Chapter 3
Summary . . .

Regulation as a Driver of Change

Overview

- Regulation has proved to be a strong driver of change in the finance industry. While a wide range of regulatory changes have occurred, four significant regulatory developments have affected profoundly the structure of the industry.

Key Findings

- The liberalisation of trade and cross-border capital flows has occurred in almost all countries, including Australia. This has resulted in greater international integration of financial markets and has increased the interdependence of economies of different nations. A further consequence is that the market for many financial services products is now global.
- Australia’s ageing population has led successive Commonwealth governments to mandate compulsory superannuation to encourage individuals to bear greater responsibility for their retirement funding. This has resulted in a growing proportion of the nation’s financial wealth being invested in superannuation relative to other investment vehicles. In addition, it has caused a shift in household assets towards market linked investments, meaning that households are directly bearing a greater proportion of investment risk than in the past.
- The Commonwealth and State governments are reducing their direct exposure to the finance sector through the sale of public

financial enterprises. As a consequence, the level of direct government guarantees and support for the industry has declined.

- Taxation arrangements in Australia, like those in many other countries, contain a wide range of distortions. Taxation has been a key factor in the creation of legal and organisational structures specifically designed to minimise taxation liability. Progress has been made in reducing taxation distortions in some areas, but the distortions which remain cover a variety of forms. These distortions have the potential to affect the competitiveness of Australian suppliers adversely relative to suppliers from those countries which have fewer distortions.

Regulation as a Driver of Change

3.1 Introduction

Just as changing customer behaviour and technology represent strong forces for change in the financial system, so too do changes in government regulation. A wide range of regulations and government activities influence the finance sector. The most important areas of regulatory change to have profoundly influenced the structure of the financial system in recent decades are:

- **the liberalisation of trade and capital** — most developed nations, including Australia, have undertaken reforms which have increased the level of global competition and trade and have largely removed restrictions on the flow of capital;
- **compulsory superannuation** — the Government's retirement incomes policy has resulted in a substantial shift in the flow of funds into long-term savings products, an effect which will continue;
- **the removal of direct government participation in the financial services industry** — the substantial withdrawal of government from ownership of financial services industry participants has resulted in the phased reduction of direct government guarantees and support; and
- **changes in taxation** — taxation will continue to be a major factor influencing the structure of the industry and the behaviour of its participants, the availability of products, the relative attractiveness of different investments, the competitiveness of Australian suppliers in international markets and the institutional structure of the financial system.

3.2 Liberalisation of Trade and Capital Flows

Globalisation refers to the international integration of markets and the increasing interdependence of the economies of different nations. It is clear that globalisation is the result of several factors.

- Technology has provided the communications infrastructure necessary for international financial transactions to be conducted.
- Customers searching for the lowest cost products and services have provided a ready market for international financial activities.
- Financial services providers seeking a return on their capital (both financial and intellectual) have developed the product engineering skills and innovation necessary to undertake cross-border financial activities.

While these factors have provided the impetus for change, also of critical importance has been the facilitation of global markets through regulatory change. The lifting of foreign exchange controls and the removal of regulatory impediments to movements of goods and capital have dramatically increased the globalisation of commerce and financial markets.

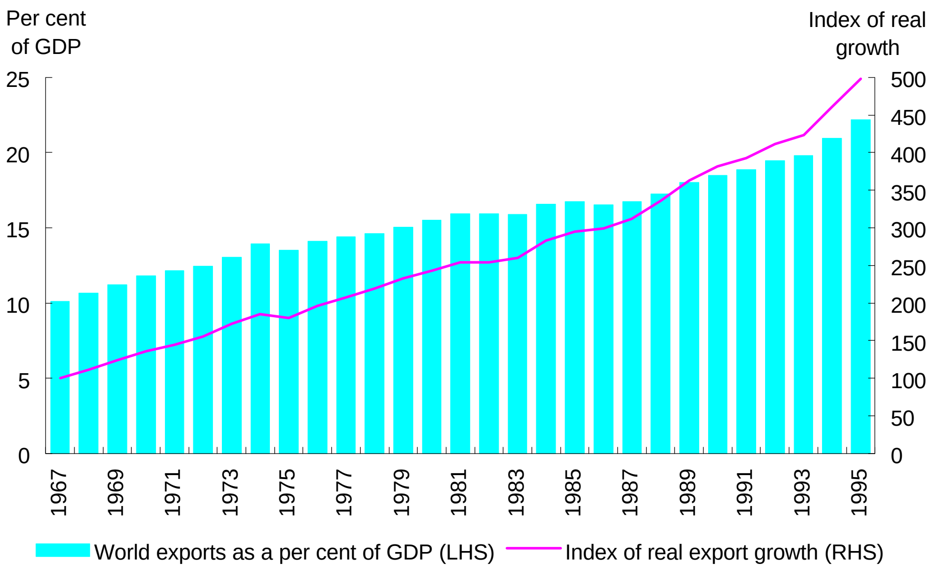
3.2.1 The Globalisation of Commerce

Despite the continued existence of tariff and non-tariff trade barriers worldwide and considerable complexity in the structure of trade barriers, the trend is clearly towards greater liberalisation of global trade. In recent decades, regulatory changes have seen the proportion of world output traded internationally increase significantly. For OECD countries, exports as a proportion of gross domestic product (GDP) doubled from 10.1 per cent in 1967 to 20.2 per cent in 1995. In real terms, this represented an increase of almost 400 per cent (see Figure 3.1). Over the same period, the nominal value of exports from all countries rose from US$200 billion to US$5,014 billion.[1]

1 IMF 1996, *International Financial Statistics Yearbook*, pp. 114-115.

World Trade is Growing Rapidly . . .

Figure 3.1: Total Value of Worldwide Exports of OECD Countries



Note: Based on price levels and exchange rates of 1990.
Source: OECD 1996, *National Accounts.*

As a result of regulatory changes such as reductions in tariffs and quotas and despite the continuation of a wide range of non-tariff barriers, the economies of most industrialised nations, including Australia, are closely linked to the global economy. As trade barriers have fallen, each country's reliance on the economic and financial health of its trading partners has consequently increased.

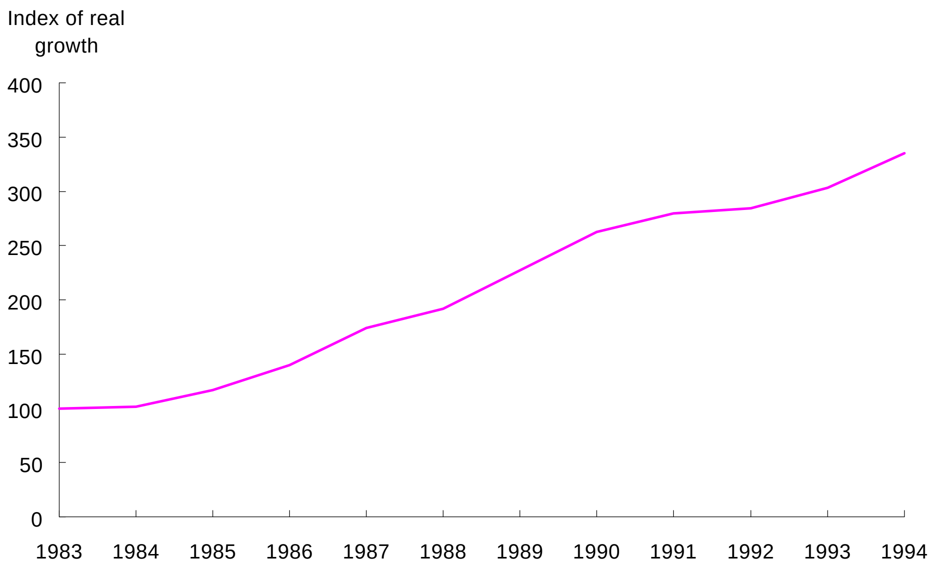
3.2.2 The Globalisation of Financial Markets

Like the markets for goods and services, financial markets in most industrialised nations are becoming increasingly global. The level of interaction and interdependence among participants has increased significantly. Cross-border transactions are growing as investors increasingly view international investment opportunities as part of their investment universe.

- Between 1983 and 1994, the total value of direct investment in overseas enterprises by investors from OECD countries increased from US$447 billion to over US$2,100 billion. In real terms, this represented an increase of over 230 per cent (see Figure 3.2).[2]

Investment Abroad is Growing Strongly . . .

Figure 3.2: Index of Real Growth in Direct Investment Position Abroad of all OECD Countries



Source: OECD 1996, *International Direct Investment Statistics Yearbook*; OECD 1996, *National Accounts.*

- As at December 1995, the value of international debt securities outstanding was US$2,803 billion, with the largest category (US$1,039 billion) representing international borrowing by financial

2 OECD 1996, *International Direct Investment Statistics Yearbook* and OECD 1996, *National Accounts*. Precise definitions of direct investment abroad differ by country but are broadly similar. The definition usually refers to investments made in an enterprise which give the investor significant influence over the operations of the enterprise.

institutions.[3] In 1995, total international borrowing represented 15.7 per cent of all net global bond raisings (up from 9.6 per cent in 1992).[4]

- Similarly, international equity placements by all countries in 1995 totalled US$41 billion. The US, UK, Germany, France and Canada represented US$17 billion of this amount, compared with equity issues in the domestic markets of those countries in the same year of US$126 billion.[5]
- Cross-border transactions in bonds and equities have increased substantially in OECD countries since 1980, reflecting an increased willingness to invest and borrow offshore (see Figure 3.3).[6]

As a consequence of increased cross-border capital flows, related financial markets such as foreign exchange, currency swaps and currency futures contracts have grown strongly in recent years. A survey conducted in 1995 by the Bank for International Settlements (BIS) measured the value of derivative instruments outstanding. The notional value (ie the face value or measure of market size) outstanding of all reported over-the-counter (OTC) foreign exchange derivative contracts was US$13,095 billion as at March 1995, while the reported gross market values (the value received or paid to close an open position) was US$1,048 billion. Based on these reported data, the BIS has estimated that the total global notional and gross values of all outstanding foreign exchange derivative contracts (ie adjusting for amounts not reported) were US$17,700 billion and $US1,420 billion, respectively. [7]

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3 This is defined as bonds issued by companies and residents in foreign markets as well as bonds issued in the local market but denominated in a foreign currency. For euronotes, this definition excludes issues in foreign markets denominated in local currency.

4 BIS 1996, *66th Annual Report*, p. 147.

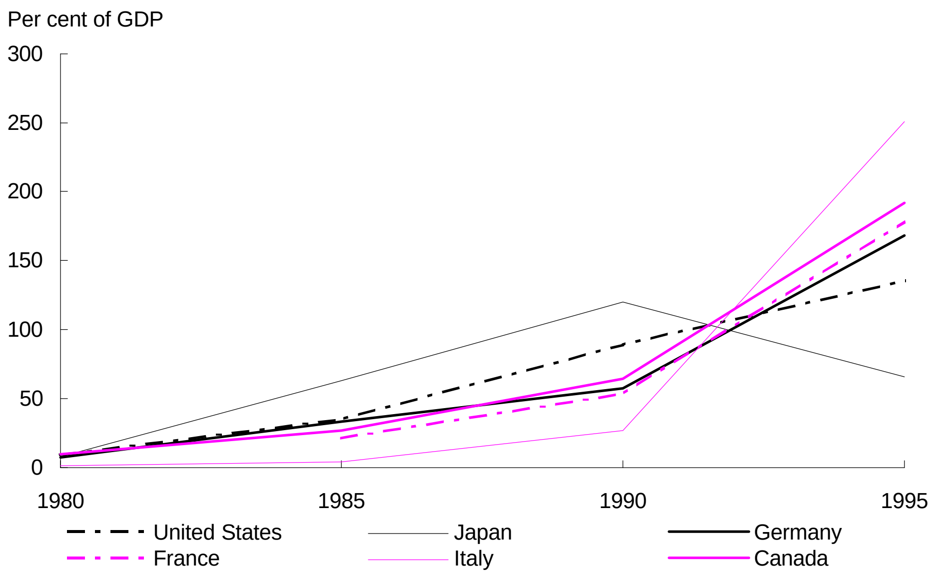
5 IMF 1996, *International Capital Markets; Developments, Prospects, and Key Policy Issues*, p. 65.

6 Japan is the only country to have reduced its cross-border securities transactions since 1990. The Bank for International Settlements considers this to be due largely to the reduced willingness of Japanese institutions to assume additional currency risk, following poor returns on overseas investments and large declines in Japanese real estate and equity values.

7 BIS 1996, *Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, p. 23. Amounts are expressed net of local and cross-border double counting.

Cross-Border Transactions are Growing in most Countries . . .

Figure 3.3: Cross-Border Transactions in Bonds and Equities



Source: BIS 1996, 66th *Annual Report*, p. 98.

Since the early 1980s, the Australian financial system has also undergone substantial regulatory change which has opened the Australian market to the global economy. The principal reforms include:

- the lifting of restrictions on outward investment by Australian companies in the early 1980s;
- the floating of the Australian dollar and the abolition of exchange controls in 1983;
- an extensive program of liberalising foreign investment restrictions since 1989; and
- the progressive opening of the Australian banking system to foreign banks with:
  - — the relaxation of foreign investment guidelines on the ownership of merchant banks in 1984;

— the issuing of 16 new trading bank licences to foreign banks in 1985; and

— the authorisation of foreign banks to operate branches in Australia in 1992.

These regulatory changes have influenced profoundly the way in which financial services are provided in Australia. The responses of businesses and markets to the forces of globalisation are discussed in Chapter 4.

3.3 Superannuation

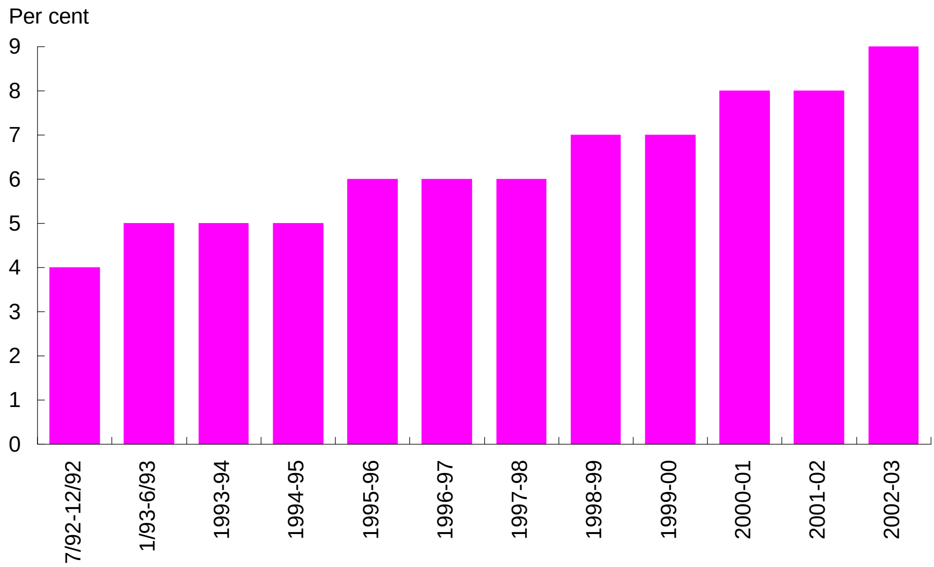
In all industrialised nations, ageing populations are placing increasing pressure on government funded pension programs. Australia's ageing population (see Chapter 1) has led the Government to legislate for compulsory occupational superannuation in an attempt to make individuals take greater responsibility for their retirement funding. In addition, superannuation is granted concessionary tax treatment relative to alternative financial investments to encourage further voluntary savings for retirement and to increase the returns to retirees.

Following the 1986 national wage case decision, many workers became entitled to a 3 per cent productivity superannuation contribution under industrial award provisions. This was subsequently extended to almost all employees by the *Superannuation Guarantee (Administration) Act 1992*.[8] Compulsory employer contributions under the Superannuation Guarantee are scheduled to rise to 9 per cent of total income by 2002-03 (see Figure 3.4).

8 Some categories of employees are excluded. These include those aged under 18 or over 65 years, foreign workers and employees earning less than $450 per month.

Compulsory Superannuation Contributions are Increasing . . .

Figure 3.4: Prescribed Level of Superannuation Guarantee Contributions



Note: For employers with payrolls greater than $1 million. Prior to 1995-96, lower limits applied for employers with payrolls below $1 million.

As a result of government initiatives, the proportion of employed Australians covered by superannuation increased from 51 per cent of the work force in November 1988 to 81 per cent by November 1995. In November 1995, the coverage was highest among full-time workers, at 87 per cent, while 62 per cent of part-time workers were covered.[9]

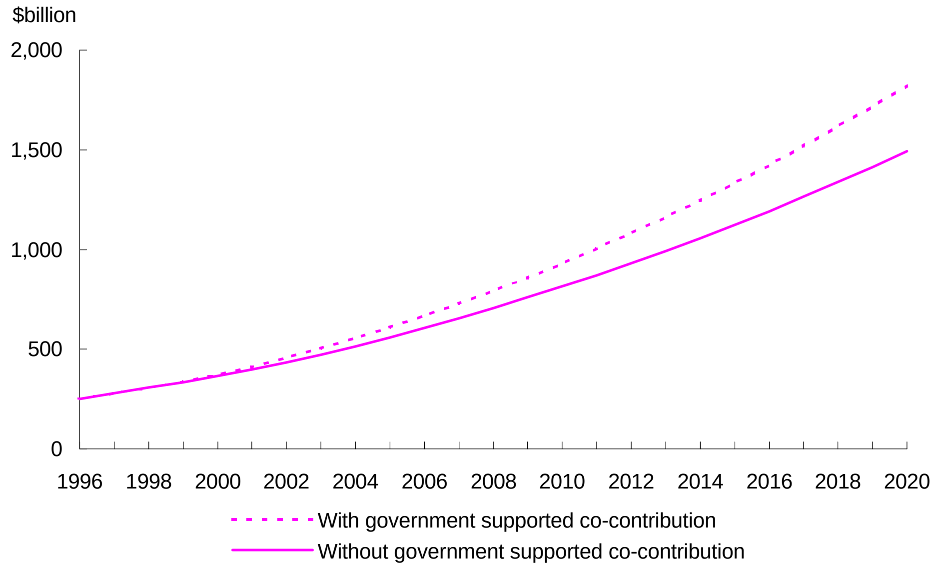
The rise in contributions to superannuation has resulted in considerable growth in the value of superannuation fund assets and caused the investment patterns of Australians to shift. Projections by the Commonwealth Government's Retirement Income Modelling (RIM) Task Force suggest that the total value of superannuation assets will grow from approximately $250 billion in 1996 to between $1,494 billion and $1,825 billion by 2020, depending upon whether or not government supported co-contributions are introduced (see Figure 3.5). In real terms, this

9 ABS 1996, Cat. no. 6319.0.

will represent an increase in total superannuation assets of approximately 190 and 250 per cent, respectively.

Superannuation Assets Are Expected to Grow Strongly . . .

Figure 3.5: Projected Nominal Future Value of Superannuation Assets



Note: Growth assumptions are based on a projected nominal earnings rate of 7 per cent per annum and an underlying inflation rate of 3 per cent per annum.
Source: Data provided to the Inquiry by the RIM Task Force.

As the value of superannuation assets increases, a shift in the share of household assets is expected to occur. In 1980, superannuation and life insurance products represented 7 per cent of total Australian household sector assets, with investments in cash and deposits representing 12 per cent of household assets.[10] By 1988, the proportion of household assets invested in superannuation and life products equalled investments in cash and deposits and, by 1996, the shares were 15.2 per cent and 10.9 per cent

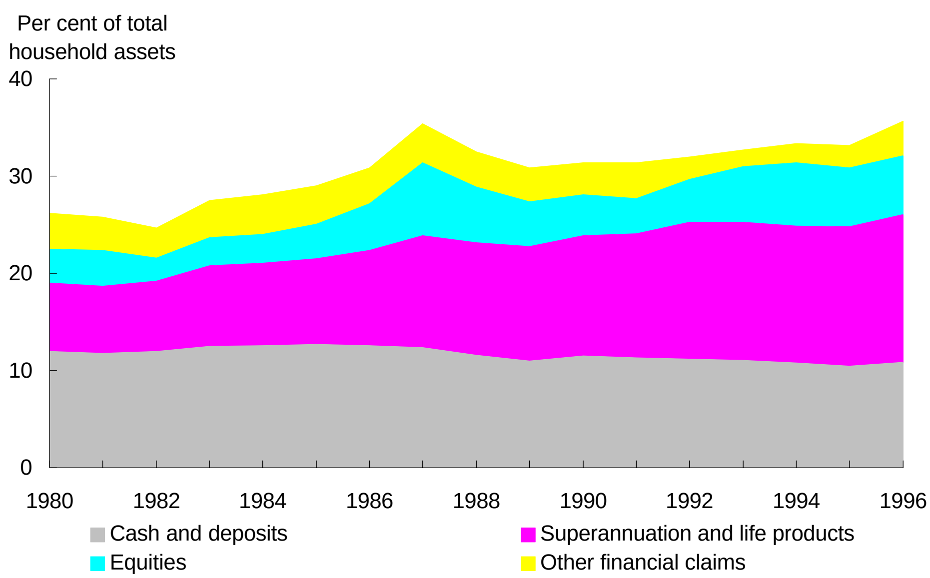
10 Household assets comprise financial assets (cash and deposits, equities, superannuation and life products and other financial assets) dwellings, motor vehicles, durables and other non-financial assets.

respectively. As more household wealth shifts into superannuation, the proportion of wealth held directly by households in the form of cash and deposits is likely to decline further. The share of household sector assets held in equities also grew strongly during this period, rising from 3.5 per cent in 1980 to 6.0 per cent in 1996. The result is that an increased share of wealth is being invested in long-term savings vehicles (see Figure 3.6).

To date, most superannuation has been channelled into the funds management industry, meaning that an increasing proportion of household sector wealth is being invested in market linked investments rather than on the balance sheets of traditional financial intermediaries through investments such as deposits. The growth of managed funds represents a transition in the investment profile of Australians from capital certain investments to market linked investments. Since the value of market linked investments can rise and fall, households are directly bearing a greater proportion of market risk.

Households Are Assuming More Investment Risk . . .

Figure 3.6: Australian Household Sector Assets



Note: The definition of households includes unincorporated businesses.

Source: Data supplied to the Inquiry by the RIM Task Force.

The proposed introduction of retirement savings accounts (RSAs) may slow this trend, depending upon the future risk preferences of superannuation fund members. Estimates of the proportion of superannuation likely to be invested in RSAs vary widely. However, projections by the RIM Task Force assume that 10 per cent of industry funds and defined contribution funds will shift to RSAs.[11] While the introduction of RSAs may slow the trend towards market linked assets, the trend is not expected to reverse.

3.4 Government Exit from Ownership

In recent years, the Commonwealth and State governments have corporatised and privatised previously public financial enterprises (PFEs)(see Table 3.1). This has been motivated by the desire of governments to exit commercial businesses (including non-financial enterprises) to ensure competitive neutrality is restored in those markets, and has also been prompted by losses in certain State government owned organisations and the resultant burden on taxpayers.

One result of such privatisations is that the proportion of financial system assets which contains some form of direct government guarantee has been substantially reduced. As the Commonwealth Government noted in 1995:

> *The PFEs listed under actual or proposed privatisations . . . [in 1995] . . . accounted for more than half of the total assets of the PFE sector excluding the RBA at the start of the decade. This represents one of the most significant developments in the PFE sector, and will ensure a corresponding reduction in the exposure of governments to risk through their ownership of PFEs.*[12]

11 Rothman 1996, p. 11.
12 *Budget Statements 1995-96*, p. 6-17.

Government is Reducing its Ownership of Industry Participants . . .

Table 3.1: Corporatisation and Privatisation of Government Owned Institutions

Government	Institution	Action
Commonwealth	CBA, CFM	Fully privatised
	AIDC	Full privatisation planned
	HLIC	Previously offered for sale, unsuccessfully Currently undergoing restructuring
New South Wales	GIO, State Bank	Fully privatised
Victoria	State Bank, SIO	Fully privatised
Queensland	SUNCORP, QIDC	Corporatised & partially privatised
Western Australia	R&I Bank, SGIO	Corporatised & privatised
South Australia	SBSA	Bank split up and partially privatised
	SGIC	Fully privatised
Tasmania	State Bank, TGIO	Fully privatised

Source: Based on information contained in the *Budget Statements 1995-96*, updated for subsequent announcements.

3.5 Taxation

Taxation has a pervasive influence on the financial system.

Financial products embody a wide range of promises or claims. Ideally, and in the absence of other competing considerations, taxation would affect those promises in a neutral way so as not to distort the preference for one product over another.

However, taxation systems in most countries, including Australia, fall short of this ideal. Differences in the taxation treatment of various financial products are so great as to drive a large proportion of the efforts of investors and financiers to develop legal structures designed to minimise taxation. This imposes a substantial cost on the conduct of business in Australia and magnifies the complexity of financial products. These differences potentially reduce the attractiveness of household saving and raise the cost of administration and compliance with the taxation system. As a result, these taxation differences put Australia at a competitive disadvantage relative to some other countries which have already addressed these distortions.

The differences in taxation provisions take many forms.

- There are differences in the basic taxation treatment of different types of equity entitlements, debt instruments and derivatives. Recently foreshadowed reforms should address many, although not all, of the concerns in relation to debt and derivative instruments. However, the taxation treatment of equity claims (ie shares, trust entitlements and direct proprietary or partnership interests) continues to involve very large differences in the treatment of capital gains, income and capital losses, tax preferences and foreign sourced income. Against these remaining distortions, the Australian dividend imputation system has reduced some of the most important of these biases.

- In the area of savings products, there are differences in the taxation treatment of substitute instruments such as investment linked life policies and unit trusts. In some cases, where taxation preferences are granted for particular reasons (such as concessions for superannuation) there has been a restrictive approach to accessing the concession, with some providers favoured over others.

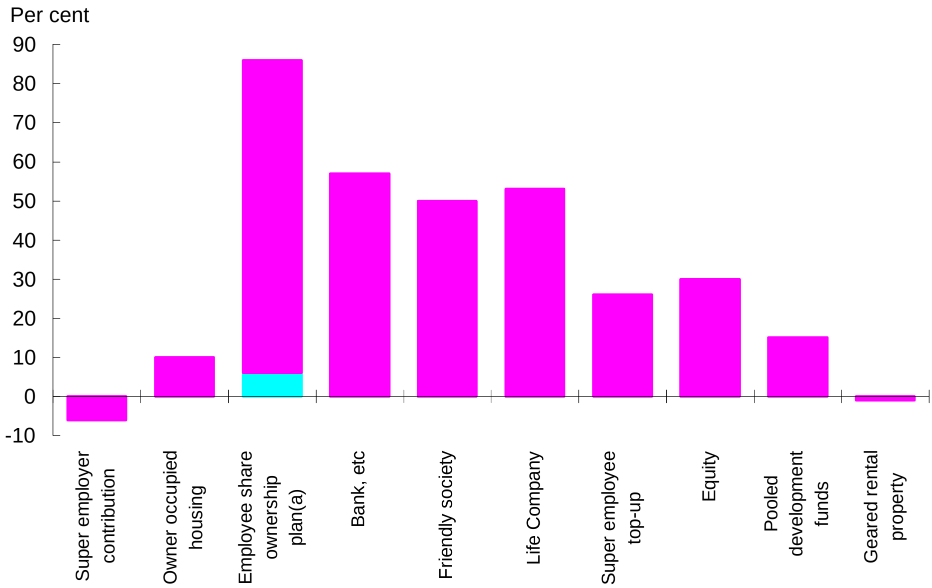
- A variety of transaction taxes are imposed at different rates on different transactions which directly restrain the development of a number of domestic financial activities.

- Arguably, a similar adverse impact on the domestic competitiveness of Australian financial activities arises from some features of the income tax arrangements, including certain withholding taxes, the application of Australian taxation to foreign sourced income derived by non-residents and the application of different tax rules to income derived from foreign, as opposed to domestic, sources.

A report by the Economic Planning Advisory Council in 1994, entitled *Taxation, Regulation and Private Savings in Australia,* highlighted the substantial differences in taxation rates which applied at that time to individuals investing in a range of asset classes.[13] The report contained calculations of the real effective taxation rates which applied to investments in a wide range of asset classes. While changes to taxation arrangements have since reduced some of these inconsistencies, the analysis illustrated the considerable taxation differences that existed (and in some cases still exist) across asset classes (see Figure 3.7).

The Tax Burden is Uneven . . .

Figure 3.7: Real Effective Tax Rates for Selected Financial Assets (1993)



(a) Employee Share Ownership Plans (ESOPs) received different taxation treatment depending upon the structure of the plan. Employers issuing new shares received no tax deduction, while deductions were available for plans which purchased existing shares. Taxation considerations for ESOPs have subsequently been changed.
Note: Assumes investor is on an average income and is taxed at 35.4 per cent, that the investment is held for a representative holding period and that inflation is 3 per cent per annum.
Source: Pender and Ross 1994.

13 Pender and Ross 1994.

The existence of different taxation treatments in the financial system continuously interacts with other developments — such as changing customer needs and preferences, increasing product innovation and globalisation — to influence the pattern and performance of financial industry participants. Any change in the financial system regulatory framework will similarly confront these features of the taxation system. The impact of any finance sector reforms may be muted or amplified according to the extent of distortions imposed by the taxation system.

Two broad themes in the recommendations of the Inquiry on the financial system regulatory framework are:

- the removal of regulations which inhibit active competition among providers of similar or substitute financial products — features of the taxation system similarly distort the choice of such products or their actual or potential providers; and
- the removal or modification of regulations which inhibit the growth, development and international competitiveness of financial sector activities in Australia — again, there are taxation provisions which have a similar effect.

It is beyond the Terms of Reference of the Inquiry to make specific recommendations with respect to taxation. However, the Inquiry has reported on the effect certain taxation policies have on the competitiveness of the Australian financial system.

The impact of a range of specific taxation policies is discussed in Chapter 11.

3.6 Conclusion

Regulation continues to be a strong driver of change in the finance industry. It influences the actions of consumers and participants and in turn influences the structure of the industry.

This chapter focuses on the four key drivers of regulatory change for which the impact has been most substantial.

- The liberalisation of trade and cross-border capital flows has resulted in an increase in international financing and investment. As a result of these developments, the economies and financial systems of most countries are now highly integrated.
- Compulsory superannuation has seen a greater share of household assets shift from capital certain investments, such as bank deposits, into market linked investment classes. A growing proportion of the nation's financial wealth is being invested in superannuation and the level of risk being directly borne by households is increasing.
- Commonwealth and State governments are reducing their participation in the finance sector through the privatisation of public financial enterprises.
- Distortions remain in Australia's taxation system, which have driven the legal and organisational structures of those seeking to minimise taxation liability.

These regulatory developments, together with changing customer needs and technology driven innovation (described in Chapters 1 and 2 respectively), are combining to cause substantial change in the financial landscape. This is discussed in the following chapter and must be considered in designing the regulatory framework for the industry.