# The Financial System: Towards 2010

## Introduction

The stability, integrity and efficiency of the financial system are critical to the performance of the entire economy. The financial system is an essential component of the infrastructure of commerce, providing in excess of $40 billion worth of services annually to other sectors of the economy.

The financial system has entered an era of accelerated change that is likely to continue into the next century. Change in the financial system implies the need to adapt regulations imposed on financial institutions and markets. Regulation must adapt both to facilitate greater competition and efficiency in the financial sector and to secure the integrity and stability of its operations.

The Financial System Inquiry was asked to analyse the forces driving change in the financial system and recommend ways to improve current regulatory arrangements.

The main findings and recommendations of the Inquiry are summarised in this overview. The Inquiry's detailed findings and recommendations are presented in Parts One and Two of the Report.

The Inquiry was asked to report on the results of financial deregulation flowing from the Campbell Report published in 1981. The Inquiry's report on these matters is presented in Part Three.

## Outcomes Sought by the Inquiry

The efficiency of the financial system affects every business and individual in the nation. There are very large efficiency gains and cost savings which could be released from the existing system through improvement to the regulatory framework and through continuing developments in technology and innovation. Markets can only deliver these outcomes where competition is allowed to thrive and where consumers have confidence in the integrity and safety of the system.

The Inquiry has not pursued change for its own sake, but has sought an appropriate balance between achieving competitive outcomes and ensuring financial safety and market integrity. In particular, its recommendations seek to:

- create a flexible regulatory structure which will be more responsive to the forces for change operating on the financial system;
- clarify regulatory goals;
- increase the accountability of the agencies charged with meeting those goals;
- ensure that regulation of similar financial products is more consistent and promotes competition by improving comparability;
- introduce greater competitive neutrality across the financial system;
- establish more contestable, efficient, and fair financial markets resulting in reduced costs to consumers;
- provide more effective regulation for financial conglomerates which will also facilitate competition and efficiency; and
- facilitate the international competitiveness of the Australian financial system.

Precise prediction of the direction and performance of the financial system cannot be made. However, the Inquiry is confident that implementation of its recommendations will place Australia's financial institutions and markets in a strong position to adapt to change and to respond to the ever increasing competitive pressures which lie ahead.

# Change in the Financial System

Rapid technological innovation and an evolving business environment together with longer-term changes in customer needs and profiles are reshaping the financial system.

The system will have a progressively greater array of participants, products and distribution channels which, in some cases, will expand beyond the traditional categories of banking, insurance and financial exchanges.

Competition is emerging from new providers of financial services and through the increasing globalisation of financial markets. This generates increasing pressure for improved efficiency and performance.

## The Forces Driving Change

### Customer Needs and Profiles

Changes in customer needs and profiles are gradual but powerful influences on financial sector developments. The impact of these changes is particularly strong in two areas.

First, the role of the financial system in the economy is deepening, with households increasing both their financial asset holdings and their borrowing from the financial sector. This higher demand for financial services reflects increasing wealth and changing financial needs arising from demographic and life cycle changes, including:

- the ageing of the population and increasing expectations of higher retirement incomes; and
- more diverse life cycle experiences including greater job mobility, longer periods spent in training and education, shifts in work-leisure preferences and changes in family structures and experiences.

Secondly, customer behaviour is changing in two broad ways which are together promoting a more competitive marketplace.

- Better access to information and weakening of traditional supply relationships are raising consumer awareness of product and supplier value, thereby increasing competitiveness in markets.
- Greater familiarity with the use of alternative technologies means that more households are pursuing lower cost and more convenient means of accessing financial services.

## Skills and Technologies

Technological innovation has been a major force shaping financial service delivery over the past two decades and appears likely to accelerate over the next few years. Systems for processing, communicating and storing information are an essential part of the infrastructure supporting financial activities. These are all undergoing substantial and irreversible changes as a result of technological advances.

Technology has made it easier to access markets and products both domestically and internationally. Technology has also made it possible to analyse and monitor risk more effectively, to disaggregate it on a broad scale, to price it more accurately and to redistribute it more efficiently. While the pace of innovation cannot be predicted precisely, it is likely to accelerate over coming years for two main reasons.

- The costs of technology will continue to fall.
- Innovations will increase the ease and security of electronic transactions.

These factors will facilitate the conduct of financial activities through homes, workplaces and other sites physically remote from service providers, further reduce cost and lower entry barriers to new suppliers.

## Changing Regulatory Framework

The regulatory framework is itself an important driver of change in the financial system. The governmental and regulatory environments profoundly influence the structure and scale of finance sector activities. Their influence is by no means confined to direct financial regulation. Also of considerable importance are:

- the increased opening of the Australian economy to the global marketplace, including the financial system;
- the introduction of compulsory superannuation;
- changes in the role of government, in particular the almost complete departure of government as an owner of financial institutions and the associated removal of explicit government guarantees of finance sector liabilities; and
- the impact of the taxation system on investment choices and the international competitiveness of the Australian financial system.

Deregulation following the Campbell Report has been a major influence. Among other important changes, this involved a lowering of barriers to entry into the banking sector and the removal of controls over interest rates and other aspects of banking business.

Deregulation stimulated change in the financial landscape in two respects. First, it focused innovation on the delivery of financial services rather than on the unproductive activity of circumventing outdated regulations. Secondly, it created a more competitive environment in financial markets. Nonetheless, the financial system remains subject to a wide array of regulations and entry restrictions and there is scope to encourage greater competition and efficiency through further regulatory reform.

# The Changing Financial Landscape

Major change in the financial system is being shaped by the interaction of these different forces. Some of the more significant effects are summarised as follows.

## Increasing Business Focus on Efficiency and Competition

Technological innovation has fostered innovation in products and delivery channels. Regulatory costs have also prompted innovation with products engineered to exploit gaps, inconsistencies and imperfections in the regulatory scheme. Customers are becoming increasingly sophisticated and effective in demanding value for money.

The implications of these developments are several.

- Business survival will increasingly depend on accurate costing and pricing — there will be ever-decreasing scope for cross-subsidies in banking and other financial services.
- High cost services and delivery channels will be subject to rationalisation, irrespective of change in regulatory arrangements.
- Many markets will be more competitive and contestable, with lower entry barriers allowing niche or specialist providers to exploit opportunities created by the mismatching of price and cost or by inefficiencies in production.

## Increasing Globalisation of Markets

A striking feature of wholesale financial markets is the trend towards international integration as deregulation has removed many of the barriers to cross-border transactions and technology has lowered their cost.

As markets have become increasingly global, the volume of cross-border financial activity has increased. The strongest areas of growth in international financial activity in the past decade have been international bond issues and derivatives trading.

Australia has actively and irreversibly embraced globalisation. A consequence is that competition in many financial markets occurs globally, rather than at the national or regional level, presenting both opportunities and challenges for Australian financial service providers.

While globalisation of wholesale markets is already well advanced, most retail financial markets have scarcely been affected. It is clear, however, that the new technologies and techniques which will stimulate change are now imminent. Advances in the means of achieving secure electronic transactions and the critical mass of electronic network coverage are now well within sight. Global retail electronic financial transactions are likely to emerge in the near future and will almost certainly flourish over the period to 2010 if the regulatory environment is accommodating.

## Concurrent Conglomeration and Market Widening

Innovation in product design and distribution has blurred the boundaries between financial instruments and institutions. Consumers now have greater choices, offered in many cases by entities which have not previously operated in the financial system. The range of choices, and the channels through which they may be exercised, are likely to multiply further.

Competition for existing markets is likely to be intense, with new competitors emerging from outside the financial system and from overseas. Technology will make it easier for foreign markets to attract investors away from domestic markets. As globalisation increases, investors will increasingly be represented by global funds managers with scant loyalties to products or markets. They will buy shares, bonds, mortgages and other financial products wherever the price is most attractive.

These forces will widen the boundaries of financial markets and lead to heightened competitive pressures.

Many of these changes will occur within the institutions already providing financial services. To ensure that the most efficient and competitive services can be offered, these institutions will need to ensure that they do not bear greater regulatory costs than their competitors. This will often involve large financial institutions establishing conglomerate structures under holding companies, and conducting as much business as possible through subsidiaries subject to lighter regulation.

To choose among a plethora of options, consumers may rely to an increasing extent upon trusted names, resulting in brands of preferred financial system suppliers or advisers becoming very valuable. It may prove highly profitable for financial conglomerates to use their brand strength across a wide range of activities.

## A Shift in the Balance from Intermediaries to Markets

The evolution of financial systems is characterised by a continuing struggle between financial intermediaries and financial markets. As imperfections in the operation of markets have receded with the development of new transactions technology and new ways of harnessing information, trade on markets has been increasingly substituted for financial intermediation.

This trend has a number of dimensions, the most important of which are:

- disintermediation in certain credit and risk management markets;
- as part of that trend, securitisation; and
- developments in household savings preferences and the means of meeting them.

### *Disintermediation in Credit Markets*

Disintermediation in credit refers to the tendency of firms or individuals to access financial markets directly and independently of a balance sheet financial intermediary.

Large firms, especially multi-national corporations, can increasingly raise funds directly in capital markets. This partly reflects improved information technology which permits ultimate lenders to inform themselves about the characteristics of borrowers more easily and at lower cost. It is partly also the result of the sheer size and multi-national presence of the world's largest corporations, which have improved their credit ratings in international financial markets.

The response of balance sheet intermediaries to disintermediation by their larger clients has been to join the process as advisers and arrangers and to concentrate traditional lending efforts in those sectors of the market less able to take advantage of direct finance. Banks in some markets have focused more on small and medium sized firms and on personal clients. At present, such clients are mostly unable to issue bonds directly into markets because of the absence of sufficient information about their creditworthiness. They can raise funds only via an intermediary whose creditworthiness substitutes for their own.

The trend towards disintermediation in credit markets has been relatively weak in Australia to date. Banks remain strong sources of corporate credit, and there is no clear trend away from them at this time. Private corporations' use of bond markets is relatively less developed, and it is the banks themselves which are among the heaviest issuers. However, technological advances that lower information costs and extend the reach of markets have the potential to change this situation rapidly.

### *Securitisation*

Securitisation refers to the process of issuing marketable securities against an income stream derived from a pool of otherwise illiquid assets. It involves sales of loans or other assets into specially designed trusts which then issue securities directly into the capital market.

In Australia, securitisation has become a force in home mortgage finance. It has also emerged in some other retail markets, such as credit card receivables and motor vehicle loans, although at this stage only on a small scale.

Like disintermediation, securitisation represents the substitution of trade on financial markets for functions traditionally performed via the balance sheet of financial intermediaries. By originating loans and providing recourse to an insurer in the event of default, financial institutions screen loans and enhance their creditworthiness sufficiently for the loans to be traded in open financial markets. The role of the institution is not displaced entirely by this process but it is substantially restricted in scope. In many cases, it is the institutions themselves which are using securitisation as a means of better managing their capital.

The prospects for growth of securitisation will depend on its cost effectiveness relative to balance sheet intermediation. The question also arises as to possible limits to securitisation. At present, securitisation is largely restricted to assets which have very low, even negligible, risk or which represent a homogeneous class on which risk can be statistically estimated and priced. Whether there will be a market for higher risk or less homogeneous assets is unclear. The test will come with assets like loans to small businesses (some mortgage backed lending has recently emerged in this area).

### *Competition for Household Savings*

The trend to markets has been reinforced by changes on the household demand side. The retirement savings needs of an ageing population are steadily increasing the proportion of financial sector assets taking the form of market claims rather than products offered from the balance sheets of financial intermediaries. This is particularly evident in the relative growth of superannuation funds and products.

Despite this, products backed by balance sheets will not cease to exist in the foreseeable future. Indeed, the recent decision to allow superannuation savings to take the form of deposits through retirement savings accounts may provide some easing for a time in the trend towards market claims. There is also evidence of an increasing demand for capital certain income products for retirees and immediate annuity products offered from balance sheets are already a growing sector for life companies.

However, the broad sweep of the forces for change suggests strongly that the overall balance will continue to shift towards funds managers and markets. The evolution of financial systems has been consistently in the direction of reducing obstacles to the more efficient operation of financial markets. Developments in information technology and risk management techniques are accelerating this trend.

### *Possible Future Developments*

Over time, the processes of disintermediation and securitisation will increasingly offer households alternatives to balance sheet contracts like deposits. For example, more accurate pricing of individual risk categories facilitates the retail packaging and offering of low-risk securities such as those backed by insured home mortgages. An implication is that deposit taking intermediation is likely to shrink in relative importance within the financial system, albeit at a pace that is difficult to predict.

Another key development is likely to be the increasing tendency for superannuation funds and other funds managers to use new technologies in order to link their funds management activities to other financial services. Already, superannuation funds have begun to offer related financial products such as housing loans, group insurance and retirement income products. In the future, other services could be linked to managed funds, notably payments instruments. This could diminish one of the remaining key advantages of balance sheet intermediaries over funds managers.

Beyond this, developments may increasingly transcend existing institutional patterns. For example, financial claims, including loans and bonds, could bypass intermediaries to be bought and sold by electronic auction through global bulletin boards at minimal cost. Users and suppliers of financial claims may be networked together to exchange real-time data and documents. Payments systems are likely to extend beyond the present deposit-based stores of wealth to broader credit-based systems linked to the security of other forms of wealth, perhaps including illiquid assets such as real estate.

All this not only suggests that providing financial services will become very competitive but that the boundaries observed today between markets and between institutions could quickly disintegrate.

# A Vision for the Future

## Alternative Views

The future is necessarily uncertain, and there is worldwide debate about the nature, scale and pace of change in the financial system.

One view is that change will remain gradual and incremental. It is observed that the basic functions of the financial system are not changing, and that the impact of new technologies on the basic structure of the financial system has been relatively limited to date. If the recent pace of change is merely projected forward, this vision would suggest that the financial system in the year 2010 may not look very different from that of the present.

On another view, the financial system (and perhaps other areas of the economy) is undergoing a 'paradigm shift', a more revolutionary transformation which represents a sharp discontinuity from the trend experience of the past. Those holding this view expect that financial processes and structures will be transformed by the rapid emergence of much lower cost information technology and its equally rapid dissemination into homes and workplaces. This shift would not only dramatically alter service delivery channels but could also redefine the character and boundaries of markets. Such discontinuities have occurred in the past in other industries, and it is argued that the financial services industry will now experience a similar shift.

Between these two extremes lie a diversity of views which perceive some truth in both positions. There is a great deal of common ground on many aspects of the debate and there is no doubt, in the Inquiry's view, that considerable change will be experienced over the medium term.

## Inquiry Task

The Inquiry is unable to resolve this debate. However, it considers that it does not need to base its recommendations on firm or precise predictions about the future of the financial system. Creating the future and securing a place in it is a role for the private sector responding to customer demands. Provided processes are genuinely competitive, the private sector is best placed to determine the future shape of the financial system.

For the Inquiry, charged with considering the regulatory framework, the need is to ensure that change can be accommodated within responsive and flexible regulatory arrangements, and that regulation encourages innovation and competition so that the most efficient players and processes prevail.

There is, nonetheless, advantage in anticipating the broad nature of the likely changes which will be the focus of regulatory concern in the near term.

In forming some broad judgements about the scale and pace of change, the Inquiry considers sufficient change is underway for it to recommend modifications to financial regulation. Similar views are emerging overseas with changes to regulatory arrangements being made or considered in several countries.

This is not to say that change is so rapid or pervasive that a fundamentally new approach is required. The Inquiry has steered a course based on the changes which are already clearly emerging rather than on assumptions of radical change in the future.

## Elements of the Inquiry's Vision

The key changes to the financial system likely over the next decade will not alter the rationale for financial regulation, but will shift much of its focus.

- Advances in information technology could well erode the traditional roles of financial institutions, and more niche and specialist players may enter a variety of financial markets.
- In some areas, this new entry may include participants offering services from abroad.
- Many new payment instruments and payments service providers may emerge, some divorced from traditional deposit products and many using new technologies and new delivery channels.
- The emergence of new players will be matched by the continued evolution of large financial conglomerates, using their brand and other strengths to provide a wide range of financial services. The market may come to be polarised into large and small players, with relatively fewer participants of middle size.
- Within the larger financial service corporations, there will be continuous changes in the way services are designed and bundled. The range of activities will be allocated among group entities to minimise regulatory costs, and this will be increasingly important to meet competition from niche (and perhaps foreign) players.
- A much larger share of household financial wealth will be held in the form of market claims, particularly through superannuation savings and retirement income products. The share of financial system assets taking the form of deposits is likely to continue to fall.

For some time to come, however, most of the existing institutional forms are likely to remain, including deposit taking institutions (DTIs), insurance companies, superannuation funds and public unit trusts. The relative balance will depend as much on taxation developments as other factors. In the case of the larger financial services corporations, the regulated entities may become divisions of much broader entities, while all participants will operate within broader markets encompassing close substitute products.

These trends are already evident and have provoked many ad hoc regulatory responses, such as efforts to harmonise conflicting disclosure regulations, efforts to tighten and extend credit laws, the establishment of codes of practice providing flexible but duplicated regulatory coverage, and lead-supervisor protocols for financial conglomerates.

Given these considerations, the challenge is to design a regulatory structure that represents a more systematic and complete response to current trends. The changes which the Inquiry proposes are designed to facilitate market developments already underway. The Inquiry believes that this will provide the best chance of unlocking the potential efficiency gains that a more competitive market can bring, while at the same time maintaining necessary prudence and safety in the financial system.

# A Blueprint for Reform

## Establishing Priorities

The ideal regulatory scheme requires a balance between preventing market failure and allowing financial markets to perform efficiently the functions for which they were designed.

While this is a general principle, the balance required and the environment in which the judgment is made may vary over time. Consequently, it is possible that a particular structure will not meet the objectives of regulation at all times and in all circumstances. The blueprint for reform presented by the Inquiry in this Report is a measured response to the need for change — a response that maintains many of the features of current regulatory arrangements in Australia.

As previously noted, the Inquiry's recommendations are based on trends that are already evident. The Inquiry believes that a more fundamental paradigm shift, should it occur, will bring pressure for further change.

In particular, a paradigm shift is likely to lead to a world of low-cost information and many specialised providers at each point in the distribution chain. Further, these specialised providers may range across international boundaries. In such an environment, the Inquiry believes that there would be both a philosophical justification and a practical need to wind back the more intense forms of prudential regulation and to shift the focus of regulation more to conduct by market participants and disclosure of information.

While these considerations have not been foremost in the Committee's deliberations, it has been conscious of the need to provide a regulatory framework that is flexible enough to cope with more dramatic changes in the financial landscape, should they occur.

## Competition and Efficiency

A principal aim of the Inquiry is to achieve a more competitive and efficient financial system. Even a 10 per cent improvement in efficiency would translate into cost savings for the economy in excess of $4 billion per annum.

To this end, the Inquiry has concentrated on two main objectives:

- to identify the best overall framework for the efficient delivery of regulation; and
- consistent with the Inquiry's Terms of Reference, to propose changes to the way regulation is conducted which will enhance competition and efficiency.

In designing regulatory arrangements, it is important to ensure minimum distortion of the vital roles of markets themselves in providing competitive, efficient and innovative means of meeting customer's needs.

Like the Campbell Committee before it, the Inquiry has proceeded in the knowledge that the performance of the financial system relies heavily on maintaining free and competitive markets. However, where such markets cannot alone meet performance objectives, it is essential to provide effective regulation by government. Regulation is necessary only to the extent that markets may fail, and then only where it can be demonstrated that the benefits of intervention outweigh its costs.

A more competitive and efficient financial system can be promoted in a variety of ways:

- more neutral regulatory treatment of competitors from different institutional sectors encourages those who are most efficient;
- reducing barriers to entry promotes more contestable markets;
- arrangements for regulation which are more responsive to market changes facilitates innovation and new entry;
- more cost-effective conduct and disclosure regulation lowers costs and promotes competition; and
- regulatory and taxation arrangements designed with greater regard to their effect on competition and administrative efficiency would contribute substantially to lower costs.

## Conduct and Disclosure

### Main Issues

Financial markets cannot function effectively unless participants act with integrity and there is adequate disclosure to facilitate informed judgements.

Regulations for these objectives are necessary across the entire economy. In considering their application to the financial system, the main issues for this Inquiry were:

- to decide where such regulation should be provided by general economy wide regulators and where specific financial sector arrangements are needed; and
- in the latter case, what the most effective structures and approaches to the provision of this regulation might be.

As a general principle, and to avoid regulatory inconsistency, economy wide regulation should not exclude the financial system. Thus:

- subject to the most consistent and efficient administration, consumer protection laws, including the prohibition on misleading or deceptive conduct, should apply to the provision of financial products and services; and
- privacy rules for the financial system should be the same as those being developed for the broader economy (subject to any special considerations that may be appropriately implemented through industry codes).

## A Single Regulator for Conduct and Disclosure: Establishment of the Corporations and Financial Services Commission

While there are economy wide objectives for conduct and disclosure regulation, the complexity of financial products and the specialised nature of financial markets has led most countries to establish specialised regulatory arrangements for the financial sector.

In Australia, this has been provided through a variety of agencies, with arrangements governed by the institutional form of the service provider. The Inquiry considers such arrangements to be inconsistent with the emerging structure of markets. It considers that they have resulted in inefficiencies, inconsistencies and regulatory gaps and that they are not conducive to effective competition in financial markets.

A single market conduct and disclosure regulator for the financial sector should be established by the Commonwealth. This new body should seek to establish a consistent and comprehensive disclosure regime for the whole financial system, albeit one with flexibility to apply different rules, in response to different situations, beyond a common core. This regulator should also have responsibility for the regulation of advice and sales of retail financial products, including the licensing of financial advisers under a single regime. It should oversee industry based schemes for complaints handling and dispute resolution and establish a common means of access for consumers.

Regulation for the integrity of market conduct, consumer protection and the regulation of companies have significant synergies. These functions should therefore be combined by establishing the **Corporations and Financial Services Commission (CFSC)** comprising the existing Australian Securities Commission and that part of the Insurance and Superannuation Commission (ISC) which deals with disclosure, sales and advice. The consumer protection codes presently overseen by the Australian Payments System Council chaired by the Reserve Bank of Australia (RBA) should also be transferred to the CFSC.

## Roles of the CFSC

The CFSC should be established by statute with power to administer the various conduct and disclosure laws which currently apply. The laws should be amended to ensure consistency of treatment of like products. Streamlined disclosure requirements should be introduced, including the right to sell products on the basis of succinct profile statements and shorter prospectuses.

The CFSC should also be given powers, exercisable within its jurisdiction, which mirror those provided under the consumer protection provisions of the *Trade Practices Act 1974*. Vesting administration of these powers in the CFSC for the financial system to the exclusion of the Australian Competition and Consumer Commission (ACCC) will avoid duplicate administration while retaining substantive universal coverage of the provisions. These substantive provisions will also greatly enhance the enforcement capacity of the CFSC. Existing inconsistencies within and between various laws should be removed, in particular by ensuring that specific due diligence defences have full effect. Such defences play a vital role in the efficient functioning of financial markets.

The CFSC should adopt a flexible approach to regulation. No one model of regulation should be imposed on the whole system. Where industry standards and performance suggest that the most practicable method involves self-regulation or coregulation, such methods should be preferred. In other areas, where good conduct is not so well established, a stronger statutory style should prevail. In all cases, the cost effectiveness of regulation should be subject to ongoing stringent assessment.

The Inquiry would in principle prefer that the CFSC assumed responsibility for the *Uniform Consumer Credit Code* (UCCC), but has not recommended this change because of the practical constraints that such a transfer would face. However, if after further experience and review the UCCC proves not to be efficiently and uniformly meeting its objectives, consideration should then be given to the Commonwealth assuming current State/Territory responsibilities for the regulation of credit.

## Financial Safety

### Case for Financial Safety Regulation

As noted previously, the case for regulation is founded in the prevention of market failure.

The sources of potential market failure in the financial system include information asymmetry and systemic risk. Where these are present, the market may not deal efficiently with financial risk. This provides the basis for financial safety regulation.

Risk is an intrinsic feature of financial products, and a major role of financial markets is to manage, allocate and price risk. The ultimate source of risk is commercial, and constitutes the inherent uncertainty facing all economic activity. This risk can never be eliminated, but it can usually be allocated through markets to those who are willing to bear it in return for appropriate reward. Thus, it is not the role of regulation to eliminate financial risk wherever it arises. To do so would destroy the vital risk-management role of financial markets with highly adverse consequences for economic activity.

It is therefore necessary to circumscribe the application of financial safety regulation. This is all the more so because financial safety regulation can induce ‘moral hazard’ by encouraging the risky behaviour it is seeking to deter. The Inquiry has reviewed the case for financial safety regulation and confirmed, broadly, that it should continue to be applied in the areas to which it is currently applied. At the same time, it has reviewed the form and intensity of prudential regulation and formed the following judgments.

- Since there is a spectrum of risk in financial markets which should be preserved for reasons of economic efficiency, the degree of regulatory intervention for financial safety should be proportional to the intensity of potential market failure.

- Over time, the scope and intensity of prudential regulation should be adjusted to take account of changes in the intensity of these risks in the different parts of the financial system.
- Government should not guarantee any financial promise, just as the government does not underwrite any other product, even where its safety is intensively regulated.
- It is important for participants and consumers to understand the goals of regulation, and for the framework of regulation to promote such an understanding.

## Prudential Regulatory Framework: Establishment of the Australian Prudential Regulation Commission

To maximise public certainty as to the scope of financial safety regulation, its coverage should be clearly defined by requiring licensing or other authorisation of providers. This would not extend to entities which do not offer the defined classes of regulated products, such as most collective investment schemes — the latter would be regulated only by the CFSC.

### *A Single Prudential Regulator*

A new regulatory entity, the **Australian Prudential Regulation Commission (APRC)**, should be established to undertake prudential regulation within the financial system, combining the existing prudential regulation functions of the RBA, the Financial Institutions (FI) Scheme and the ISC.

To achieve national coverage and remove artificial and anti-competitive distinctions in the marketplace, all prudentially regulated financial corporations should be brought under Commonwealth jurisdiction. This should replace the existing State/Territory FI Scheme for the licensing and prudential regulation of building societies, credit unions, and friendly societies.

Combining prudential regulation in a single regulator will better accommodate the emergence of wide ranging financial conglomerates and enable a more flexible approach over time to changes in the focus of prudential regulation. Such an entity will be better placed to reduce the intensity of regulation, and so lower its cost, in the likely event that new technologies or other developments facilitate a reduction in systemic risks.

The Inquiry considers that the APRC should be separate from the central bank — the RBA — for the following main reasons.

- The combination of deposit taking, insurance and superannuation regulation is unlikely to be carried out efficiently and flexibly by a central bank whose primary operational relationships are with banks alone and whose operational skills and culture have long been focused on banking.
- Separation will clarify that, while the central bank may still provide support to maintain financial stability, there is no implied or automatic guarantee of any financial institution or its promises in the event of insolvency.
- Separation will enable both the RBA and the APRC to focus clearly on their primary objectives and will clarify the lines of accountability for the regulatory task.

The APRC should be empowered under legislation to:

- establish and enforce prudential regulation of any licensed or approved financial entity (unlicensed entities generally would be prohibited from offering products of specified classes including deposits, insurance and retirement savings or income products);
- issue or revoke authorities for DTIs, including banks, building societies and credit unions, life and general insurance companies and friendly societies, and approvals for superannuation funds;
- administer and enforce retirement incomes policy requirements on superannuation products (other than excluded funds where the trustees are the only beneficiaries — these should be regulated by the Australian Taxation Office); and
- assume management control of any licensed financial entity which fails or is considered likely to fail under clearly defined provisions and procedures for early resolution.

### *Approach to Prudential Regulation*

In exercising its powers, the APRC is to cooperate closely with the RBA and, where applicable, the CFSC. It is desirable that its operations, including its findings in relation to financial entities, be publicly disclosed to the maximum practicable extent.

Under the Inquiry's approach, licences for banks, building societies, credit unions and other licensed deposit takers will in most respects be identical. Some differences will remain in the rights to use certain names, and the APRC will have the discretion to apply different intensities of regulation according to the characteristics of the individual institution. A credit union licence will apply only to a mutual organisation using the name credit union. The use of the name 'bank' will require the approval of the APRC, and banks, as now, will be required to have a minimum capital of $50 million and hold an exchange settlement account (ESA) with the RBA.

Similarly, the licences and associated regulatory requirements for life companies and friendly societies issuing life products will be identical (subject to suitable transitional provisions or any case-by-case variations in regulatory intensity).

Policies preventing mutual ownership of banks should be removed. The general principle of spread of ownership should be retained, particularly for DTIs. However, a more flexible approach should be adopted, allowing exceptions where there is a strong case; for example, where other activities within a corporate group are congruent with the provision of financial services. Restrictions on the number of licensed or authorised entities within a corporate group should be eased.

The Inquiry considered the option of introducing deposit insurance but, on balance, was not convinced that such a scheme would provide a substantially better form of protection than is available under existing arrangements. However, the Inquiry recommends that existing arrangements be clarified and adjusted in certain respects. Depositors with banks, building societies and credit unions should enjoy statutory preference in the event of a winding up of the institution, as bank depositors do now.

In the case of mutual entities, restrictions on the issuance of capital instruments should be removed to facilitate meeting capital and liability requirements. In the case of small institutions, provision may be made for voluntary contingency fund arrangements to assist resolution of financial difficulty. Participation in such schemes should be recognised in setting other regulatory requirements. The existing statutory preference protection provided to policy holders by the statutory and benefit funds of life companies and friendly societies should be maintained.

## Systemic Stability and Payments

### Stability

Since instability can arise from a wide variety of sources and must be addressed by the monetary authorities, the systemic stability of the financial system should remain the responsibility of the central bank. The RBA should be responsible also for the payments system because of its central importance to stability.

The RBA should continue to have powers as a lender of last resort to those financial corporations operating ESAs with it. However, the RBA should cease to have explicit responsibilities for the protection of bank depositors and should act instead in the national interest only. Depositor protection functions should be transferred to the APRC, helping to make it clear that, while the RBA may intervene to maintain systemic stability, its balance sheet is not available to guarantee deposits.

The RBA should have unfettered access to financial information held by the APRC and the CFSC. It would be expected that the RBA and the other regulatory agencies would maintain close and continuous liaison.

### Competition in the Payments System: Establishment of the Payments System Board

The task of ensuring systemic stability is closely linked with maintaining the integrity of the payments system. The central bank itself plays a pivotal role in the final settlement of payments.

Accordingly, it is proposed that the RBA remain the regulatory authority in charge of the Australian payments system, but with a separate subsidiary board established to oversee this function — **the Payments System Board (PSB)**. The PSB would have some common membership with the parent board of the RBA, including the Governor and one deputy governor. It would make its decisions independently of the main board which would concentrate on monetary policy and economic stability.

The RBA should be empowered to set standards for the payments system, adopting the role of regulator. Any provision of payments clearing services to its customers in competition with the private sector should be clearly separated from the RBA's regulatory function and be subject to transparent reporting arrangements. The RBA should, however, retain its ownership and participation in those parts of the payments system where high level control and coordination is necessary to ensure maximum efficiency; for example, in the provision of the infrastructure for the high-value payments system.

The clearing systems should be subject to access rules which are transparent and subject to approval by the competition regulator. There should be no presumption that any one class of financial institution should have exclusive rights to issue particular payment instruments, with the exception that only DTIs should be able to issue cheques in their own name. Conditions of access to clearing streams will vary and especially high standards may be mandated as necessary. Entry to payments clearing streams should be determined by the PSB and not be controlled by industry organisations.

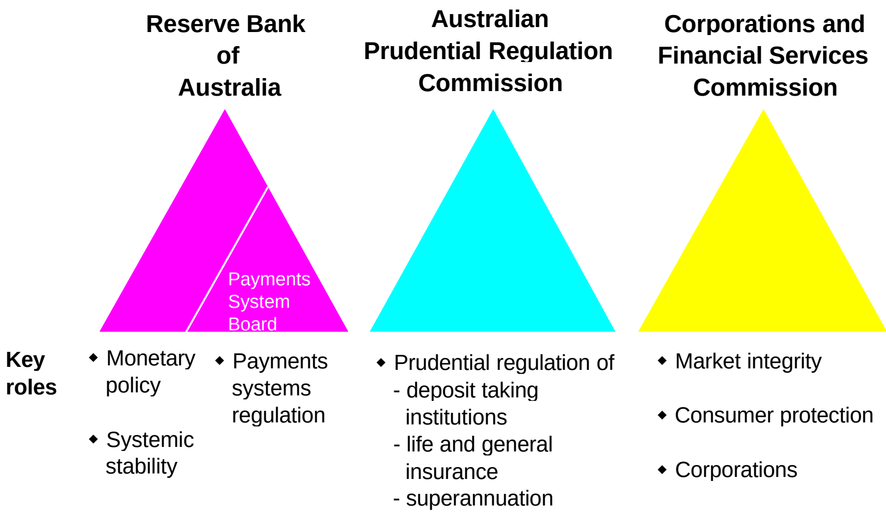
There should be no presumption that banks will be the only holders of ESAs. The right to hold an ESA should be determined by the RBA on the basis of clear and open guidelines, including the requirement that participants have extensive payments business with third parties.

Providers of open system payments instruments such as stored value cards, electronic cash or paper instruments should be required by the PSB to meet appropriate prudential, collateral or other requirements. This is needed to provide some assurance that funds outstanding in such systems are safe.

## The Regulatory Framework: Summary

In summary, the Inquiry proposes that the existing regulatory framework based on four institutional regulators be replaced by three agencies established on functional lines. The new structure is illustrated below.

Figure 1: Proposed Regulatory Framework




## Mergers and Acquisitions

### Mergers

The Inquiry considers that the threat of takeover can be an important source of competitive pressure.

At the same time, mergers which would result in a substantial lessening of competition in markets should be regulated in the financial sector, as in any other sector. Accordingly, merger regulation in the financial system should be administered by the ACCC pursuant to the *Trade Practices Act 1974.*

There is no clear case for retaining restrictions such as the ‘six pillars’ policy which has imposed a blanket ban on mergers among the largest banks and life companies in Australia. The Inquiry considers that the prudential aspects of mergers should be administered by the APRC and would rarely prevent their occurrence (although their funding or conduct may be affected).

In its Report, the Inquiry presents a number of findings about the nature of competition in certain financial markets. In particular, it comments on the cluster of services methodology used by the ACCC, the importance of retail transaction accounts and small business lending to competition assessment, and the pace of movement of retail banking products from the regional to the national level. However, it has refrained from commenting on any particular merger scenario.

### Foreign Acquisitions

As for competition regulation, foreign investment policy should apply to the financial system in the same way as it applies to other sectors of the Australian economy, without the application of special rules or limitations.

The Inquiry considers that no part of the financial system should be immune from foreign acquisition, including major banks and life companies. However, it considers that a large scale transfer of ownership to foreign hands would reduce Australia's future policy flexibility and should be considered contrary to the national interest.

## Promoting Greater Efficiency

The regulatory framework proposed by this Inquiry is founded on the premise that the financial system should be more strongly competitive and efficient.

A broad suite of regulatory issues needs to be revisited to establish whether changes can be made to promote further competition and efficiency, even in the absence of the major changes envisaged for the financial landscape.

- Where regulations or taxes distort or restrict choices, efforts should be made to find more neutral alternatives.

- In the face of globalising markets, every effort should be made to ensure that Australia's financial system is able to compete without the impediments of outdated, inadequate or costly regulations (whether financial or otherwise) or discriminatory taxes.
- Regulators should pursue cooperative arrangements with their overseas counterparts to ensure that global trading is facilitated rather than impeded by local requirements which have no international equivalent, and that international enforcement action can be taken expeditiously.
- Moves towards more efficient pricing reducing cross-subsidies should be recognised as a necessary outcome of heightened competitive pressures. Government could contribute to efficiency and fairness in this area by expediting examination of alternative low cost means of meeting the transaction needs of social security and other recipients of government transfer payments.
- Choice should be maximised in superannuation and other steps taken to increase competitive pressures, including by simplifying regulatory arrangements.
- Impediments to the introduction of electronic commerce should be addressed as a high priority.
- Foreign investment policy should be reviewed where it discriminates between foreign owned and domestically owned life companies and managers of collective investments.
- Privacy provisions which restrict the development of data bases for credit scoring purposes should also be reviewed as they may be imposing considerable costs on consumers.

The taxation system at present does not appear fully conducive to attaining international competitiveness and other financial system goals. It will be important that in any future review of the taxation system its effects on the financial system be extensively and closely considered. For example, taxation provisions, including income tax provisions and stamp duties, inhibit structural reorganisation of corporate entities. Taxation provisions aimed at minimising tax avoidance through foreign portfolio investments also act to discriminate between foreign and domestic providers of collective investments.

### Accountable and Responsive Regulation

A number of organisational improvements in financial regulation in Australia are desirable, including:

- secure funding for the regulatory agencies based on industry charges which match costs;
- maximising the operational independence of the regulatory agencies; and
- establishing boards comprised mainly of members independent of management.

It is also important to maintain a Council of Financial Regulators for information sharing and cooperation among the RBA, APRC and CFSC.

### Establishment of the Financial Sector Advisory Council

Arrangements should also be established for the ongoing participation of private sector experts in the review of financial sector developments and policy. The Inquiry proposes the establishment of a **Financial Sector Advisory Council** to advise the Treasurer on developments in the financial system and their implications for regulatory arrangements and on the cost effectiveness and compliance costs of regulation. The Council should also focus on the international competitiveness of Australia's financial sector and how Australia could become a preferred location for financial activities in the region.

## Concluding Comments

The Inquiry's recommendations are set out in the following listing.

If these recommendations are adopted, the existing institutional framework for regulation would be replaced by industry wide arrangements based on clearly distinguishable regulatory functions:

- regulation for market integrity and consumer protection would be provided by the CFSC;

- prudential regulation would be provided by the APRC; and
- the protection of the payments system and the broader economy from both price inflation and financial instability would remain the regulatory focus of the RBA.

This would provide much more than a restructuring and rationalisation of existing regulatory arrangements. The reconfiguration of the regulatory framework would:

- create a flexible structure better able to adjust regulation to maintain cost effectiveness in the face of changing circumstances;
- provide a more clearly focused and accountable structure that meets (and helps form) legitimate community expectations for consumer protection and financial safety;
- provide more efficient and effective regulation for financial conglomerates;
- provide more consistent regulation and greater competitive neutrality across the financial system; and
- contribute to the effective implementation of the various other reforms which the Inquiry has proposed and which aim at establishing more contestable, efficient, and fair financial markets.

The successful pursuit of these goals will require considerable ongoing effort. Over time, it will be highly desirable to align a broader array of policies, including taxation policies, towards this task.

Success also requires that the institutions charged with these responsibilities remain strong and effective, that they coordinate their work closely and that financial system participants retain a close and continuing role in the development of financial system policies.