IBSA’s Submission to the Wallis Financial System Inquiry in Response to the Discussion Paper

1. Introduction

The Discussion Paper contributes to future development of the financial sector by identifying the key problems and issues that face the financial sector and by focusing public attention on them. Greater community awareness of the issues and understanding of the role of the financial sector will improve the framework for public policy development. One of the great difficulties encountered by the Inquiry is that the future is uncertain; for example, the future impact of technology, globalisation and innovation on the financial sector is not at all clear. Therefore, we acknowledge that this uncertainty is reflected in the options presented in the Discussion Paper and must condition the Inquiry’s final recommendations.

The Discussion Paper does not materially alter the views and recommendations that we presented in our primary submission to the Inquiry. We request that the Inquiry take note of this when making its recommendations to the Government. We advise the Inquiry that several of the options raised by it in the Discussion Paper are inappropriate and would be a cause of great concern to investment banks, if they were included as recommendations in the Inquiry’s final report. In particular, options to depart significantly from the current framework for bank regulation (for example, by creation of a mega-regulator) should not form part of the Inquiry’s recommendations.

This short submission supplements our primary submission to the Inquiry, made last September, by addressing important concerns raised in the Discussion Paper. In preparing our comments, we acknowledge the Inquiry’s call for new submissions to be concise and refer the Inquiry to our September submission for the substance of our contribution to its proceedings.

2. Financial Sector Regulation - No Fundamental Change is the Best Option.

The Discussion Paper offers several options to serve as the framework for financial sector regulation, ranging from the existing arrangements with a number of regulators and a co-ordinating Council of Financial Supervisors to a mega-regulator. IBSA believes that an institutional focus is the only sensible approach to financial sector regulation and that creation of a mega-regulator would be a serious mistake. The current regulatory framework for banks should be maintained, subject to modification of the character outlined in IBSA’s primary submission to the Inquiry.

The need for radical change has not been established by those seeking it and, while there is some room for improvement, current arrangements operate satisfactorily. There is a need to better co-ordinate financial regulation, but the Council of Financial Supervisors can be invigorated to accommodate this.

There are significant risks and adjustment costs associated with a marked departure from the current arrangements. For example, the solid working relationship that has developed between the Reserve Bank and the investment banks would not easily translate to a new regulator. Effective financial sector regulation involves a close dialogue between the supervisor and the institutions being supervised, that reflects a keen understanding of each others’ business and mutual confidence in that relationship. The current system works well for investment banks in this respect and should not be put at risk. It would take a considerable amount of time to
establish a similar relationship with a new regulator (if it can be developed, which is quite uncertain) and mistakes could be costly for banks and the wider community.

The Inquiry is charged with providing a regulatory framework that will meet future challenges arising from technological change, globalisation and other market innovations. However, it would be wrong to pre-empt changes which have not yet occurred. It is better to put in place a framework that will facilitate major regulatory change, if it becomes necessary, rather than to disrupt a system which works satisfactorily. It need not, and should not, require another major inquiry to act as a catalyst for future change to the regulatory system. The Inquiry can recommend substantial preservation of the present arrangements and put in place a framework that will efficiently identify and implement change as it is needed. An invigorated Council of Financial Supervisors operating alongside a Financial Markets Council, of the type suggested in our primary submission, would provide such a framework.

3. Taxation and Competition - Inextricably Tied and Serious Problems

It is impossible to conduct a satisfactory critique of the financial system without reference to tax impediments that inhibit its efficient operation, especially financial institutions duty (FID) and interest withholding tax. In its review of submissions to the Inquiry, the Discussion Paper draws attention to many tax problems in this regard, that also have the effect of reducing the international competitiveness of the financial system. This analysis is useful, as it widens community awareness of the economic loss caused by these taxes and provides a better informed base for consideration of tax reform.

The Inquiry can further contribute to reform of the financial system by making a firm statement in its final report to the effect that FID and interest withholding tax prevent the efficient and competitive operation of the financial sector, with consequent economic loss to the community. We recognise that the Inquiry’s terms of reference preclude it from making recommendations on tax matters, but this statement would help stimulate appropriate tax reform by the Federal and State governments.

4. Bank Ownership - Greater Flexibility is Required

As outlined in our primary submission, we acknowledge the need for proper regulation of financial markets and view it as a tool to enhance the industry's performance. However, there is a critical need to maintain an appropriate balance in regulation and such regulatory framework must be sufficiently strong but flexible to accommodate the changing shape of the financial sector. Importantly, the regulatory framework must be compatible with international practice and market developments. In this context, there is a need to reform current bank ownership regulations.

IBSA, as a representative of foreign banks, supports the view that the existing restrictions governing the entry to Australian banking markets are out of line with recognised international practice. Prudential regulation should permit banks to operate within whatever organisational structure best suits their circumstances, subject to key criteria like financial strength and prudent management being met. The current policy should be modified to provide for banking authorities to be issued at the discretion of the Reserve Bank without the broad restrictions that apply to ownership or structure. For example, bank partnerships should be permissible provided standard prudential criteria are met, which is the case in leading industrial countries. Reliance on balanced individual assessment of bank licence applications would better safeguard
the soundness of individual banks and enhance the stability and competitiveness of the financial sector, than the application of unrefined criteria that depend upon the regulatory status of the applicant’s parent. We believe that market discipline and the Reserve Bank's existing prudential supervision are appropriate protection for Australian consumers.

5. Derivatives Regulation - Do Not Impede the Wholesale Markets

We agree with the principles of financial market regulation enunciated in the Discussion Paper. In particular, it is good to see that the need for flexibility is recognised. We would emphasise that regulation must be justified by reference to the underlying policy objectives and should be subject to periodic critical review.

However, with regard to derivatives, page 117 of the Discussion Paper states that “there was broad support for the concept for extending futures regulation to cover derivatives more generally”. This does not reflect IBSA’s position, which is better reflected in the statement in paragraph 5.60 that “there was widespread disposition towards lighter regulation of wholesale financial markets”. It is accepted by industry that some regulatory oversight of derivatives trading is necessary, however, the application of futures regulation to OTC derivatives is inappropriate, as it would be unnecessarily intrusive on market operations. It is our view that derivatives regulation should be built upon the critical difference between retail consumers and sophisticated users of derivatives.

Derivatives are traded either on-exchange or over-the-counter. The bulk of OTC derivatives transactions are accounted for by financial institutions that are subject to some form of prudential supervision and governments which are large enough to self insure. A similar situation applies on the Sydney Futures Exchange (SFE) and Australian Stock Exchange (ASX) and their operating rules greatly limit the potential for systemic difficulties originating from that source. Therefore, the concerns about systemic instability that form the basis of public policy objectives are substantially met independently of specific derivatives market regulation (except to the extent that the SFE operating rules and the other regulatory arrangements have legislative backing).

Market integrity concerns are managed differently in the on-exchange and OTC derivatives markets. The operating rules of the SFE and ASX are designed with a view to maintaining fair and orderly markets (again with legislative backing). Participants in the OTC market are professional traders and the market self regulates through a series of agreed operating standards and market governance of individual participants.

Therefore, the key public policy objective to be met by derivatives regulation is consumer protection. Consumers of derivatives are not homogeneous and can be broadly divided into two groups; wholesale and retail consumers. Wholesale market participants are financially sophisticated entities, that participate in the markets in a professional capacity. Retail investors are generally unsophisticated in a financial sense, are minor participants in the on-exchange markets and do not feature in the OTC markets. In other words, regulation to meet public policy objectives is directly relevant to only a small part of the total derivatives market and should not unduly impinge on the operation of the rest of the market. Consequently, the distinction between retail consumers and sophisticated users of derivatives is the cornerstone upon which an efficient, least intrusive regulatory regime must be based.
Finally, there is a need to differentiate between securities and derivatives because, as the CASAC draft report on the regulation of on-exchange derivatives argues, the former are primarily fund raising instruments and the latter are risk management instruments.

6. **Consumer Protection Regulation - Of Limited Application to Investment Banks**

Investment banks conduct their business primarily with corporate and government clients. Their direct interaction with retail consumers is minimal, though their subsidiaries in funds management, securitisation and other services have a direct retail exposure. Internal investment bank management controls on business, like those that determine acceptable transaction counterparties, in many cases prevent them from dealing with retail clients. This is similar in impact to the regulation of bank branches and merchant banks, which effectively preclude them from dealing with retail depositors.

A good consumer protection regulatory regime should not effect investment banks that deal only with wholesale clients, whether in derivatives, investments, loans or otherwise. In effect, their business would be quarantined from the prescriptive regulations designed to protect retail consumers and a *de facto* wholesale banking sector would exist. This should be an objective of financial regulation and achievement of this should serve as a benchmark from which to assess the quality of regulation.

7. **Consumer Protection Regulation - Uniform Consumer Credit Code is a Problem**

The Discussion Paper notes that the Inquiry will give further consideration to industry concerns raised with regard to the Uniform Consumer Credit Code legislation. We endorse this approach by the Inquiry, as significant problems that will impair development of the financial sector remain to be addressed. The legislation is unbalanced, is inadequate in its attempt to assist consumers and is costly for banks to implement.

It is particularly important that the Inquiry addresses the difficulties imposed on the securitisation industry by the legislation. Securitisation has the potential to lift financial sector efficiency, heighten competition and deliver significant consumer benefits. As it stands, the legislation is an impediment to this.

8. **Merchant Banks - Practical Limitations to Change**

Merchant banks have played an important role in the development of the financial sector over recent decades and will contribute to its future development. The Reserve Bank in its submission to the Inquiry suggests that merchant banks be required to operate as licensed banks. In our primary submission, we identified a range of obstacles that stand in the way of merchant banks that wish to convert to licensed bank status. Penalties that they face include adverse interest withholding tax arrangements, non-callable deposit requirements and inappropriate ownership restrictions, amongst others. Any fundamental alteration to the regulatory status of the merchant banks will not be viable until these problems are eliminated. We recommend the Inquiry take account of this practical limitation in formulating its recommendations on the regulation of banks.

9. **Retail Deposit Acceptance by Foreign Bank Branches - A Welcome Suggestion**
The suggestion in the Discussion Paper that prohibition on foreign bank branches accepting retail deposits be ended is welcome. This would accord proper recognition to the sound character of foreign banks operating in Australia and would allow foreign banks that directly conduct retail business here to restructure their operations in a manner that satisfies commercial efficiency criteria. It may also encourage more foreign banks to enter the retail product markets. Consumers will be the ultimate beneficiary of the resultant competition.

10. **Financial Regulation - Regulator’s Approach Matters as Much as Rules**

The efficient operation of the financial sector requires that the correct regulatory framework is established and that legal and administrative regulatory instruments that accord with it are put in place. However, it is equally important that the institutions and officers that implement those regulations are properly attuned to market conditions and the commercial character of financial transactions. This requires development of expert staff and an organisational culture that is sensitive to the needs of the market. This is not always easy, given the innovative nature of financial markets. For example; derivatives are an area where the development and application of regulation has been difficult at times. It should be an objective of the Inquiry to improve the culture of regulation, as well as its organisation and prescriptive form.

11. **Competition - Framework Issues that Require Consideration**

With regard to the organisation framework for consumer protection, we make the following brief comments on the Discussion Paper:

- As a minimum the ACCC should be required to consult with the relevant financial regulators, when assessing competition issues;
- Only national interest and prudential restrictions should apply to foreign banks in considering their access to the banking market, through takeovers;
- The market definition for judging competition must take proper account of the role of financial markets in providing competition to intermediaries;
- A simple cluster approach to assessment of competition fails to take account of niche market players and underestimates competition facing an institution.

12. **Community Service Obligations - Inappropriate and Inefficient**

Banks provide immense direct and indirect benefits to the community through a range of financial services. In order to maximise their economic contribution, banks must be required to operate according to strict commercial criteria. The requirement for banks to incorporate community service obligations into their operations conflicts with this requirement.

Bank consumer service obligations are iniquitous, poorly targeted and opaque. They also impair the efficient operation of banks. Assistance should be transparent to all and properly accounted for by government. This cannot be achieved by imposing community service obligations on banks. The best way to maximise the contribution of banks to the community is to require them to operate in a competitive environment, according to strict commercial criteria.