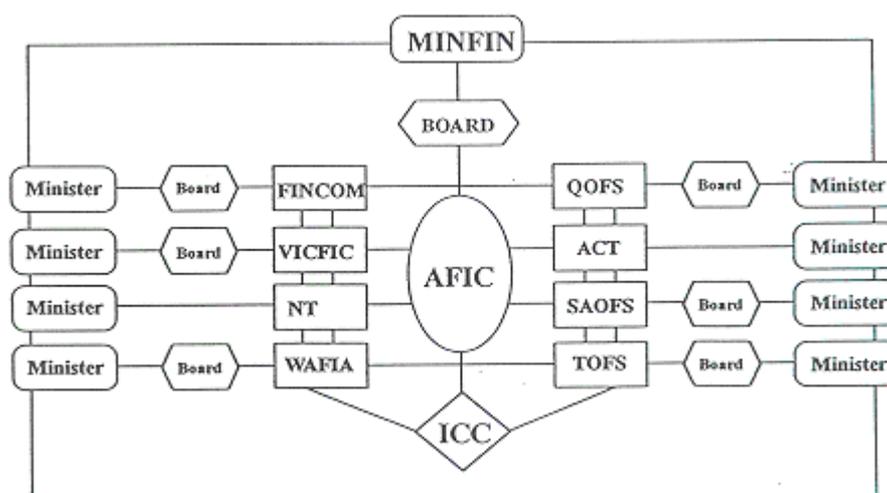
Source: Beetham Report, 1994

4.3.2 Compliance Costs

Compliance costs, on the other hand, are the costs incurred in meeting the requirements of the new legislation. The implementation of the FI Code in June 1992 imposed significant costs to institutions in terms of:

- internal audit;
- systems development;
- documentation; and,
- staff training

In addition, societies face ongoing costs in terms of

- reporting;

- external audit costs; and,

- inspection time.

It should be noted that such costs are also incurred by parties other than the institutions themselves. Compliance costs are also incurred by government, including costs of certification, reviewing and processing the statements filed.

Significant cost savings to both industry participants and government regulatory agencies could be obtained by:

- standardising regulatory reports as far as is possible within the framework of standard financial reporting. This would remove some of the existing duplication of existing financial and regulatory reporting on the part of societies; and,

- implementing an institutional risk measure or early warning system for use by regulatory bodies to maximise the use of regulatory resources. Such a system would ensure a better use of resources in that only institutions identified as being a concern would be subject to more intense supervision (such a measure was developed in Ralston and Hall, 1995). This measure would also lead to a less intrusive supervisory system.

### 4.3.3 Net Opportunity Costs

Regulation can also impose opportunity costs on financial institutions. Imposition of portfolio constraints can reduce potential for profit. As the previous section demonstrated, there are very few opportunity costs to societies through capital, liquidity and portfolio eliminations in the FI Code.

The FI Code has, however, imposed significant direct and compliance costs on cooperative societies without necessarily returning benefits in terms of a reduced cost of funding. While the enhanced standing of cooperative societies is well understood in wholesale markets, where PBSs in particular enjoy advantages in enhanced access to

funds and lower cost funds, these benefits have generally not been well communicated to the general public.

Although AFIC has acknowledged that one of the key benefits of the FI Code should be a lower perceived risk for cooperative societies and therefore a reduced costs of funds, Practice Notes have been issued prohibiting societies from advertising compliance certificates or referring to the safety and stability benefits of the scheme. At the same time, the regulators themselves do not consider that they have a role to play in 'advertising' the Scheme. Consequently, the general public remain relatively uninformed about the risk of CUs and PBSs. Given that cooperative societies still rely on retail funds for approximately 95% of their funding base, this is a critical issue. Figure 4-6 demonstrates the risk premium paid by CUs and PBSs over bank 'at call' deposit rates.

Figure 4-6: At Call Deposit Rates for Credit Unions, Building Societies, and Major Banks 1988 - 1995
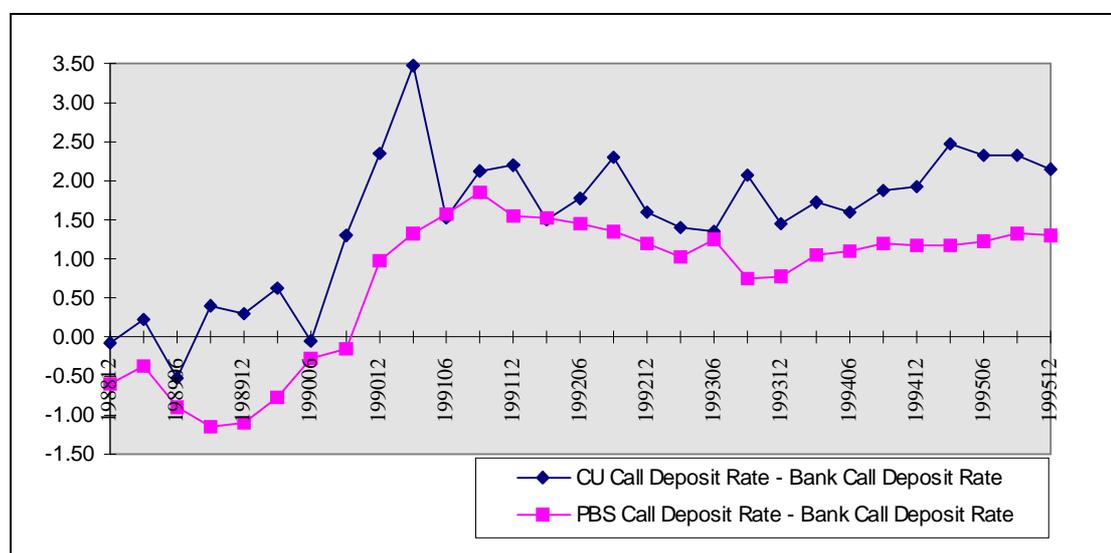
Source: AFIC database, RBA Bulletins, various

As the above figure shows, the premium paid by cooperative societies has gradually widened since June 1990, the time of the Pyramid collapse. The gap between bank and cooperative societies' 'at call' deposit rates does not appear to have diminished markedly since the introduction of the FI Code in June 1992, and gives every

indication of widening further, particularly in light of compulsory superannuation and the intense competition for an ever-diminishing pool of discretionary savings.

4.3.4 Conclusion

While existing regulation under the FI Code has produced benefits to cooperative societies, it is imperative that the costs to institutions of this or any subsequent regulation be minimised to contain the net regulatory burden of both industries.

Clearly there are opportunities to reduce the costs of the existing scheme and therefore the net regulatory burden faced by cooperative societies through a reduction in direct, compliance and opportunity costs. This net regulatory burden has been imposed through:

- direct costs: state and federal levies have been paid to support a federal system which is too complex, prone to duplication and conflict on policy interpretation;
- compliance costs: societies have made a considerable investment in the FI Scheme through the establishment of new systems and reporting procedures; and,
- opportunity costs: the net regulatory burden faced by societies has been higher than necessary through failure to ensure lower cost of funds by addressing the level of perceived risk for the industry.

Recommendations

∗   *That cooperative society regulation be rationalised to ensure a more efficient and truly national scheme.*

∗   *That any new regulation imposed on this sector should be sympathetic with existing systems in order to minimise any additional compliance costs.*

∗   *That compliance costs for societies be reduced by ensuring that reporting to regulatory bodies conforms as far as is possible with normal financial reporting requirements.*

∗   *That supervisory resources be more efficiently utilised and the system made less intrusive by application of an early warning model or risk measure.*

∗   *That all depository institutions be regulated by the same body in order to ensure a 'level playing field' in terms of the cost of funding.*

5. IMPLICATIONS FOR REGULATORY STRUCTURE

Over time, the distinction between bank and non-bank depository institutions has become increasingly blurred. With the growth and development of non-bank depository institutions, and the move of banks into non-traditional activities such as insurance and travel, a technical definition of what constitutes a bank on the grounds of function has become an impossible task.

Historically legal judgements were used to define the business of banking. These judgements were based on the functions undertaken and consequently the usefulness of such definitions has diminished. For example, in the landmark case of Commissioners of the State Savings Bank of Victoria v. Permewan Wright and Co Ltd (1915) it was decided that a bank collects money as deposits on a loan, repays these deposits as per agreement and utilises money for lending. In the 1990s there are many non-bank depository institutions that fit this definition. Similarly in a British case, United Dominions Trust Limited v Kirkwood (1966), it was found that a bank accepts money from and collects cheques on behalf of customers, honours cheques and orders drawn by customers, and keeps some form of current account with debit and credit entries. Again, with the increased access of non-banks to the payments system, this definition applies to many institutions apart from banks.

While case law offers few insights, banking legislation has not been very specific on the subject of definition either. In Australia, the Banking Act (1959) states that a bank is *a body corporate authorised ... to carry on banking business,* and recognises a number of banking institutions including the Reserve Bank, the Commonwealth Bank, the State Banks, and other licensed trading, savings and specialist banks. The Cheques and Payments Orders Act (1986) provides a similar definition, specifying:

    a. the Reserve Bank of Australia;
    b. a bank within the meaning of the Banking Act (1959);

    c. a person who carries on banking within the meaning of s.51(xiii) of the Constitution; and,

    d. a person (not (a), (b) or (c)) who carries on the business of banking outside of Australia.

These legislative definitions provide a clear indication as to which institutions may be identified as banks, but they provide no guidance in establishing what it is about the business of banking which sets these institutions apart from other non-bank institutions. Given this lack of clarity, the first recommendation of the Martin Committee Report (1991, p xvii) was that *the Reserve Bank develop a definition of a bank for inclusion in the Banking Act 1959 and other relevant legislation.*

The inability of either the judicial process or legislation to clearly distinguish between banks and non-banks suggests that there is little difference in the functions that they perform. Both groups perform each of the special functions of transaction services, portfolio management, and the allocation, monitoring and control of credit contracts. Most of the differential treatment of banks and non-banks is based on their historical development. Indeed, the US National Commission[7] which investigated the S & L failures, recommended that due to this lack of distinction *thrifts (should) cease to be separately chartered and regulated entities* (NCRRE, 1993, p.69).

With recent institutional innovations such as 'bankassurance' firms, and mutual funds with electronic card access, it becomes increasingly difficult to discriminate between different types of financial institutions, depository and non-depository. The differentiation issue becomes even more blurred, however, when the financial role of non-financial firms is considered.

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[7]   The National Commission on Financial Institution Reform, Recovery, and Enforcement

5.1 Financial v Non-Financial Firms

Traditionally, the primary function of depository financial intermediaries lies in the process of asset transformation, that is the acquisition of primary securities, and the issuance of secondary securities. Financial institutions gain their main income from the margin between primary and secondary securities, and the public accept a lower rate of return on secondary securities rather than face the additional monitoring, liquidity, and price risk costs of direct investment. Clearly, however, there has been some erosion in direct investment costs through advances in telecommunications and electronic processing, which have lead to a breakdown in the traditional structural barriers between depository and non-depository, financial and non-financial firms.

There has, for example, been a move away from traditional deposit products and the use of thrift institutions as the primary repository of householders' funds. During the 1980s, household financial assets placed on deposit with financial institutions declined in all the major economies[8], while direct investment in corporate and government bonds, pension and insurance funds increased. This direct investment has been facilitated by the innovation of products designed for the individual[9]. For example, mutual funds with electronic funds access provide direct investment with a high level of liquidity and little price risk. In addition, modern communications, financial market reporting, and benchmarking of investment funds provide a ready means of monitoring the investment.

Government policy has also played an important role in redirecting savings away from depository institutions. Motivated by concerns for an ageing population[10], governments in most western countries have introduced compulsory savings schemes

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[8]   The share of householders financial assets held as savings deposits declined in the United States from 30% to 26%, in Japan from 52% to 45%, in West Germany from 41% to 36% , and in Britain from 25% to 19% over the period 1980 to 1987. (Saunders, 1994, p.67).

[9]   Examples of this are Eurodollar bonds, government securities such as "Aussie" bonds, and the wide range of mutual fund products that have been developed.

[10]   The expected percentage increase in the population over 65 years between 1990 and 2020 is 33% in the US, 8% in the UK, 40% in Germany, 83% in Japan, 63% in Canada, and 41% in France (Davis, 1991).

such as superannuation and pension funds. The impact of this policy on the direction of household savings has had a significant impact on institutional balance sheets[11]. As a result of this trend, depository institutions have had to compete fiercely for funds and can no longer be regarded as the principal repository of household savings[12].

Not only is there evidence to suggest that financial institutions are losing their comparative advantage in the asset transformation process, but in addition, they are competing against firms which do not have the same net regulatory burden. Non-financial firms are undertaking functions which previously would have been the province of financial intermediaries. The situation then arises that financial and non-financial firms are competing for the same clientele, offering the same services, yet one is regulated and the other is not. In the US, large corporations such as Westinghouse, for example are providing real estate finance, asset-based lending, and leasing, while retailers such as Marks and Spenser are using existing retail networks to offer a full range of retail financial services. This trend appears to be on the increase with more firms becoming involved and strong growth in these services[13].

The unequal regulatory burden that is felt by financial and non-financial firms offering the same services reflects the failure of the regulatory framework to adapt to the emergence of new structures and products, with the consequence, according to US Federal Reserve Board Chairman Volker, that in some cases financial services :

> *are less readily available, at higher cost than would otherwise be the case.*
> *Important competitive inequalities exist, as some institutions are able to take*
> *advantage of loopholes or ambiguities in the existing legal fabric and others*
> *are not. And, in some cases, important objectives of public policy embodied*
> *in existing law are threatened or undermined. The pervading atmosphere of*

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[11]   In Australia, for example, deposit liabilities which comprised 85% of all bank liabilities in 1982 had fallen to around 65% by 1992 (KPMG, 1994).
[12]   By 1988, pension funds' share of personal sector savings had risen to around 70% in the UK, 50% in the US, 40% in Canada, and 20% in Japan (Davis, 1991). In Australia, assets of superannuation funds grew by approximately 20% per annum during the 1980s, reaching 46% of household savings by 1992 (Tease and Wilkinson, 1994).

unfairness, of constantly stretching and testing the limits of law and regulation
and of circumvention of their intent, and of regulatory disarray is inherently
troublesome and basically unhealthy (D'Arista, 1994, p.168).

5.2 The Mortgage Origination Industry - Potential for Moral Hazard?

One of the new non-financial firm competitors of cooperative societies is mortgage
originators. In Australia, mortgage originators who fund their lending through the
issue of mortgage-backed securities (MBS), have achieved rapid growth over the last
few years. Total share of the home loan market attributed to these firms has increased
from 2% in 1992 to 9% in 1996 (RBA, 1996). The industry shows every sign of
growing further. In the US, the mortgage-backed securities market accounts for 55-
60% of all residential mortgages (Financial Market Trends, 1995).

While this industry has brought distinct benefits through greater price competition, and
consequently greater efficiency in the home loan market, experiences in other countries
suggest that there are a number of points which should be of concern to regulatory
agencies. These are

- lack of control over credit standards;
- the potential for moral hazard through the separation of debtors and creditors;
- impact on corporate debt markets; and,
- a potential for decline in the quality of on-balance sheet home loans.

Mortgage originators operate outside the existing prudential regulatory system. As a
consequence there is no external means of monitoring the credit quality of loans
written. Given that many of these loans are written by commission-only agents who
have a disincentive to decline applications, and that many of the loans written have a
90-95% loan-to-value ratio, the risk of such loans should be a concern. As Henry
Kauffman (D'Arista, 1994, p. 29) comments, the widespread use of MBS in the US
has lead to a *financial system where credit has no guardian.* While loans must be of a

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13   In the case of Marks and Spenser, demand for financial services is growing at the rate of
30% per annum, and insurance and pension products are being introduced during 1995 (McKinsey,

high quality to satisfy the needs of risk rating agencies, and indeed credit enhancement is undertaken to ensure the quality of the loans, the potential for widespread cost to the financial system in the event of a fall in asset prices is considerable. This has been the case in the UK where a depressed housing market has eroded the quality of MBS, with the result that only 3% of residential mortgages in the UK are financed using MBS (Financial Market Trends, 1995).

Although mortgage originators raise funds in the wholesale markets and do not have depositors as such, a case can be made for the need to protect depositors who finally invest in these securities through the managed funds industry, which is their primary purchaser. A situation of *moral hazard* can arise when those responsible for incurring the risk in originating a loan, and therefore deriving the benefit, pass the risk onto the investor. Again, a comment from the US House of Representatives debate on this matter (D'Arista, 1994, p.275):

> *the origination is separate from the actual lending of funds, with third parties insuring the loans, still others doing the loan packaging, and even different firms holding the loans in escrow or as trustees. This as the recent experience in California banks suggests, may tend to encourage sloppy procedures and inadequate loan evaluation as each party relies on others to investigate the loans thoroughly. Furthermore, ultimate purchasers of the securities may lack the experience and information to make proper investigations.*

Other concerns which have been given considerable coverage in the US have been the potential for the MBS market to crowd out private investment in capital markets, and concerns that if the trend towards MBS continues, the only loan assets that banks will keep on balance sheet will be of such poor quality that bank depositors will be faced with undue risk.

1994).

5.3 Functional v. Structural Regulation

One of the most often cited solutions to existing regulatory problems is to move to a regulatory system based on financial functions rather than structure. Major problems arise, however, in defining such functions due to the blurring in distinction between institutions and products. Functions can no longer, for example, be divided on the grounds of whether they are financial claim origination, servicing, brokerage, market-making and portfolio management, as there are many areas of financial services that span several of these functions. While appealing in principle, recommendations for functional regulation are often impossible to implement as they are based on a more clearly delineated model of functions and products than currently exists in today's market. Any solution to the problem of equitable regulation of a financial sector which has expanded to include large financial conglomerates and a parallel unregulated banking system, must be based on this existing system and not the system of twenty years ago.

5.4 Summary

In returning to first principles, however, an alternative basis for regulation is suggested. The potential for market failures arises out of the special nature of financial institutions with regard to their trade in confidence and the inherent information asymmetry underlying all their functions.

Under this rationale, to protect the public interest, specific areas where intervention would continue to be required in the name of efficiency, soundness and fair dealing are where any institution 1) accepts direct deposits from the public, 2) makes loans to the public or buys such loans or similar securities, or 3) where an institution sells loans or third party securities to other financial institutions or investors. (This would obviously require the establishment of "firewalls" in many financial conglomerates to annexe such entities.) A system of renewable licensing for such institutions, a uniform application of reserve capital and liquidity requirements, administered by a single regulatory

agency, and appropriate disclosure and enhanced self-regulatory procedures would remove much of the existing inequities across institutions, and safeguard the interests of the financial system.

Recommendations

∗ *That given the lack of distinction in either structure, functions or roles between bank and non-bank depository institutions, both groups should be regulated by the same agency.*

∗ *That in the public interest and for the sake of competitive neutrality the prudential safety net should extend the same controls on capital, liquidity and credit standards across all firms engaged in:*

   ∗ *accepting deposits from the public;*

   ∗ *making loans to the public or buying such loans or similar securities; or,*

   ∗ *selling such loans or third party securities to other financial institutions or investors.*

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