Chapter 4
Summary . . .

The Changing Financial Landscape

Overview

- The combined forces of changing customer needs, technology driven innovation and regulatory change (discussed in the three preceding chapters) are imposing substantial change on the landscape of the Australian financial system.
- For the purpose of its task, the Inquiry considers it unnecessary to predict precisely the future shape of the industry. To do so accurately would be impossible. Rather, it has confined its analysis to identifying the broad directions of change which are now under way.
- Four broad changes are identified.

Key Findings

- Increased competition will result in the rationalisation of pricing and costs. There will be no room in a competitive market for non-commercial mispricing. Competitors with high cost structures will also be forced to rationalise their operations in order to remain competitive.
- The Australian economy and its financial system are now closely linked to international markets. Financial services participants in Australia face increasing competition from offshore providers and are simultaneously pursuing international opportunities themselves.

- Increased conglomeration and further market widening will continue to challenge traditional institutional and regulatory boundaries. New competitors are also emerging from outside the finance industry. As competition intensifies, many firms will seek to specialise in those activities they perform best, causing the value chain to disaggregate. Alliances, joint ventures and outsourcing are likely to become commonplace.

- Markets are increasingly challenging intermediaries for the provision of finance and the management of risk. Large corporations have had access to financial markets for some time, but developments in securitisation now allow markets to provide finance to retail borrowers. An increasing range of risks can be managed through an array of market based instruments, while the needs of savers are also increasingly being met through financial market products. Balance sheet intermediaries will continue to perform an important role in meeting the financial services needs of their clients, but the form of their participation is likely to change.

The Changing Financial Landscape

4.1 Introduction

This chapter presents a broad outline of changes in the financial system which the Inquiry considers should be taken into account in designing the regulatory framework. The analysis is based on the forces which have shaped and are continuing to shape the financial system and on the way in which institutions and markets have responded to them. In doing this, the chapter considers the likely effects on the financial system of the major forces for change introduced in the preceding three chapters.

To meet its Terms of Reference, the Inquiry does not need to predict precisely the future form and structure of financial institutions and markets. Indeed, it is impossible to do so. A wide range of strategies will be undertaken by different participants and it is not the role of the Inquiry to pick the winning strategy.

The Inquiry's task is to ensure that the regulatory framework is able to accommodate outcomes determined in competitive markets. To do this, the regulatory framework must comprehend the potential benefits of changes in the operations and structures of institutions and markets and must address any risks inherent in these changes. Importantly, the framework must have the flexibility to respond to developments as they occur.

Thus, the Inquiry has confined its consideration to forming broad judgments on the likely scope and nature of change, and has limited its time horizon to the next decade or so (say, to 2010). It has identified four main elements which are changing the financial landscape.

- **Increased focus on efficiency and competition** — changes in customer behaviour and technology driven innovations are increasing competition, placing pressure on participants to seek new sources of revenue and to lower costs. The main developments include:
  - — improved identification of costs and profitability;
  - — vigorous competition for profitable segments;
  - — reduced product mispricing and increased price differentiation; and
  - — rationalisation of high-cost operations.
- **The further globalisation of markets** — as barriers to trade and commerce are reduced through a combination of government policy and improved communications, markets for financial services are becoming increasingly global, further intensifying competitive pressures and challenging regulatory arrangements.
- **Conglomeration and market widening** — participants are reconfiguring operations, including through more efficient conglomerate structures, outsourcing and alliances to gain market advantage through operational and marketing synergies. In addition, they are exploiting imperfections in regulatory arrangements. Product and institutional boundaries are blurring and substitutes for traditional lines are being created. The boundaries are also extending beyond traditional providers of financial services, as companies with non-financial backgrounds enter sectors of the industry.
- **A further shift from intermediaries to markets** — markets are developing to meet the financial services needs of a wider range of users. These developments include securitisation and its application to a wider range of financing activities, the development of the corporate debt markets and the continuing growth of investments in market linked instruments relative to deposits and similar instruments offered by intermediaries. In addition, markets are providing a means of managing risk through a wide range of derivative instruments.

4.2 Focus on Efficiency and Competition

New technologies make possible, and many customers increasingly demand, improved product performance and lower prices. These pressures are combining to change the dynamics of the financial marketplace, sweeping away many traditional practices and organisational arrangements. Competitive pressures and the need to innovate are heightened by these trends. They mean that customers will face increasing change in the financial system, irrespective of the regulatory arrangements that may apply. This section discusses some of the key dimensions of this trend.

4.2.1 Improved Identification of Costs and Profits

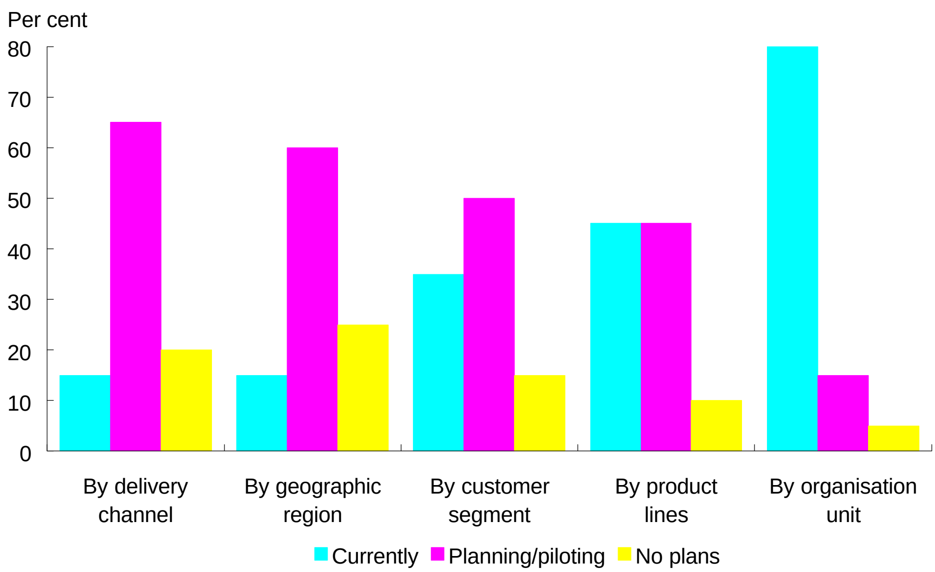
In order to remain competitive, financial institutions are placing greater emphasis on the use of customer and product profitability models to allow them to price products more accurately. As such methods become more widely used for decision making, pricing will become more closely associated with the underlying cost of supply. Greater differentials of pricing across business segments can be expected as a result of more accurate methods of determining the cost of providing services to each segment.

Figure 4.1 illustrates the shift from the measurement of performance of broad organisational units towards the measurement of more specific business dimensions such as delivery channels, customer segments and product lines.

Increasing Sophistication of Pricing and Profitability Analysis

. . .

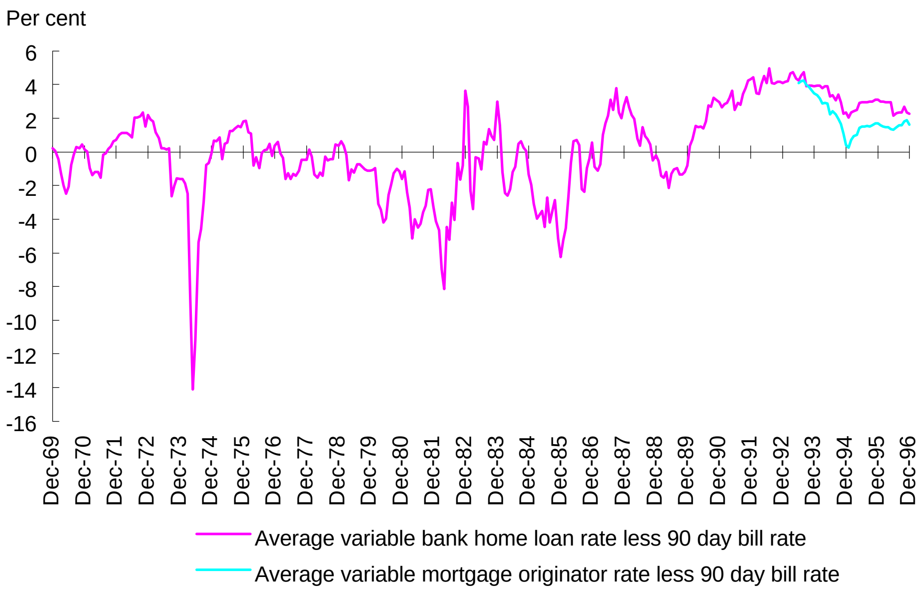
Figure 4.1: Use of Profitability Analysis Systems by Leading Banks Worldwide



wholesale rate of funds) on variable rate residential home loans was relatively slim. Indeed, for many years it was negative.[1] However, by 1992, the interest spread on variable rate home loans offered by banks had widened to over 400 basis points (ie 4 per cent over the 90 day bill rate). This created an opportunity for specialist providers to enter the home loan market and undercut deposit taking institutions (DTIs) by raising funds in the wholesale market, without the cost of a branch network. The resulting loss of share in the home loan market by traditional DTIs forced them to respond by aggressively cutting margins, which has resulted in an overall decline in the profitability of home lending for all providers (see Figure 4.2).

Wide Interest Rate Differentials Invite a Competitive Response . . .

Figure 4.2: Interest Rate Differentials in Australian Home Lending



Source: RBA data, supplied by CANNEX (Aust) Pty Ltd.

1 In the absence of a deposit taking activity, specialist lenders must raise funds in the wholesale markets in order to fund loans. Similarly, DTIs have the option of lending funds to the wholesale market, rather than making loans. For this reason, the wholesale rate can be used to understand better the individual economics of lending and deposit taking.

The resultant lower profitability of home lending reduces the ability of full-service providers to offer other products at prices below their cost of supply.

4.2.3 Product Mispricing and Price Differentiation

Product mispricing refers to charging prices which do not reflect costs. Mispricing has long been a common feature of financial services, particularly in retail markets (banks, building societies and credit unions), and has occurred across customer groups, products and distribution channels.

It is necessary to distinguish between the mispricing of products for non-commercial reasons and mispricing for commercial reasons. Mispricing can occur for non-commercial reasons through the forced provision of community service obligations or due to poor customer or product cost information. Alternatively, mispricing may be undertaken for commercial reasons, where a supplier may intentionally underprice one product in order to generate sales of another more profitable product to the same consumer. Both forms of mispricing can be inefficient since they encourage overuse of underpriced products and discourage use of overpriced products.

One frequently cited example of mispricing is the under pricing of transaction services. Such mispricing is claimed to have effectively cross-subsidised the provision of transaction services to other customers who are heavy users of such services. The reasons for the Inquiry's focus on this issue are:

- a move by many institutions towards increased transaction and account keeping fees;
- a widespread public feeling that fees and charges for transaction services, even at their present levels, are unjustified;
- concern that, if the industry moves further towards 'user pays' fees for transaction services, those services may become unaffordable for some sections of the community, including low income groups or those in remote areas; and

- consequent suggestions that it is part of government's responsibility to intervene and impose on retail banking institutions a requirement that transaction services remain available at low cost to everyone.

In the past, this form of mispricing could be sustained without considerable difficulty because:

- most institutions in profitable segments were typically full-service providers, meaning that competitors provided a similar cross-subsidy within their portfolio of activities;
- most customers usually had only one relationship with a financial services provider, so that losses on the provision of one product could be recouped through profits on other products supplied to the same customer;
- customers often stayed with one financial supplier, with the result that losses sustained on customers at certain stages of their life cycle could be recouped through the provision of profitable products and services at other stages; and
- in many instances, financial institutions' internal data about product and customer profitability were insufficient to identify areas of significant mispricing. From the customer's perspective, pricing differentials were also difficult to ascertain.

Several forces have created pressure on financial institutions to reduce all forms of non-commercial mispricing, including those associated with transaction services.

Competition, in particular from specialist lenders, makes it unsustainable to derive additional revenue from lending products as a means of cross-subsidising transaction services. In addition, selective targeting by competitors of the most profitable customer and product segments forces suppliers to reprice loss making segments.

As more and more customers maintain transaction accounts with only working balances, net interest income declines, forcing the institution to rely more heavily on fee income. In response to the greater range of products available, consumers are better informed as to their options, and are more likely to switch products or providers in order to obtain the most suitable terms and conditions. Consequently, cross-subsidisation within transaction accounts can be expected to diminish over time.

In June 1995, the Prices Surveillance Authority (PSA) released the results of the Inquiry into Fees and Charges Imposed on Retail Accounts by Banks and Other Institutions and by Retailers on EFTPOS Transactions. The PSA report made a wide range of observations and recommendations. At the time, it was found that fees and charges on retail transaction accounts (RTAs) recovered less than 15 per cent of the costs of RTAs.[2] According to data supplied by one bank to the Financial System Inquiry, this was substantially lower than the proportion of direct cost recovery in other countries at the time of the PSA Inquiry (see Figure 4.3).

Direct Cost Recovery from Fees is Small . . .

Figure 4.3: Cost Recovery for Retail Transaction Services via Fees — International Comparison (1995)

Note: Data are provided for a selection of broadly comparable transaction accounts. For each of Canada and the USA, data are supplied for three different accounts. The Inquiry has not independently verified these data.
Source: National Australia Bank, Submission No. 131, p. 1-24, based on data contained in the Bank's submission to the PSA Inquiry.

An additional source of income from transaction accounts is the differential between the interest rate paid on account balances and the cost of obtaining funds from wholesale markets (the alternative funding source for DTIs and their competitors). At the time of its inquiry, the PSA noted that it was yet to be convinced that net interest margins were being squeezed. However, the ability of providers to continue to use net interest margin as an ongoing source of funding for other services is likely to diminish as customers (particularly those with substantial balances) continue to migrate out of low-interest transaction accounts.

Institutions use a wide range of methodologies to allocate costs to products and customers. Confidential evidence obtained by the Financial System Inquiry from several institutions (using methodologies which the Inquiry has not sought to validate) continues to support claims that, at current fee levels and interest rates, the majority of retail transaction accounts remain unprofitable. That is, despite some fee increases since the PSA Inquiry, for the majority of accounts the average cost of providing transaction services, based on the cost allocation methodologies used by those institutions, is not covered by the fee income from those services or the interest rate differential on the balance of the accounts. This implies that the cost of providing transaction accounts for these customers is being cross-subsidised by other products or customers.

It is necessary to note here the distinction between marginal and average costs. While the marginal cost of a single financial services transaction may be small, the investment in infrastructure required to support transactions is considerable. In the short term, it may be more profitable for firms to price on marginal cost. In the long term, however, firms must obtain revenues at least equal to average long-run costs (including an adequate return on invested capital) in order to justify reinvestment in that activity. Thus, mispricing can be said to occur only if it is sustained over the longer term.

Competition can be expected to reduce or even eliminate these forms of non-commercial mispricing over time. Some charges may still fall short of costs where institutions find that such pricing can be used to promote

2 PSA 1995, p. xxi.

profitable bundling with other financial products (ie where there are clear commercial reasons underlying the 'mispricing' decision).

More efficient pricing policies would encourage consumers to use lower cost channels and therefore facilitate a more efficient financial system.

The experience of PostBank in New Zealand provides an illustration of the successful migration of customers to lower cost electronic channels.[3] PostBank was acquired by the ANZ Banking Group (ANZ) in 1989. A combination of customer education, advertising, pricing incentives, the introduction of telephone banking and a greater than 50 per cent increase in electronic outlets has dramatically altered the transaction profile of target customers and resulted in an increase in customer satisfaction:

- or branch transactions decreased from 55 per cent of all transactions in April 1994 to 8 per cent by August 1995; and
- 97 per cent of customers are satisfied with the new electronic based transaction arrangements, and 90 per cent prefer it to the old way of transacting (a further 5 per cent saw no difference, while only 5 per cent preferred the old passbook method).

Over the long term, competitive forces mean that all product prices will more accurately reflect their costs of supply. The degree of mispricing will be reduced as suppliers adopt more differentiated pricing structures across customer and product segments which more closely reflect the underlying cost of servicing those customers or products. In the same way that competition forces repricing in profitable segments, so too does it force repricing in loss making products. As a result, the prices paid by individual customers are likely to be more differentiated than at present, depending on the range of services they use, the frequency of that use, and the channels through which they seek to have those services delivered. Alternatively, failure to reprice loss making products or to replace them with suitable substitutes may ultimately lead to their withdrawal.

3 Based on information supplied to the Inquiry by ANZ.

4.2.4 Cost Rationalisation in the Sector

The pressures of heightened competition are also likely to drive the continued rationalisation of high-cost services in a variety of segments of the financial system. This will particularly occur as the duplication in delivery channels is rationalised since, over recent years new channels have added to, rather than replaced, older and more expensive channels.

The process of rationalisation, including the closure of bank branches, is likely to occur irrespective of regulatory change, since it is driven by the fundamental competitive forces unleashed by new technologies and other factors. The scope for, and potential gains from, such rationalisation are discussed in Chapters 6 and 10.

4.3 The Further Globalisation of Markets

As a result of the liberalisation of trade and capital flows, Australian financial markets have become increasingly global over the last decade and are now characterised by a relatively high degree of integration with international markets. Australian businesses and markets have responded in four ways: fundraising by corporations and institutions is becoming increasingly global; foreign inwards and outwards investment are both growing; trading is becoming more international; and the location decisions of many financial services corporations reflect an increasingly international perspective.

At this stage, the globalisation of retail financial services is still relatively undeveloped. The rapid development of technologies such as the Internet means that there is scope for globalisation to emerge over the next decade as a much more powerful dynamic, with substantial potential implications for financial sector regulatory arrangements.

4.3.1 The Current Extent of Globalisation

The following evidence illustrates the extent of existing international linkages in the Australian financial services industry.

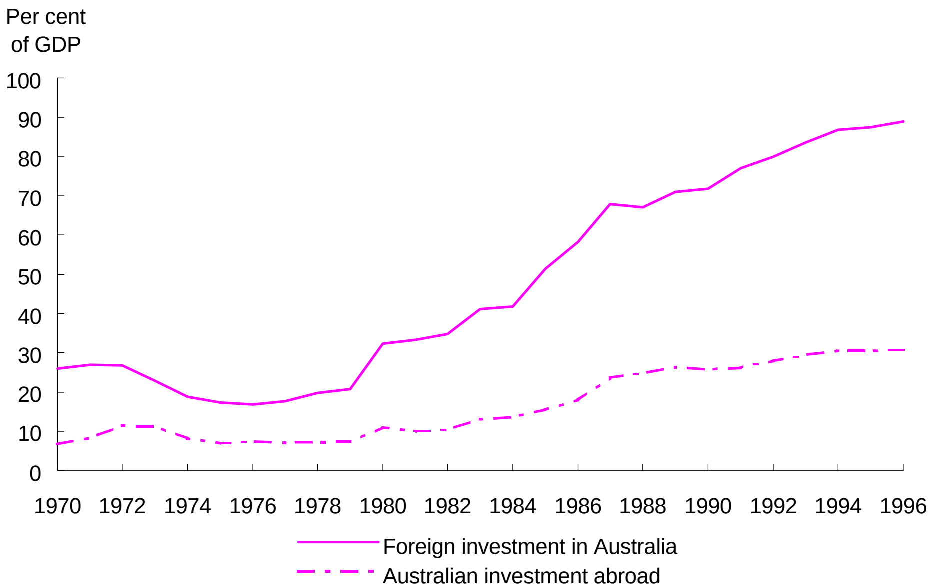
Fundraising, Ownership and Investing

- Australian corporations regularly access international markets for the raising of debt and equity. In 1995, the value of outstanding borrowings by Australian private sector corporations in the international bond market exceeded the outstanding value of borrowings in the domestic bond market.[4]
- During 1995-96, foreign investors purchased $34 billion of Australian equities, and by March 1996 foreign ownership of Australian equities had reached a record high of 32.5 per cent, or $109 billion.[5]
- Australian managed funds have increased the proportion of funds invested offshore, from 8.0 per cent of total assets in June 1988 to 14.5 per cent in September 1996.[6]
- Total Australian investment abroad (across all industries and sectors) has grown to $156 billion (as at September 1996) while total foreign investment in Australia now stands at $444 billion. As a proportion of gross domestic product (GDP), foreign investment in Australia has increased approximately two and a half times since 1970, while Australian investment abroad has increased approximately three and a half times over this period (see Figure 4.4).

4 BIS 1996, *66th Annual Report*, p. 149.
5 Australian Stock Exchange, Submission No. 65, p. 22.
6 ABS 1996, Cat. no. 5655.0.

Increasing Investment into and out of Australia . . .

Figure 4.4: Australian Investment Abroad and Foreign Investment in Australia



Note: Figure shows the total level of investment at June 30 for each year.
Source: Foster 1996, pp. 54-55; ABS 1996, Cat. no. 5206.0; ABS 1996, Cat. no. 5306.0.

Global Market Trading

- All of the 10 largest Australian companies listed on the Australian Stock Exchange (ASX) are also listed on overseas exchanges, with BHP listed on seven foreign exchanges and News Corporation listed on eight foreign exchanges.[7] The ASX estimates that between $20 billion and $30 billion worth of shares in Australian companies are traded annually on overseas exchanges.[8] Similarly, the market capitalisation of foreign companies listed on the ASX exceeds $200 billion.[9]

---

7 The Allen Consulting Group 1996, p. 98.
8 Australian Stock Exchange, Submission No. 65, p. 22.
9 Australian Stock Exchange, Submission No. 65, p. 23.

- The Australian dollar is the world's eighth most frequently traded currency, with over 60 per cent of trades occurring offshore.[10]
- Daily foreign exchange trading in Australia in all currencies in 1995/96 averaged $52.1 billion, of which trading against Australian dollars averaged $25.5 billion.[11]

Location Decisions

- A wide range of international financial services providers have entered the Australian market and now compete with Australian providers to offer services to local users. In addition, some of these firms use their Australian operations to conduct services for offshore affiliates. For example, in 1995, State Street Bank announced that Australia would become the regional processing centre for the group's Asia Pacific operations, and Bankers Trust Australia is now the worldwide headquarters for Bankers Trust's global funds management operations.
- In addition, a large number of Australian financial services organisations are pursuing activities in foreign markets. A number of banks and life companies now have a substantial share of their operations in markets overseas. For Australia's 30 largest financial institutions, assets overseas exceed $230 billion and represent around 24 per cent of their group operations.[12]

4.3.2 Implications of Globalisation

Australian financial markets are already closely linked to global markets. At the wholesale level, participants regularly access international products.

There are four main implications of Australia's continuing high level of integration with global financial markets.

- Exposure to global competition is a powerful force driving improved efficiency, through better resource allocation in the

10 BIS 1996, *Central Bank Survey of Foreign Exchange and Derivatives Market Activity 1995.*
11 RBA 1997. Data excludes inter-dealer double counting.
12 Council of Financial Supervisors 1996, *Annual Report*, p. 57.

domestic economy. At the same time, it can promote innovation and other dynamic efficiency gains. These advantages of globalisation provide the principal rationale for the regulatory reforms which have been made to facilitate it.

- Such opportunities also present a competitive challenge for domestic industries. For the Australian financial services industry, the challenge is to provide internationally competitive products and services. If the Australian industry fails to do so, it will lose market share to overseas financial services providers. The ability of both wholesale and retail clients to tap worldwide markets through rapidly improving technology raises the possibility that, in the future, entire sections of the finance industry could relocate offshore virtually overnight if Australia does not remain competitive.
- In order to ensure that Australia remains a participant in global financial markets, it is often necessary for regulations in Australia to be in harmony with those overseas. For example, capital adequacy standards and regulations concerning fundraising in Australia must be broadly consistent with similar regulations in other financial markets. In some cases, it may also be appropriate to seek improvement by adopting world's best practice regulation.
- A further consequence is the possibility of 'regulatory competition' between competing jurisdictions, to which Australian regulators must respond. While regulatory competition could lead to an overall lowering of regulatory standards, the more likely outcome is that regulators will have an incentive to develop a range of regulatory frameworks across jurisdictions which best meet the needs of participants and users in those markets.

It must also be recognised that there are new risks in globalisation. In the same way that demand for a nation's goods and services is influenced by the health of its trading partners, so too is the financial economy influenced by events offshore. Examples are plentiful: a change in real interest rates overseas is likely to result in a change in real interest rates in Australia; and a significant change in share market valuations overseas (as occurred in October 1987) is likely to result in a re-evaluation of share market values in Australia (see Chapter 17 for a discussion of the global linking of asset markets). Similarly, for institutions undertaking international expansion, the complexity of managing global operations increases as geographic spread expands. Regulators and institutions must continue to recognise that risk can be transmitted from overseas events (such as the failure of a leading overseas bank or securities participant) and ensure that exposures are managed accordingly.

Australia's financial system will continue to remain highly integrated with global markets and, indeed, can be expected to become even more integrated as technology enables greater access to overseas markets. Regulatory developments are also likely to facilitate further globalisation of financial markets. Progressive implementation of the multilateral General Agreement on Trade in Services, other World Trade Organisation administered agreements, and regional agreements such as those under Asia-Pacific Economic Co-operation aim to promote freer trade in services and more open investment flows through continual processes of review and liberalisation. Further liberalisation within trading blocs such as the European Union will also increase trade among member countries (but not necessarily between member and non-member nations).

4.4 Conglomeration and Market Widening

The increase in competition, both from domestic markets and from abroad, has significant implications for the configuration of financial operations in Australia.

For existing institutions, attention is focused on achieving more efficient conglomerate structures, outsourcing and alliances, to gain advantage through operational and marketing synergies or the exploitation of anomalies in regulatory arrangements. In this quest for advantage, product and institutional boundaries are blurring and hence markets are effectively widening through the creation of substitutes for traditional lines.

These boundaries are also extending beyond traditional providers of financial services, as companies with non-financial backgrounds enter sectors of the industry.

4.4.1 Conglomeration

The Australian financial system already comprises predominantly financial conglomerates. Traditionally, these have taken the form of either a bank or a life company, with other activities having a secondary place. The clear identification of institutions as banks or insurance companies is reinforced by the regulatory system, which is based on institutional lines. In the case of banks, this has required the ultimate holding company of such a group to be a licensed bank or, in one case, a life company.

Increasingly, the underlying trends in the development of the financial system are resulting in conglomerates which focus on a wider spectrum of activities. Heightened competition is encouraging a reconfiguration of conglomerates to achieve the most cost-efficient structures. To some extent this is driven by the advantages that individual institutions can obtain through ‘regulatory arbitrage’ — that is, shifting business into vehicles which enjoy lower regulatory costs. Lending, for example, may be shifted from banks to life companies or unregulated entities in order to reduce capital charges.

Conglomeration is assisted further in some cases by innovation in product design to enable products which traditionally have been the preserve of one class of institution to be offered by entities of another class. For example, life companies have developed products which have most of the characteristics of deposits, and banks have developed superannuation and market linked products which are offered through subsidiary operations.

4.4.2 Bundling and Unbundling of Products

In response to specialist competitors and increased competition, traditional balance sheet intermediaries are pursuing a wide range of bundling and unbundling strategies. Some are choosing to focus only on selected market segments, while others are offering their customers the full range of services. Examples of both strategies are already in evidence.

In Australia, many full-service providers are encouraging customers to ‘bundle’ their financial purchases, by offering discounts on products based on the level of other business conducted with the institution, or even on the length of time a customer has been with the institution (see Chapter 10). Meanwhile, other players are focusing selectively on specific product categories, and are attempting to dislodge that business from existing competitors. Mortgage originators, for example, are focusing only on selected product categories such as home loans and, more recently, small and medium sized enterprise lending (secured by residential housing) in order to secure the more profitable products supplied by traditional full-service providers.

In the US, Wells Fargo, the second largest bank in California and the eighth largest bank holding company in the US, no longer provides standardised housing mortgages itself, relying instead on external suppliers to manufacture these loans on behalf of the bank's customers. The bank's primary focus is now on deposit taking and small business lending, areas in which the bank considers itself 'best in class'.

The degree of product bundling is not uniform. The contest between the bundling of products by full-service providers seeking to secure a greater proportion of a customer's financial services expenditure and the unbundling offered by product specialists is likely to be a continuing feature of the Australian financial landscape. The extent to which consumers bundle their financial services purchases is discussed further in Chapter 10.

4.4.3 Extending Traditional Boundaries

As the Australian market becomes more contestable, a wider range of competitors can be expected to emerge. These firms will come from a range of backgrounds, but increasingly will include companies with linkages to non-financial services operations.

Non-traditional competitors which could eventually (or already do) offer financial services in Australia include:

- utilities such as postal, telecommunications and electricity groups that can utilise a considerable physical and communications infrastructure for the delivery of transaction services;
- retail organisations or consumer product companies (airlines, motor vehicle manufacturers, etc) that can use a strong brand name, large customer networks and a well-developed marketing and

segmentation capability to offer a wide range of financial services and products to consumers; and

- software companies that can develop sophisticated software able to act as a customer ‘gateway’ for the search and delivery of financial services and products.

Such organisations may choose to enter the financial services market on their own, or may enter via alliances, joint ventures or marketing agreements with existing participants.

4.4.4 Outsourcing

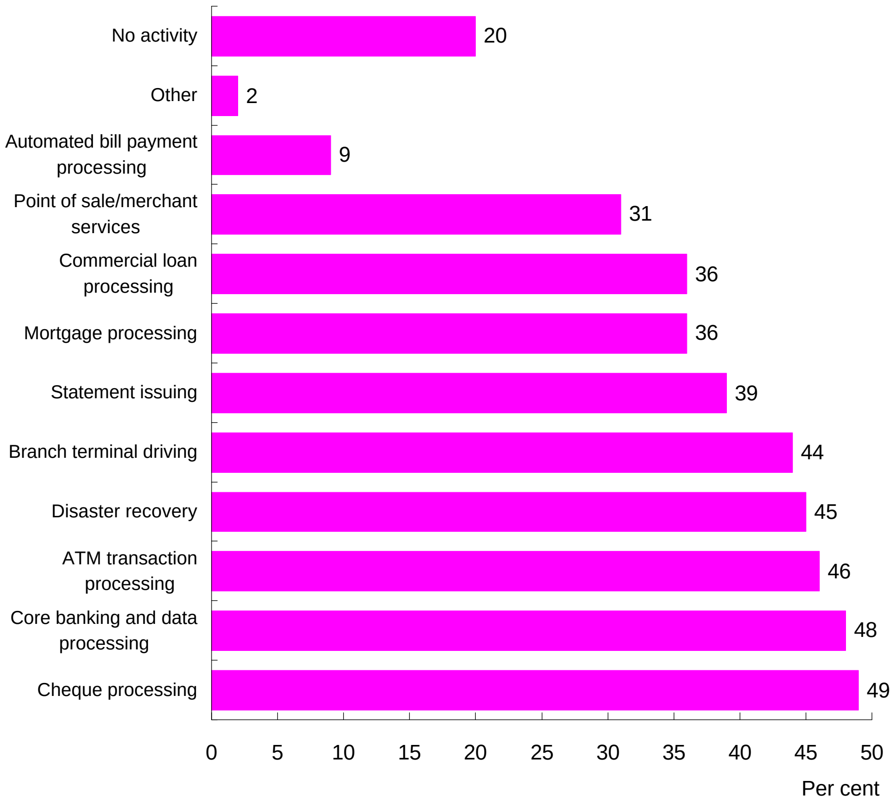
Outsourcing refers to contracting with an outside party to perform a certain activity. Examples of activities which are commonly outsourced in many industries include cleaning and printing. Similarly, a motor vehicle manufacturer will rely on hundreds of external suppliers for parts critical to the production of a motor vehicle.

As competition intensifies, the ‘value chain’ (the sequence of individual activities which constitute the provision of a good or service) is likely to disaggregate into specialised components. Some firms may seek to secure a competitive advantage by specialising in those activities which they do best. Similarly, those activities for which a firm does not possess any special capability or scale advantage may be contracted to another firm with such skills (perhaps to a competitor) or even be discontinued altogether. Some institutions which currently perform all activities in the value chain themselves may end up performing relatively minor activities — other activities (including even the provision of finance) may be conducted outside the institution.

In the United States, outsourcing of key financial services functions is common. In particular, processing activities are often outsourced (see Figure 4.5).

Outsourcing is Common in the United States . . .

Figure 4.5: Proportion of US Banks using Third Party Providers by Activity (per cent outsourcing)



Source: *American Banker* 1996, 22 May, p. 3A.

Outsourcing is less common in Australia than in the US or Canada. Many Australian providers choose to perform most functions in-house. However, some Australian organisations have chosen to outsource selected activities, including funds management, data processing and cheque processing. There is considerable potential for further outsourcing in these and other areas such as mortgage processing.

Outsourcing has the potential to lower industry costs and remove an existing barrier to entry for new competitors. A new entrant will no longer be required to provide all activities in house, but will be able to contract with other parties for the provision of various functions.

4.5 Shift from Intermediaries to Markets

The evolution of financial systems has been characterised by a continuing struggle between financial intermediaries and financial markets.

Reasons for the growth of markets are several. As imperfections in the operation of markets have receded with the development of new transactions technology and new ways of using information to assess and minimise risk, trade on markets has begun increasingly to substitute for financial intermediation. While these processes are driven by developments in the technologies available for market operations, another driver underpinning these changes are changing preferences of savers. As noted in Chapters 1 and 3, the ageing population, increased holdings of financial assets by households and the development of compulsory and tax-assisted superannuation have combined to shift investment preferences towards the higher end of the risk-return spectrum. This too has favoured market products and funds managers over traditional intermediaries.

Disintermediation refers to the process of borrowers bypassing balance sheet intermediaries and obtaining finance directly from the capital markets. Traditional intermediaries may still perform valuable functions in a disintermediated lending environment, such as advice, placement and underwriting activities, but finance is derived directly from the markets rather than from an intermediary's balance sheet.

The development of corporate debt markets and securitisation illustrate the competition faced by traditional balance sheet intermediaries for the provision of finance. In addition, markets for other financial instruments such as futures, swaps and options have also recorded strong growth and are used extensively to manage price risk on a wide range of instruments and commodities.

4.5.1 The Corporate Debt Market

The increasing capacity of large firms to access markets directly is partly a result of improved information technology which allows ultimate lenders to inform themselves about the characteristics of borrowers more easily and at lower cost. It is also the result of the sheer size and multinational presence of the world's largest corporations. These firms, which were once known only in local markets, now have an international presence and recognition.

In some overseas jurisdictions, disintermediation has been aided by the substantial deterioration in the credit ratings of some of the world's largest banks during the late 1980s and early 1990s. As the credit ratings of banks fell, some large corporations found themselves with credit ratings superior to those of their bankers, and were therefore induced to access capital markets directly so as to secure cheaper funding. The eventual recovery of banks' balance sheets in the mid-1990s did not reverse the situation since, by then, banks had become subject to more stringent capital requirements under guidelines laid down by the Bank for International Settlements. Tougher capital regulations on banks helped to preserve the funding advantage some large companies had developed in accessing international capital markets on their own.

The worldwide market for debt securities is large and growing. At the end of 1995, the total value of debt securities outstanding was US$26,913 billion. In all markets, government issued debt securities represent the largest and most liquid debt instruments, with the value of outstanding public sector securities totalling US$16,320 billion. The remaining US$10,593 billion comprises issues by private sector firms — in many cases, financial institutions.[13] Also included in this group are debt securities issued by large corporate borrowers, usually with strong credit ratings, which are able to access capital markets at interest rates lower than comparable bank lending rates. In 1995, capital market raisings for debt and equity by US corporations were around three-quarters of the value of capital raised from bank loans (US$637 billion and US$818 billion, respectively).[14]

---

13 BIS 1996, *66th Annual Report*, p. 149.

14 *American Banker* 1996, August edition, p. 1.

Australian issuers of corporate debt face the constraint of a relatively small local market. This has meant that Australian issuers largely rely on overseas markets, where rates are generally more favourable. In 1995, the Australian private sector's outstanding borrowings in the international securities markets exceeded those in the domestic market. The Australian bond market (for both government and private sector debt) is small by international standards and, relative to GDP, is also smaller than bond markets in many neighbouring countries.[15]

The future of Australia's corporate debt market will depend on three factors:

- the number of companies able to achieve a sufficiently high credit rating to attract demand for their paper from investors;
- the willingness of investors to hold a portion of lower rated paper in their debt portfolios; and
- the intensity of competition from alternative sources of funds from both the banking sector and offshore debt markets.

The domestic corporate bond market will grow only if it offers corporations the ability to borrow at more competitive interest rates than alternative sources.

4.5.2 Growth in Securitisation

Securitisation refers to the process of issuing marketable securities against an income stream provided by a pool of otherwise illiquid assets, such as mortgage loans, credit card receivables and motor vehicle loans. These securities represent a form of off-balance sheet financing because they are issued directly to investors and are not provided on an intermediary's balance sheet (notwithstanding that the securities may be held on an institution's balance sheet prior to being sold to investors or may be held by an institution once issued).

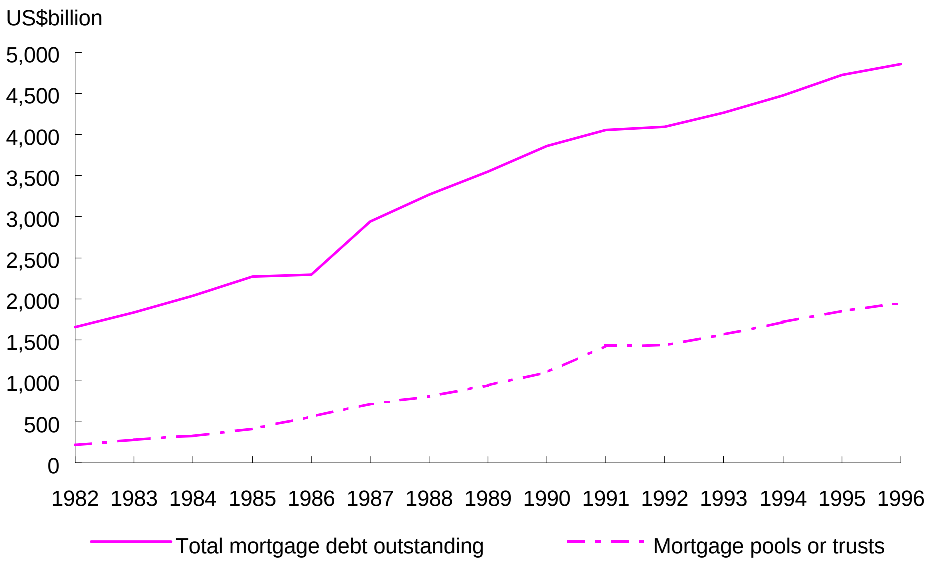
15 The Allen Consulting Group and Arthur Andersen 1996, p. 56.

Securitisation in the US and UK

In the US, securitisation represents a substantial source of funding for a wide range of credit needs. Residential home loans represent the largest category of securitised loans, with 40 per cent of outstanding mortgage debt in the US funded through securitisation programs (see Figure 4.6). Credit card receivables, motor vehicle loans and other forms of consumer credit are also funded increasingly through securitisation programs (see Figure 4.7).

Mortgage Securitisation in the US is Growing . . .

Figure 4.6: US Mortgage Debt Outstanding



Note: Data for 1982 to 1995 are at 31 December. Data for 1996 are at 30 June.
Source: *Federal Reserve Bulletin*, various editions 1985-1996.

Securitisation in the UK began in 1985 with the issue of mortgage backed securities, but the market has had a volatile history since then. While the total value of asset backed securities issued in the UK between 1985 and 1993 was £16 billion, the value of issues outstanding had fallen to just over £5.4

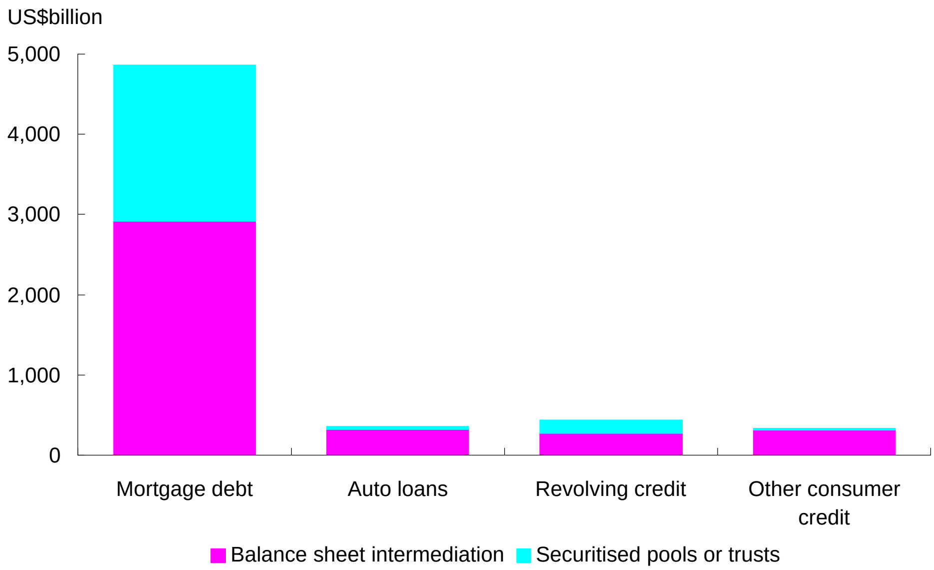
billion by 1995.[16] However, the UK market has recently expanded to cover other asset classes: 1995 saw the first issue of credit card receivables, while in late 1996 NatWest Bank securitised a £3.2 billion portfolio of corporate loans.

The experience in the UK can be explained by the volatility of its housing market, together with problems experienced in the mortgage insurance market.

16 Bank of England, *Bank of England Quarterly Bulletin*, May 1994 and 1996.

Other Forms of Consumer Credit are also Securitised . . .

Figure 4.7: Securitisation as a Proportion of Total US Loans Outstanding by Class of Lending (June 1996)



	Mortgage debt	Auto loans	Revolving credit	Other consumer credit
Per cent securitised	40.1	12.2	38.2	7.3

Source: *Federal Reserve Bulletin,* November 1996.

Securitisation relies on a variety of 'credit enhancement' techniques. The most common form of credit enhancement in the US is via the support of government agencies. A key feature of the US securitisation market is the extent to which asset backed securities are supported by government. US mortgage backed securities issued through private mortgage conduits total US$303 billion, or around 15 per cent of total mortgage backed securities outstanding.[17] No such government agencies exist in the UK. The most common form of enhancement in the UK is 'pool insurance', whereby an

17 *Federal Reserve Bulletin* 1996, November edition.

external party provides insurance against failure of the underlying assets in the pool to meet repayment obligations.

Securitisation in Australia

Securitisation programs began in Australia in 1987 with the issue of mortgage backed securities sponsored by various State governments. Since then, the market has grown, reaching $12.4 billion in June 1996. The market comprises 46 per cent private sector mortgage backed securities, 26 per cent government sponsored mortgage backed securities and 28 per cent other classes of privately issued securities.[18]

Mortgage insurance is the principal means in Australia for securitisers (and traditional mortgage lenders) to shift the risk of default to another party. For this reason, the solvency of mortgage insurers is critical to the continued smooth functioning of the securitisation industry. Most private mortgage backed securities in Australia are mortgage insured. The Australian mortgage market is dominated by four companies. Of these, the Housing Loans Insurance Corporation, which is 100 per cent owned by the Commonwealth Government, has an estimated 40 per cent share.[19]

The future of securitisation in Australia will be a function of the degree to which it is able to offer borrowers a sustainable cost advantage over traditional forms of balance sheet intermediation, and the extent to which it offers a superior funding alternative for loan originators (including traditional intermediaries). It is possible in the future that traditional balance sheet intermediaries will use securitisation as a means of shifting selected existing assets ‘off-balance sheet’, if it is found that securitisation offers greater flexibility than existing forms of ‘on-balance sheet’ funding (such as deposits and wholesale funding). In such a scenario, the relative focus of these institutions would shift from balance sheet management to activities such as loan origination and servicing. Their role in the funding process would not diminish, but the nature of their role would change.

---

18 Based on unpublished data provided by Standard & Poor’s.
19 Standard & Poor’s 1996, p. 47.

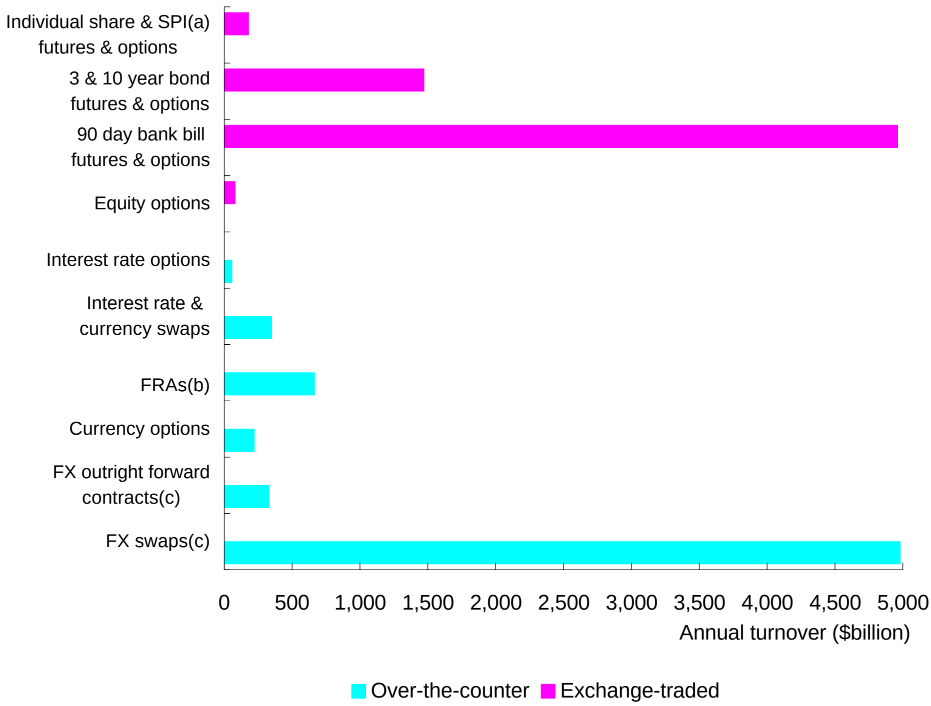
4.5.3 The Use of Markets for Risk Management

Markets for a wide range of other financial instruments are also growing strongly, and in many cases are replacing the risk management roles of traditional intermediaries. Similarly, balance sheet intermediaries are themselves major users of these markets, to manage the risk inherent in their own operations. For example, an institution with an interest rate mismatch between its assets and liabilities can seek to reduce the imbalance through the intermediation process (eg by altering the maturity profile of its loans to, or borrowings from, customers). Alternatively, it can use a wide range of interest rate derivatives to hedge its exposure. These are available through over-the-counter or exchange-traded markets.

These markets allow users to access directly a range of risk instruments which, in many cases, would have been provided previously only by traditional balance sheet intermediaries. Risks such as movements in currencies and interest rates, share prices and commodities can be managed through instruments such as swaps, futures, options and forward contracts (see Figure 4.8). In turn, this reduces the need for customers to rely directly on the balance sheet intermediation function of an institution. As financial markets continue to grow, traditional institutions may still perform a valuable role in the financing and risk management processes of their clients. However, their involvement is likely to be based more on the provision of services such as advice and trading, and less on the direct use of their balance sheets.

Financial Markets offer a Wide Range of Risk Management Instruments . . .

Figure 4.8: Australian Trading of Selected Risk Management Instruments (1995-96)



(a) Share Price Index.
(b) Forward rate agreements.
(c) Against the Australian dollar.
Source: AFMA 1996, *The 1996 Australian Financial Markets Report*.

4.5.4 Competition for Household Savings

The trend to markets has been reinforced by changes on the household demand side. Growing household wealth and the retirement savings needs of an ageing population (reinforced in Australia by the introduction of compulsory superannuation) are gradually increasing the proportion of finance sector assets taking the form of market claims. This trend has been evident particularly in the relative growth of superannuation funds and products.

Financial institutions have actively participated in this new environment so, while some of their groups' activities are now off-balance sheet, their presence in the financial system has not declined. In particular, they have increased their role in the domain of funds management. This has been increasingly evident in the development of investment management businesses by banking corporations. It is also now evident in the shift towards investment in unit trusts relative to non-superannuation life insurance investment policies, even within the product mix offered by life insurance companies themselves.

Over time, the processes of disintermediation and securitisation will increasingly offer to households alternatives to balance sheet contracts such as 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 with any confidence.

Another development which could reinforce the shift in household preferences is the increasing tendency for superannuation funds and other funds managers to link their funds management activities to other financial services, using new technologies. Already, superannuation funds have begun to offer related financial products such as housing loans and group insurance, in addition to retirement income products. In the future, other services could be linked, most notably payments instruments (as already occurs in the US). This could potentially remove one of the remaining key advantages of balance sheet intermediaries over funds managers.

4.6 Conclusion

As noted in the introduction to this chapter, in presenting these various elements of the changing landscape of the Australian financial system, the Inquiry has focused only on the broad directions of change and has not sought to estimate precise timing.

However, on the basis of the evidence before it and noting, in particular, advances in the technology platforms that are likely within the next few years, the Inquiry believes that accelerated changes are likely to occur in the future.

Three main drivers of change are profoundly influencing the structure of the financial services industry.

- Changing customer needs are causing shifts in channel, product and supplier choice. Principal among these changing needs are an ageing Australian population, reduced job security and increased mobility. Household ownership of financial assets is growing, while consumers are demonstrating greater value awareness and an increasing willingness to adopt new technology. Many customers are moving to cheaper (usually electronic) transaction channels and are demanding more convenient products with a wider range of attributes (see Chapter 1).
- Technology driven innovation is also reshaping the finance industry. Advances in communications and network technologies are reducing physical barriers to financial trade and in many cases are expanding the range of services and suppliers available to customers. Choice is expanding and is altering the cost structure of transactions and financial services distribution. Improvements in data assessment and risk management are allowing greater spreading and pricing of risk. Improvements in the technology supporting the conduct of financial markets and exchanges is resulting in greater globalisation of trading and increased competition between markets and exchanges (see Chapter 2).
- Regulation has also proved to be a strong driver of change. Regulatory developments have permitted the liberalisation of trade and cross-border capital flows which have been key factors in the globalisation of financial markets. Australia's compulsory retirement incomes policy is driving a growing proportion of the nation's wealth into superannuation assets and has increased the proportion of risk directly assumed by households. Governments are reducing their ownership of industry participants, which has led to a reduction in direct government support and guarantees. Taxation arrangements have also stimulated a vast array of

organisational and legal structures designed to reduce taxation liability. The many distortions that remain in the taxation system take a variety of forms (see Chapter 3).

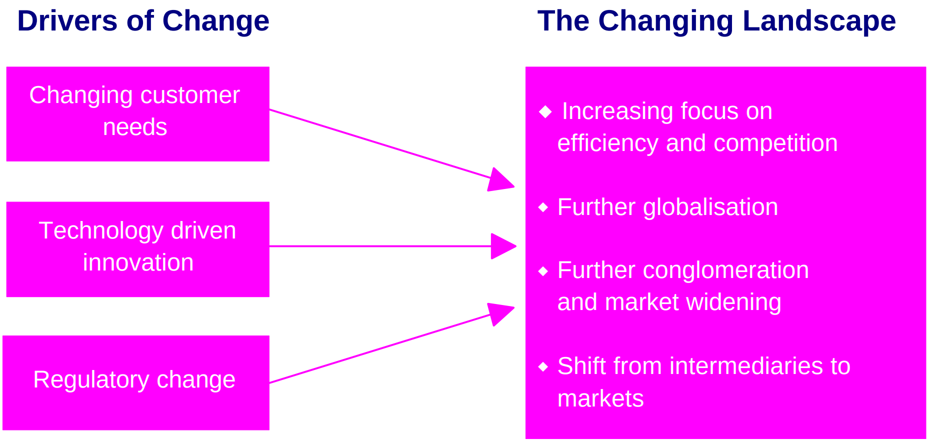
Together, these three main drivers of change have combined to shape the financial services landscape in several ways (see Figure 4.9).

- Increased competition is driving changes in pricing and cost structures. Competitive pressure will cause non-commercial mispricing to become unsustainable, while high cost suppliers will be forced to rationalise their operations, irrespective of regulatory change. The further globalisation of markets is intensifying competitive pressures and challenging existing regulatory arrangements. Decisions concerning fundraising, investing and ownership now take place on an international basis. Australian institutions are facing increasing international competition in the domestic market and at the same time are pursuing opportunities offshore.
- Further conglomeration and market widening are changing the institutional structure of existing competitors and are also introducing a range of new participants from outside the financial services industry. Traditional distinctions between institutions are blurring as substitutes for traditional products are created. Similarly, greater competition is likely to see many organisations focus on those activities they perform best, causing the value chain to disaggregate.
- A further shift from intermediaries to markets for the provision of both financing and risk management activities is likely to occur, with a corresponding redefinition of the role of traditional competitors.

The changes in the financial landscape described in this chapter are unlikely to be so revolutionary as to demand a complete overhaul of every element of the regulatory framework. In broad terms, the task and areas of focus for regulation are likely to remain much the same. These changes do, however, demand a greater emphasis in regulation on competitiveness and efficiency. They also require flexibility, not only in dealing with changes already in train, but also to respond to more dramatic changes, should they occur.

Three Key Drivers are Changing the Financial Services Landscape . . .

Figure 4.9: Drivers of Change and the Changing Landscape



Accordingly, while the Inquiry has taken account of these changes in forming its judgments on a number of aspects of financial sector regulation, its recommendations are not wholly reliant on any particular predictions for the future. More important for the Inquiry has been its assessment of the existing regulatory arrangements against the principles of regulation. These principles are based on the philosophy of regulation discussed in Chapter 5.

Nonetheless, the changing landscape presented here poses several important challenges for regulation. For example:

- increased conglomeration and institutional and product blurring will be an important feature of the future financial services environment — regulation of these entities will require intensive coordination;
- similarly, regulation will need to address the potential gains from entry to financial markets by new competitors from outside the existing financial services industry and growing linkages between financial activities and the provision of other products and services;

- the costs and market imperfections which drive the quest for regulatory arbitrage will increasingly demand regulatory review and reform; and
- globalisation will intensify the need for regulation to be designed to minimise any competitive disadvantage for activities based in Australia and to ensure that Australian users of financial services obtain the benefits of international competition without incurring unacceptable new risks.

The keys to successful financial system regulation are flexibility and competitiveness. Regulation must be mindful of the increasingly global nature of the industry. The recommendations for regulatory change presented in Part Two take account of these and other themes drawn from the changing financial landscape presented in this chapter.