Chapter 11
Summary . . .

Promoting Increased Efficiency

Overview

- Regulation can impede the efficient operation of markets. Reforms to the framework of financial regulation set out in earlier chapters would be complemented by removing regulatory and other impediments to more competitive markets. This chapter considers a number of specific measures to promote greater efficiency in the funds management industry and makes observations and recommendations on a range of other government matters which affect the financial system.

Key Findings

- The Australian funds management industry is highly fragmented. The regulatory framework impedes rationalisation and creates barriers to foreign entry.
- Taxation arrangements do not have a neutral influence on product and institutional arrangements in the financial system. Present arrangements, particularly for superannuation and other collective investments, have high compliance costs and do not facilitate consumer understanding of financial products. The increasing globalisation of financial markets places pressures on those aspects of the taxation system which adversely affect Australia's international competitiveness.
- While SMEs face higher financing costs than larger institutions, this is primarily a reflection of the attributes of SMEs themselves.

Continued competitive pressure in the financial sector should yield benefits to SMEs.

Key Recommendations

- The Corporations Law should be amended to streamline the merger and reconstructions provisions for collective investments. In addition, the regulation of public offer superannuation and collective investments should be harmonised.
- Superannuation fund members should have greater choice of fund, subject to any constraints necessary to address concerns about administrative costs and fund liquidity.
- The regulation of trustee companies should be replaced by a uniform, national regime. Their corporate trustee and fundraising business should continue to be regulated under the Corporations Law and *Superannuation Industry (Supervision) Act 1993*.
- To facilitate electronic commerce, a substantial program of legislative reform should be implemented to ensure that legislation does not differ between different technologies or delivery mechanisms. Australia should adopt international standards for electronic commerce and pursue measures to ensure that, as far as possible, Australian law enforcement and consumer protection legislation is consistent with laws in major centres of electronic commerce.
- Financial institutions should have freedom to set fees and charges and governments should expedite the examination of alternative means of providing low-cost retail transaction services to remote areas and for social security recipients.
- The Attorney-General should establish a working party to assess the costs and benefits of positive credit reporting. Extension of the privacy regime should include striking an appropriate balance between consumer protection, consumer choice and the effective and efficient delivery of financial services.

Promoting Increased Efficiency

11.1 Introduction

Chapter 6 highlighted areas of the Australian financial system where costs are high relative to world best practice and considered the potential gains from greater efficiency in the system. This chapter considers a variety of specific measures which could promote greater efficiency, in particular by removing regulatory and other impediments to more competitive markets. These measures would complement the reforms to the framework of financial regulation set out in Chapters 7 to 10 and, together, could be expected to increase substantially the efficiency and competitiveness of the Australian financial system.

The chapter is structured in six sections. The first section considers measures to produce efficiency gains in the funds management industry. The Inquiry considers that there is considerable scope to improve the functioning of this sector and to lower regulatory barriers to entry.

The subsequent five sections deal with issues in the financial system which cut across industry sectors. In each of these, there is scope for greater efficiency through regulatory and other changes designed to make markets work more effectively. These issues are:

- taxation impediments;
- coordination of advice on technology;
- cross-subsidies;
- improving market information; and
- neutrality in mortgage markets.

11.2 Funds Management

In 1995, the share of household financial assets invested in cash and deposits was around 32 per cent compared to around 61 per cent for the share invested in life insurance, superannuation funds, equities and unit trusts.[1] Funds under management are expected to continue to grow strongly, particularly as a result of the Government's retirement incomes policy. These issues are discussed in detail in Chapter 4.

11.2.1 Cost Due to Fragmentation

Data presented in Chapter 6 suggested that fund management fees in Australia appear to be higher than those in comparable countries.

One of the major potential reasons for higher costs in Australia is the fragmentation of the managed funds industry.[2]

There are around 2,500 unlisted retail investment funds in Australia. Over 2,000 of these funds have total combined assets of less than $21 billion.[3] Figure 11.1 shows that most funds in Australia have total assets of less than $10 million while around only 230 funds each have assets exceeding $100 million.[4] Employer sponsored superannuation funds are also regarded as a part of the managed funds industry because they provide a mechanism for the pooling and investment of assets on behalf of members. However, employer sponsored superannuation funds are not offered to the public at large and are therefore excluded from data on retail investment funds.

1 Foster 1996 p. 171.

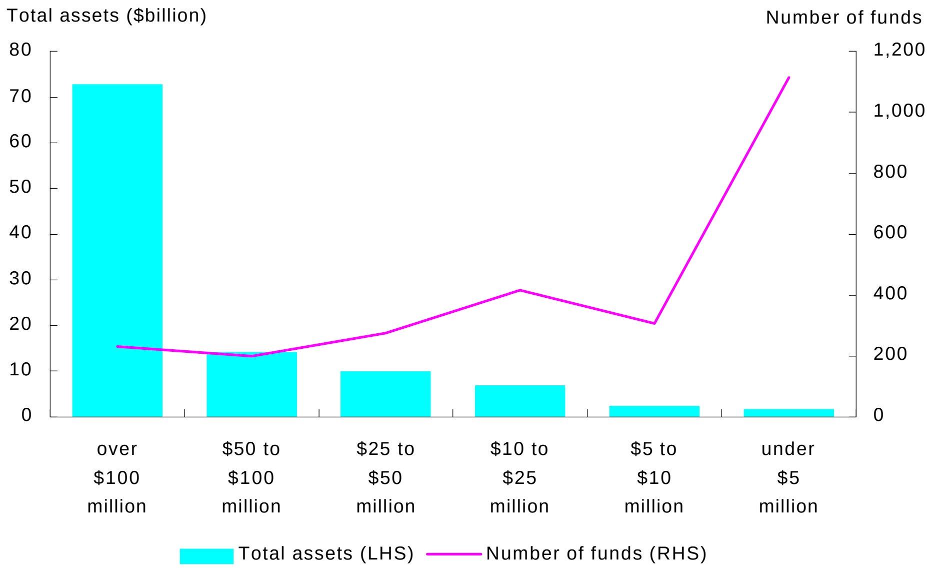
2 The managed funds industry has retail and wholesale dimensions. Retail managed funds' products include unlisted unit trusts, insurance bonds, superannuation bonds, approved deposit funds, deferred annuities, cash management trusts, common funds, friendly society bonds, and listed investment companies and trusts. The wholesale funds management industry includes pooled investment vehicles and discrete portfolios managed on behalf of clients.

3 In addition, there are approximately 165 investment companies and trusts listed on the Australian Stock Exchange with market capitalisation of $32.6 billion. Property trusts account for more than half of these assets.

4 Data provided to the Inquiry by ASSIRT includes public unit trusts and life company products.

The Funds Management Industry is Fragmented . . .

Figure 11.1: Number of Funds in Each Asset Class, December 1996



Note: Covers all retail unlisted investment products including public offer superannuation funds and investment linked life company products.
Source: Data provided to the Inquiry by ASSIRT.

Figure 11.2 shows that employer sponsored superannuation funds are also highly fragmented.

Industry experience in the US suggests that the break even scale for equity funds is US$85 million to US$185 million and in excess of US$250 million for money market funds.[5] The fragmentation of the Australian industry means therefore that domestic funds fail to capture large scale economies which reduce costs. Scale economies make it unattractive for offshore funds managers to establish a separate Australian subsidiary.[6] It has been suggested that if more competitively priced mutual funds from offshore

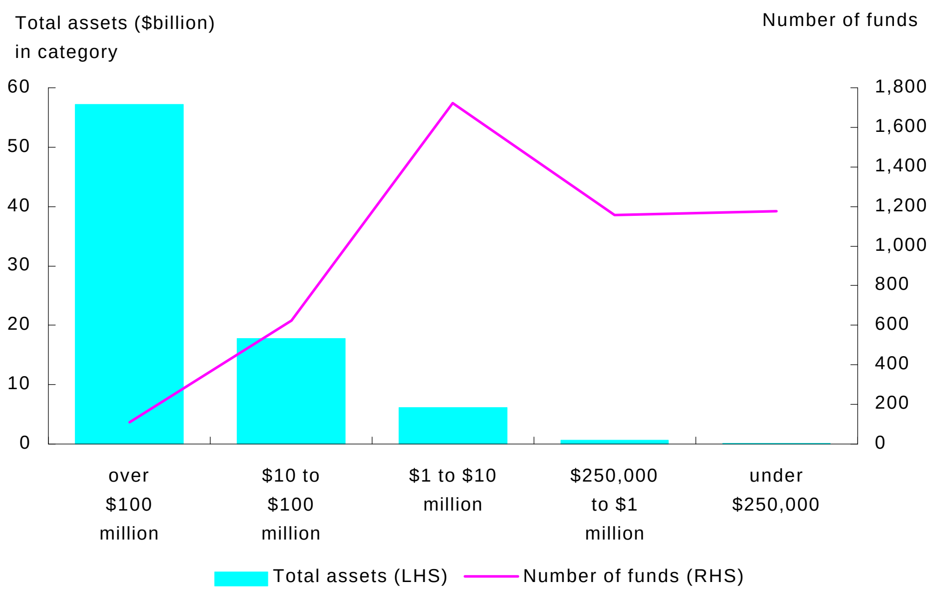
5 McKinsey & Company 1994.

6 Data provided to the Inquiry by ASSIRT show that there are only 34 retail equity funds in Australia with more than $50 million in assets. Similarly, only 55 money market funds have assets greater than $100 million.

were available to Australian retail investors, discounts of 75 per cent or more on the costs of Australian domiciled funds would be achievable.[7]

Employer Superannuation is also Fragmented . . .

Figure 11.2: Employer Sponsored Superannuation Funds, June 1995(a)



(a) Employer sponsored superannuation comprises company funds, industry funds (originally established to collect award contributions), and government employee funds. There are around 140,000 excluded funds with fewer than five members not included in this chart.
Source: Annual return data provided to the Inquiry by the ISC.

Rationalisation would be assisted by stronger competition and the removal of regulatory constraints on the amalgamation of funds. Stronger competition and other reforms may also drive further efficiencies.

Regulatory changes which could improve the performance of the managed funds sector can be considered under three headings:

- regulatory impediments to competition and rationalisation;

7 Vanguard Investments Australia, Supplementary Submission No. 120, p. 2.

- regulatory constraints in superannuation; and
- more efficient regulation of trusts.

11.2.2 Regulatory Impediments

A range of policies impede new competitors and potential rationalisation in the funds management sector. These include certain taxation and foreign investment policies.

Taxation

The Foreign Investment Fund (FIF) regime provides substantial disincentives for Australian retail investors to invest offshore. In many cases, such investments are subject to a higher burden of taxation, or higher compliance costs, than are local investments. This impedes competition from foreign funds and arguably contributes to continuing higher management fees in Australia.

Other taxation policies — including stamp duties, capital gains tax (CGT) rules and restrictions on the treatment of losses — increase the costs of industry rationalisation. Others impose significant transaction costs on the exercise of choice by investors or their funds managers.

The Inquiry's Terms of Reference preclude it from making recommendations on taxation matters. Accordingly, the Inquiry did not undertake a full study of these taxation provisions. Rather, it has confined its observations on taxation to its effects on the financial system. A more complete discussion of these effects is provided in Section 11.3.

Foreign Investment Policy

Foreign investment policy can also increase the costs of intermediation for managed funds. Under the *Foreign Acquisitions and Takeovers Act 1975*, an acquisition by an entity substantially controlled by a foreign interest requires approval where the foreign interest, together with associates, would control 15 per cent or more of the voting shares of the target company or unit trust.

In the managed funds industry, these foreign investment policy considerations may apply to life companies, approved trustees of superannuation funds and unit trust managers. Their effect is to require foreign funds managers to seek foreign investment approval before making a portfolio investment, even where the funds are managed on behalf of Australian resident investors — such as in the case of superannuation funds.

The application of foreign investment policy creates a competitive disadvantage for the foreign manager and may adversely affect investment returns. Foreign owned fund managers manage nearly $100 billion in assets for Australian residents, or around one-third of the total assets of the industry.[8] A review of the current provisions of the Foreign Acquisitions and Takeovers Act is desirable.

Recommendation 86: Foreign investment regulations for the funds management industry should be reviewed.

Foreign investment regulations requiring approval for investments made by foreign owned or controlled managers of the funds of life companies and other collective investments should be reviewed and, if possible, removed where the principal investors in these funds are Australian.

Regulation of Takeovers, Mergers and Reconstructions

A further area which may be impeding the efficiency of the funds management industry relates to the law and practice governing takeovers of public unit trusts and mergers and reconstructions of collective investment schemes.

The main means of control of a unit trust is the power of unitholders to replace the manager. This requires a majority (at least 50 per cent) of unit holders under current law. A person wishing to acquire 20 per cent or more of a public company must make a takeover offer to all shareholders under Chapter 6 of the Corporations Law. There is no equivalent law applicable to

8 National Mutual Holdings, Supplementary Submission No. 48, p. 1.

public unit trusts. The Corporations Law Simplification Task Force has issued a paper discussing whether equivalent provisions should be introduced.[9]

Because Chapter 6 of the Corporations Law does not extend to public unit trusts, some trust deeds have provisions which attempt to restrict acquisitions of units or the concentration of voting power. These provisions have the effect of importing the protection afforded small shareholders by Chapter 6, but also can entrench the management of those trusts.

The Inquiry believes that, as a matter of principle, managers of unit trusts should face the same competitive pressure to perform under threat of takeover as are the managers of public companies. It considers that unit holders should have the same rights to share in the premium for control as do shareholders in public companies. The provisions of Chapter 6 of the Corporations Law, appropriately modified, should therefore apply to takeovers of unit trusts.

It has been suggested that Australian Stock Exchange (ASX) listing rules discourage listing by collective investment schemes. Listing Rule 15.14 prevents the trustees of listed unit trusts from exercising any sanctions against takeovers available in their trust deeds. The ASX has indicated that it intends to reconsider Listing Rule 15.14 depending on the outcome of current law reform processes.[10] In the Inquiry's view, there should be no objection to the exercise of trust deed provisions which provide a mechanism for ensuring that all unit holders can share in the premium for control, without entrenching the existing management.

The Inquiry also considers there is a need to introduce streamlined provisions for mergers and reconstructions of collective investments schemes, including powers of compulsory acquisition. Such provisions would also assist in the compulsory merger or termination of defunct unit trusts and hence reduce industry fragmentation. The Corporations and Financial Services Commission (CFSC) should be given authority to approve necessary trust deed amendments where it is satisfied that this is in the best

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9 Corporations Law Simplification Task Force 1996, *Takeovers: Proposal for Simplification*, pp. 20-21.

10 Australian Stock Exchange, Supplementary Submission No. 135, pp. 29-32.

interests of investors. Precedent for such powers has been established by the Superannuation Industry Supervision (SIS) regime for superannuation funds.

Recommendation 87: Takeover and merger provisions are needed for collective investments.

The *Corporations Law* should be amended to provide:

- the application of takeover provisions modelled on Chapter 6 of the *Corporations Law* for public unit trusts; and
- streamlined merger and reconstruction provisions for collective investment schemes.

The Australian Stock Exchange should amend Listing Rule 15.14 to permit the exercise of sanctions in trust deeds reasonably designed to provide unit holders with the protection embodied in Chapter 6 of the *Corporations Law*.

11.2.3 Regulatory Constraints in Superannuation

Choice of Superannuation Fund

Superannuation is the largest component of the funds management industry. Existing arrangements limit the ability of a large proportion of members to choose their superannuation fund or to transfer accumulated benefits between funds, other than on termination of employment. This restricts competitive pressure in the sector.

Under the superannuation guarantee (SG) arrangements, the employer has choice of fund for compulsory contributions, subject to any constraints under awards or industrial agreements. Some industrial awards name the funds where compulsory superannuation contributions must be paid. As a result, current arrangements provide member choice of fund only to:

- self-employed people; and

- members of public offer superannuation schemes, who, subject to exit fees, can transfer accrued voluntary entitlements to other schemes.

Table 11.1 shows that over half of superannuation accounts are in funds where members are unlikely to have been offered full choice. The Insurance and Superannuation Commission (ISC) has estimated that around 24 per cent of superannuation members have no choice of fund at all.[11]

Most Members have Limited Choice of Fund . . .

Table 11.1: Membership and Assets of Superannuation Funds, September 1996

Category	Number of Funds	Members (000's)	Assets ($billion)
Employer sponsored funds			
Corporate	4,597	1,312	51
Industry	103	5,798	16
Public Sector	79	2,503	66
Public Offer	708	6,378	62
Life Company Superannuation	n/a	n/a	40
Excluded	138,811	223	26
Total	144,098	16,213	261

Source: ISC 1996, Press Release 1996/33.

The Government has announced policies intended to encourage employee choice of fund; to enable members in accumulation funds to move their benefits between funds; and to maintain the full vesting of SG contributions when an employee transfers to another fund.

11 Information provided to the Inquiry by the ISC.

Implications of Greater Choice

Allowing member choice of fund could increase competition between funds and should, other things being equal, enhance efficiency in the industry. However, member choice raises several concerns.

- Administrative costs for employers and funds are likely to be greater if freedom of choice is unfettered and can be exercised at will. If members exercise choice frequently, additional exit/entry fees may offset any increase in investment returns.
- Choice also raises issues for fund liquidity. Investment strategies may need to be adjusted to hold more liquid assets and may result in greater focus on short-term investment performance. United States' experience suggests that investor choice has not led to higher volatility in fund liquidity.

These problems may be partly addressed by imposing some limitations on exit, such as a suitable notice period or limits on the frequency of change. Subject to these constraints, the additional competition engendered by choice is likely to put downward pressure on costs and to encourage rationalisation of the industry.

Member choice will be successful in promoting competition only if consumers have appropriate information. It is the joint responsibility of the industry and regulators to ensure that consumers are educated and well informed. Education should cover issues such as the rights of members, different life cycle needs and their implications for risk and return, and the benefits and costs of exercising choice.

Consumer protection will need to cover requirements for good disclosure, proper regulation of the sales and advice process (including licensing of investment advisers), and speedy dispute resolution where problems occur (see Chapter 7).

Recommendation 88: Superannuation fund members should have greater choice of fund.

Employees should be provided with choice of fund, subject to any constraints necessary to address concerns about administrative costs and fund liquidity. Where superannuation benefits vest in a member, that member should have the right to transfer the amounts to any complying fund. Where a member chooses to exercise that right, payments should be transferred to the chosen fund as soon as practicable, subject to controls necessary to maintain orderly management for the benefit of all fund members.

Transfer costs, including those incurred as a result of regulatory requirements, should be transparent and reasonable.

Reducing the Compliance Costs of Superannuation

A number of submissions raised concerns about the regulatory framework for superannuation. The most frequent concerns addressed matters of taxation or retirement incomes policy and, are therefore, beyond the Inquiry's Terms of Reference.

However, as a general principle, the Inquiry considers that the administrative complexity of superannuation arrangements and compliance costs are a serious concern for both industry and consumers, particularly given the expected growth in superannuation as a proportion of household and financial system assets.

11.2.4 More Efficient Regulation of Trusts

In earlier chapters, the Inquiry recommended that:

- the Australian Prudential Regulation Commission (APRC) be responsible for supervision of superannuation funds for reasons outlined in Chapter 7; and
- the CFSC undertake compliance regulation of collective investment schemes such as unit trusts.

In effect, the Inquiry considers that the need for closer prudential oversight of superannuation justifies the maintenance of separate regulatory frameworks for superannuation funds and collective investment schemes.

Harmonising Regulation of Collective Investments and Superannuation Funds

The Inquiry believes there is scope to improve regulatory efficiency by harmonising some requirements applying to public offer superannuation funds and collective investment schemes. This recognises that many fund managers offer both superannuation and non-superannuation investment products.

The CFSC will be responsible for consumer protection and disclosure regulation for the whole financial sector, including superannuation funds and collective investments. The regulatory policies applying to consumer protection and disclosure for superannuation and collective investments can be harmonised more quickly by vesting responsibility for them in a single regulator.

The Inquiry also supports the introduction of a single responsible entity to replace the dual trustee/manager structure currently required for collective investments, subject to appropriate safeguards considered necessary for the holding of assets and ensuring scheme compliance. The single responsible entity will result in clear accountability to members, provides cost savings and would be consistent with arrangements for superannuation funds.

Recommendation 89: Regulation of collective investments and public offer superannuation should be harmonised.

The regulatory framework for public offer collective investments and superannuation should be harmonised to the greatest possible extent by:

- making both types of products subject to a single consumer protection regime (including disclosure rules) administered by the CFSC; and

- bringing the structure of collective investments into line with that for superannuation funds, by introducing a requirement for a single responsible entity.

Regulation of Trustee Companies

At present, trustee companies are State and Territory registered organisations which undertake:

- estate management subject to State and Territory trustee law;
- trustee and custodian appointments subject to the SIS regime for superannuation and to the Corporations Law for collective investments and debentures; and
- operation of trustee common funds subject to Corporations Law prospectus requirements.

State and Territory registration, reporting and other requirements imposed on trustee companies lack uniformity and mutual recognition of licences. This imposes unwarranted costs and delays on fund managers and trustee companies operating across State boundaries. These limitations also reduce competition among trustees, thereby impeding efficiency and innovation. Furthermore, legislative requirements in many States are outdated. They typically fail to strike a balance between trustee companies' traditional estate management role and their other activities.

The Standing Committee of Attorneys-General has been considering the regulation of trustee companies. The Inquiry considers that a high priority should be given to:

- creating a uniform national legislative framework for trustee companies;
- providing for a system of mutual recognition of trustee companies operating across State borders; and

- modernising the legislation and removing provisions which no longer appear appropriate.[12]

In contrast to their other business, trustee companies' activities relating to superannuation business or collective investments should continue to be covered by Commonwealth law. The Inquiry considers that the existing law provides adequate regulation of their fundraising business from a consumer protection and prudential perspective. It also ensures that trustee companies are subject to the same rules as other organisations engaging in similar activities.

Recommendation 90: Regulation of trustee companies should be modernised and applied on a uniform national basis.

The States and Territories should give urgent priority to establishing a modern, uniform, national regime for trustee companies.

The corporate trustee and fundraising business of trustee companies should continue to be regulated under the *Corporations Law* and *Superannuation Industry (Supervision) Act 1993* regimes.

11.3 Selected Taxation Impediments

Taxation policy can have pervasive influences on the financial system. These influences are outlined in Chapter 3.

The Terms of Reference of the Inquiry preclude it from making recommendations on taxation matters. Accordingly, the Inquiry did not comprehensively analyse any taxation provisions. It merely draws attention to the adverse effects of some taxation measures on finance sector efficiency. These observations may be taken into account in any future review of taxation provisions. The greater efficiencies in the finance sector that follow

12 Based on information provided to the Inquiry by the Trustee Corporations Association, there is a case for deregulating trustee company fees and charges, standardising prudent investment rules, and simplifying reporting requirements.

adoption of the Inquiry's recommendations may be constrained by continued adverse features of the taxation system.

Such observations do not alone provide sufficient basis to recommend change. All taxation provisions have effects on the economy and society, and choices between taxation arrangements should be made only after a comprehensive analysis of all of these effects.

As noted in Chapter 3, the influences of taxation policy on the financial sector are broad ranging. The Inquiry does not enumerate or detail all of these effects. As a matter of principle, the Inquiry considers that taxation arrangements should be designed as far as possible to have a neutral influence on product and institutional arrangements in the financial system. Present arrangements fall short of this ideal.

A further important goal is the achievement of a less complex taxation system, one that includes lower compliance costs and facilitates the provision of simpler, and more readily understood, financial products. Again, present arrangements fall short of this goal, particularly in superannuation and other collective investments.

A third goal, and one that is difficult to attain, is the achievement of a taxation system which is consistent with competitive neutrality in an international setting. The increasing globalisation of financial markets heightens this challenge, and will require considerable further attention from government in the near term. This will be particularly desirable if Australia's full potential as a provider of financial services in a global marketplace is to be reached.

Given the importance of this last goal, the Inquiry makes further brief observations on a number of particular areas which are adversely affecting the international competitiveness of the Australian finance sector. These observations are not comprehensive and their coverage is not complete. However, they illustrate the nature of the impact taxation can have on competitiveness.

11.3.1 Foreign Investment Fund Measures

The FIF measures aim to reduce the scope for deferral of Australian tax where Australian residents hold interests in foreign entities which they do not control. Under the FIF regime, income arising from interests in foreign entities generating principally passive income is taxed on an accruals rather than realisation or distribution basis.[13] Offshore funds managers pointed to the FIF regime as a barrier to entry in the Australian market, while resident funds managers criticised its complexity.

While the FIF measures address an area of potential tax avoidance, they also capture funds where avoidance is not a consideration. In such cases, the result is to impose compliance costs which do not apply to comparable domestic investments.

For example, in the United States, a mutual fund that qualifies as a regulated investment company (RIC) under the Internal Revenue Code is required to distribute its realised income each year. Typically, RICs distribute at least 98 per cent of their realised income to avoid an excise tax.[14] It is argued that the asset allocation of mutual funds ensures that investments are largely in liquid securities, which minimises unrealised gains. This appears to address the tax minimisation and avoidance issues which the FIF regime is designed to address.

Where the FIF measures impose higher tax, or higher compliance costs, on foreign compared with domestic funds, their effect is to protect the Australian funds management industry from offshore competition.

Offshore Banking Unit and Regional Headquarters Regime

The Offshore Banking Unit (OBU) regime was designed to attract and maintain financial activity that could easily be sourced in other jurisdictions. Under existing Australian law, activities of OBUs are eligible for concessional tax treatment on income arising from some activities relating to:

- borrowing from, and lending to, non-residents;
- dealing in financial or treasury instruments such as currency and interest rate swaps, hedges and futures;
- securities and futures trading;

13 Passive income includes interest, dividends, royalties, annuities, rents etc.
14 Investment Company Institute, Supplementary Submission No. 7, p. 2.

- a range of fee based activities such as funds management for, and the provision of investment advice to, non-residents; and
- foreign exchange trading.

It has been suggested that, although the OBU legislation was conceived with a vision to attract business to Australian financial markets, its codification into legislation and the interpretation of that legislation 'positively discourages anything but specious application'.[15] The administrative complexity of the OBU regime imposes large transaction costs on participants and is claimed to deter new entrants. In addition, the fact that only authorised banks, State banks, wholly owned subsidiaries of banks already registered as OBUs, and authorised foreign exchange dealers are eligible to be declared OBUs tilts offshore funds management towards banks. Market participants argued that there is a limited range of concessions available in Australia compared with other centres. However, the Inquiry has not been able to test this proposition satisfactorily.

The taxation provisions relating to regional headquarters companies (RHQs) have attracted similar criticism.

Revenue considerations restrict the range of concessions that the Australian Government is able to offer to attract financial market activity. However, there is evidence that there has been leakage from Australian markets to competing markets in the Asia Pacific time zone — despite the lower cost operating environment in Australia.[16] This suggests that the OBU/RHQ regime may not be significant in decisions relating to regional headquarters.

If adopted, the changes to licensing and other regulatory arrangements proposed by this Inquiry, together with considerations of competitive neutrality between different classes of financial institutions, suggest that the range of entities eligible to be declared OBUs may need to be reconsidered.

15 Australian Financial Markets Association, Supplementary Submission No. 80, p. 7
16 For discussion of these issues see Australian Financial Markets Association, Supplementary Submission No. 80.

11.3.2 Interest Withholding Tax

Interest withholding tax (IWT) applies to certain receipts of interest derived in Australia and paid to non-residents. The amount of tax paid is 10 per cent of the gross interest, and the rate is generally unaffected by Australia's double taxation agreements.

The wide range of exemptions for IWT gives rise to competitive neutrality concerns in financial markets where institutions competing in the same product markets are subject to different IWT requirements.

Foreign bank branches are subject to IWT on 50 per cent of the interest paid to their offshore head office or offshore branches. Subject to certain conditions being met, domestic banks and foreign bank subsidiaries have access to offshore funds free of IWT through s. 128F of the *Income Tax Assessment Act 1936*. For issuers to utilise the s. 128F exemption under the Government's amendments announced in June 1996, the debentures issued must meet the requirements of a 'public offer test', which prevents direct parent lending. This exemption is not available to foreign bank branches, as they fail to meet the residency requirements of s. 128F.

To overcome this effect, some foreign banks operate through both a branch and a non-bank subsidiary, with corporate lending conducted through a subsidiary which can access funds free of IWT. Such tax driven responses constrain competition, increase costs, create complexity for regulators and impede the efficiency of the capital market.

11.3.3 Tax Effects on Mergers and Reconstructions

A variety of features of income tax can constrain or raise the cost of the reconstruction of corporate groups. They can also diminish the attraction of merging trusts. Restrictive rules for taxation losses, rules for the realisation of assets (including CGT), and other provisions can inhibit mergers and rationalisation within the financial sector. Transaction taxes applied in these circumstances can also act as a significant inhibitor.

The Inquiry has made a number of recommendations which will encourage financial institutions to reassess their corporate structures and sees considerable benefits in reducing the fragmentation in the public unit trust and superannuation industries. Such reconstructions can produce more efficient and hence more competitive financial institutions. However, continuing taxation constraints may hinder the realisation of these potential benefits.

11.3.4 Transaction Taxes and Duties

There are a variety of transaction taxes and duties in Australia. The three which most directly affect the financial sector are financial institutions duty (FID), debits tax and stamp duty. All three taxes are imposed by State and Territory governments on certain financial transactions and instruments.

FID is levied in all States and Territories with the exception of Queensland. The FID tax base covers prescribed 'receipts' of financial institutions. While the legal liability for FID rests with the institution, most institutions pass the tax on to their customers in full.

Several features of FID increase administrative costs and compromise financial sector efficiency.

- Variations in the FID base and the rate of tax among jurisdictions are costly and create uncertainty in the application of FID liability.
- FID impedes the efficient operation of the financial system by taxing transactions where there has been no change in the underlying ownership. In order to minimise FID liability, businesses have structured corporate treasury operations to take advantage of the maximum amount of FID payable (the cap) and the various exemptions. These tax induced administrative arrangements add unnecessary cost and distort resource allocation decisions.
- FID encourages large corporations to maintain foreign currency accounts offshore, and therefore adversely affects Australia's ability

to develop as a regional financial centre.[17] The cap forces individual consumers to bear a disproportionate burden of the tax.

FID is a major source of revenue for those States and Territories where it applies. In order to minimise FID liability, many corporations in Australia aggregate and net payments. This erodes the FID revenue base. Where it is not possible to aggregate or net payments, or firms are too small to justify the development of corporate structures to take advantage of the FID cap, FID could delay (or increase the costs of) the widespread acceptance and adoption of electronic payments in some markets. The New South Wales Government advised the Inquiry that the impact of FID on electronic payments systems is being addressed via the FID Forum, an interjurisdictional working group made up of industry representatives and officers from State revenue offices.[18]

Debits tax is levied on accounts with banks or non-bank financial institutions which have the facility to draw cheques or payment orders. As with FID, there is no uniformity in the rate of tax among jurisdictions and there are various exemptions. The lack of national uniformity imposes administrative costs on users of cheques.

In its 1995 report into bank fees and charges, the Prices Surveillance Authority recommended that State and Territory governments consider replacing FID and debits tax with a single transaction tax.[19] State and Territory governments are reviewing FID and debits tax but have noted that, in the absence of a redistribution of taxing powers between the Commonwealth and the States, abolition is impossible.[20] States and Territories are considering a national debits tax.

Stamp duties are imposed on a range of financial transactions in States and Territories. Again, there is no uniformity in the rates of duty, nor on the

17 A Coopers & Lybrand (1996) study found that 65 per cent of businesses with annual turnover in excess of $750 million maintain offshore foreign currency accounts and that 43 per cent cited FID as a major or decisive factor in the decision to maintain offshore accounts.

18 New South Wales Government Supplementary Submission No. 157, p. iii.

19 Prices Surveillance Authority 1995, p. 84

20 See for example, The Government of the State of Victoria, Submission No. 190, pp. 18-22 and New South Wales Government, Submission No. 268, pp. 28-30.

range of dutiable instruments. However, from a financial sector efficiency perspective, the two most important stamp duties are those on transfers of marketable securities and transfers of loan securities.

A large number of submissions called for the abolition of duty on trading in marketable securities to enhance the competitiveness of the ASX. Table 11.2 shows that rates of stamp duty on transfers of marketable securities are generally higher in Australia than elsewhere in the region. Drawing on empirical work analysing the impact on the market of Queensland's decision to halve the rate of stamp duty in 1995, market participants argued that abolition could deliver net social gains sufficient to compensate for the loss in revenue.

Duties in Australia are Higher than on many other Exchanges . . .

Table 11.2: Transactions Taxes in the Secondary Market for Shares (per cent)

Country	Issuer/Seller	On Contract Notes (payable by both the buyer and the seller)	On Transfer (payable by the buyer)
Australia	ASX transactions Off-market transactions	0.15	0 0.3
Canada		0	0
Hong Kong	Domestic Foreign	0.15 0	0 0
Indonesia		0	0.5
Japan	Individual or corporation Securities company	0.3 (seller only) 0.12 (seller only)	0 0
Korea	Seller	0.35	0
Malaysia		0.10	0.3
New Zealand		0	0
Singapore	Domestic Foreign	0.1 0.1 (if denominated in S$)	0.2 0
Taiwan		0	0.1425
Thailand		0.1	0
USA		0	0

Source: The International Society for Securities Administrators, updated and cited in Allen Consulting Group & Arthur Andersen 1996.

Stamp duty also distorts the housing loan market because it increases the cost of refinancing. Only Victoria and New South Wales have exemptions from stamp duty for mortgage backed securities. This has meant that securitisation programs are structured to comply with the conditions for exemption in those two States. While such arrangements do not affect the ability of consumers elsewhere in Australia to obtain funding via securitisation programs, they add unnecessary cost for originators.

Stamp duty liability may inhibit corporate restructuring and other amendments to contractual documentation. As noted in the context of CGT, the Inquiry considers that a case can be made for a waiver of, or moratorium on, stamp duty where such arrangements flow from implementation of the Inquiry's recommendations.

11.4 Coordination of Advice on Technology

A regulatory framework which is responsive to technological innovations is essential if Australia's financial system is to be internationally competitive. There are two aspects of technological innovation which require assessment. The first is the extent to which technology has implications for the regulation of market conduct and consumer protection. The second is whether the legislative framework adequately recognises and facilitates new forms of delivery made possible by technological innovation and whether Australia has a national, uniform approach to these issues.

Chapter 7 recommends that the CFSC have responsibility for regulation which deals with the first of these issues, for example through the oversight of codes of practice for card based payments systems. These issues are not further considered here.

As to the second aspect, submissions to the Inquiry raised three broad areas of concern:

- technological aspects of regulation of the payments system;
- regulatory responses to the introduction of electronic commerce; and

- the need for better mechanisms for advising government on the coordination of technological developments affecting the financial system.

It is proposed in Chapter 9 that the Payments System Board (PSB) within the Reserve Bank of Australia (RBA) be responsible for the development and application of regulations for the conduct of the payments system, including the oversight of new technology platforms and the imposition of technical and performance standards where necessary. This provides a comprehensive and adequate response to the issues raised in this area.

A comprehensive response to the problems confronting implementation of electronic commerce is proposed in this section. Many of the recommendations fall within the responsibility of the Treasury portfolio.

The remaining proposal, that an additional coordination and advisory mechanism may be warranted to consider technological developments affecting the financial system, is also considered in this section.

11.4.1 Electronic Commerce

Many aspects of the regulatory framework are predicated on paper or physical transactions. As a result, in several areas regulation has created barriers to more efficient means of delivering and storing notices, instruments and contracts. In addition, differences between States and Territories and the Commonwealth on evidentiary issues add cost and complexity to financial transactions. Legal uncertainty over netting arrangements unnecessarily increases risks and costs.

For financial transactions over the Internet, international security standards are being developed by software companies, international credit card associations and third parties such as telecommunications carriers. Given the relatively small size of the Australian market, domestic financial institutions will adopt standards prevailing in larger markets such as the US. There is therefore no requirement for specific government intervention in this area.

The Inquiry supports efforts to develop in Australia an effective system of identifying persons and entities on the Internet and elsewhere, and ensuring the security of transactions. This will be critical to the acceptance of digital signatures and the growth of electronic commerce.

International cooperation and harmonisation of law enforcement and consumer protection regimes will become increasingly important with the growth of electronic commerce.

Recommendation 91: Legislation should be amended to allow for electronic commerce.

Regulation should not differ between different technologies or delivery mechanisms such as to favour one technology over another. A large number of legislative amendments will be required to implement this recommendation. In addition, further amendments will be required to facilitate electronic commerce. These should include:

- adoption and enactment of the recommendations of the Companies and Securities Advisory Committee Netting Sub-Committee;
- review and amendment of Commonwealth, State and Territory legislation to permit digital signatures in appropriate circumstances — such legislation includes the *Uniform Consumer Credit Code*, the *Privacy Act 1988*, and the *Financial Transaction Reports Act 1988*;
- amendments to legislation and industry codes of conduct to allow electronic provision of notices and documents to improve the efficiency of financial transactions and reduce costs;
- endorsement by industry and government of the Public Key Authentication Framework developed by Standards Australia to enable a reliable system for digital recognition of individuals and entities to be developed — interim standards should be in place by the end of 1998; and
- amendments to legislation, such as Evidence Acts, by the end of 1998 to take account of electronic transactions and record keeping — a short-term objective should be the enactment of national uniform legislation covering evidentiary issues for the electronic delivery of financial services.

Recommendation 92: Australia should adopt international standards for electronic commerce.

Australia should adopt appropriate internationally recognised standards for electronic commerce, including for electronic transactions over the Internet and the recognition of electronic signatures.

Recommendation 93: International harmonisation of law enforcement and consumer protection should be pursued.

To assist in international law enforcement and consumer protection, Australian regulatory authorities should maintain close relationships with counterparts in other jurisdictions. As far as possible, Australian law should be consistent with laws in major centres of electronic commerce.

11.4.2 Regulatory Approaches

Two alternative approaches could be pursued to improve the coordination of advice to government on technological developments in the finance sector:

- a single entity could be established to provide advice on a centralised basis; or
- the current decentralised approach could be maintained and improved with a range of measures.

Both approaches need to be assessed against existing and proposed government policy as well as the Inquiry’s recommendations to improve financial system efficiency. Under current arrangements, the Department of Communications and the Arts (DoCA) has overall responsibility for implementing the Government’s on line services policy and coordinating a whole-of-government approach to on line services.[21] DoCA also has responsibility for telecommunications policy. From 1 July 1997, there will be full and open competition in the telecommunications industry, and third-party access to existing networks is envisaged. The Australian Competition and Consumer Commission (ACCC) will be responsible for market conduct regulation. Despite some concerns within the industry about the proposed access provisions, infrastructure investment will be driven by the demands of the market. In the context of the other recommendations of this Inquiry, it is necessary to consider the new and more effectively coordinated roles of the CFSC, the PSB and the Council of Financial Regulators (CFR) (see Chapter 12).

The Case for a More Centralised Approach

Proponents of a more centralised approach point to the benefits flowing from a whole-of-government perspective and the advantages from facilitating potentially slow and inefficient market processes.

- Centralisation of technology policy advice allows government actions and interests to be timely, coordinated and balanced in respect of technical, legal, consumer, and industry development objectives and regulatory responses.
- Centralisation can contribute to avoiding inefficient technological selection processes. Helping markets proactively develop standards may avoid duplication of investments or investments in technologies which ultimately could become obsolete due to incompatibility.

These roles can be combined by creating a 'Technology Tsar' who keeps abreast of all relevant developments, advises the Government on matters of financial systems' technology and facilitates the rapid diffusion of innovations deemed advantageous for Australia. Broadly similar approaches have proven successful in some countries, notably Singapore and Malaysia.

21 In addition, there are a number of technology advisory bodies at the Commonwealth level, including those within the Department of Communications and the Arts and the Department of Administrative Services as well as the Office of Government Information Technology.

There are disadvantages associated with a more centralised approach; namely, its conflict with the deregulatory thrust of other aspects of the regulatory framework and the Inquiry's own recommendations, the possible lack of adequate technology expertise in other regulatory agencies and the incentives for governments to override market forces.

The Case for a Decentralised Approach

Proponents of a more decentralised approach to the coordination of technology policy in respect of the finance sector argue that expertise must be developed in regulatory agencies if the regulatory framework and legislation are to keep up with the pace of change. There is also some uncertainty as to whether a specialist unit could carve out an independent role for itself without cutting across the responsibilities of existing agencies and those recommended by the Inquiry.

Most concern appears to lie in the implications of technology for the delivery of payments services and in consumer protection. The Inquiry has recommended the formation of a PSB to oversee the efficiency of the payments system. The mandate of the PSB will include responsibility for the interoperability of electronic payments channels. In conjunction with authorised clearing systems, the PSB will set technical standards for participation in payments services. Given the increasing importance of electronic delivery and settlement mechanisms, the PSB will need to develop strong technical capabilities in these areas.

Technical standards for the communications networks will continue to be regulated by agencies within the DoCA portfolio. This will ensure that the requirements of the financial system are considered along with those of the telecommunications networks and the foreshadowed multimedia applications.

In addition to these regulatory and operational procedures, the Inquiry has also recommended that the ACCC continue to monitor developments in the finance sector, including the development of any monopoly in payments processing. Together, these measures suggest that there is no additional requirement for a separate technology authority to oversee network development and standard setting in the finance sector.

Technology and the globalisation of retail financial markets raise new issues for consumer protection. A key focus of the proposed CFSC will be to develop standard disclosure regimes for retail financial products, including those delivered through electronic means. The Inquiry has also recommended a common gateway for consumer complaints in the finance sector and harmonisation with international standards. To discharge these responsibilities adequately, the CFSC will need to develop a strong technical capability in electronic delivery channels. Duplication of these functions by a separate technology unit may lead to confusion about the reach of the CFSC, with consequential detrimental effects on consumer protection.

The Inquiry recommends in Chapter 12 that the Council of Financial Supervisors be reconfigured as the CFR to ensure better coordination between regulatory authorities, including information sharing and consistency in approach to regulation. The implications of new financial technology are certain to figure prominently in the CFR's work. The development of conglomerate structures and increasing globalisation will also require regulators to have greater regard to international developments. In order to derive maximum benefits from the CFR and to avoid regulatory overlap, the regulatory issues raised by technology for the finance sector would be best addressed in the CFR forum rather than in a separate technology unit.

On balance, the Inquiry therefore believes that a separate unit to provide advice on technology across the board is not required at this time. However, the proposed PSB, CFSC and APRC should liaise closely on a bilateral basis, and with the CFR, to keep abreast of developments in this area and to implement coordinated responses to consumer protection and other problems.

Should the proposed regulatory arrangements recommended by the Inquiry prove inadequate for addressing the issues raised by technological innovation, then the need for a separate unit could be reassessed in the processes of external review of financial regulation described in Chapter 12, notably the Financial Sector Advisory Council.

Recommendation 94: Regulators should coordinate on technology.

Financial regulatory agencies should keep abreast of technological developments as they affect the financial system and liaise with each other as well as government departments and other agencies.

The PSB, CFSC, APRC and Council of Financial Regulators (CFR) should be proactive in assessing the impact of technological developments on the efficiency, safety and equity of the financial system and should seek the views of industry.

11.5 Cross-Subsidies

Pricing policies in the financial system do not always reflect costs. Sometimes this represents deliberate pricing strategies on the part of institutions but, in other cases, it is the result of cross-subsidies which operate to diminish financial system efficiency. Cross-subsidies between products, channels and customer groups are pervasive in the financial system. They can be explained by historical product bundling and the difficulties with earlier technologies in accurately apportioning costs for pricing of transaction and other service charges. To some extent, institutions are constrained in correcting this mispricing by community expectations that institutions should meet community service obligations.

The most significant cross-subsidies are in product distribution and payments systems which together account for a large share of the total cost of Australia's financial system. Increased competition for the more attractive customer segments, the emergence of niche players with lower-cost structures, and new technologies provide the means and rationale for addressing these cross-subsidies. As Chapter 4 highlighted, Australia has a low rate of direct cost recovery for retail transaction banking services. The emergence of new technologies such as smart cards or Internet banking, and the further diffusion of telephone banking and EFTPOS, provides an opportunity to reduce the overall cost of the system significantly.

The key to obtaining these benefits is to let competitive forces create options for consumers. This can be achieved only if services are priced realistically. Continued mispricing will slow the development of more efficient channels and impose higher long-term costs on all participants.

Governments also have a key role to play in facilitating these developments. In keeping with the philosophy of regulation outlined in Chapter 5, the Inquiry believes that regulation for social purposes, which imposes the task of redistributing benefits on financial institutions, is inefficient. Distributive government objectives are fulfilled more effectively through alternative means. At the same time, government has a role to play in ensuring that pricing freedom does not disadvantage consumers, or selected consumer groups, or create any risk for the system.

In this context, the method by which governments make their own transfer payments could accelerate the development of alternative payment instruments. Continued reliance on cheques for a large number of Medicare and Australian Taxation Office refunds is not conducive to adoption of alternative payment instruments by institutions and markets. Similarly, the methods of payment for social welfare beneficiaries will require reassessment if full cost recovery for retail transaction accounts is introduced. The Inquiry considers that concerted effort by governments to move transfer payments into more cost-effective instruments is desirable.

Recommendation 95: Institutions should have freedom to set fees and charges based on costs.

Banks and other financial institutions should be free to set fees and charges for retail financial and transaction services based generally on the cost of provision of those services, without government intervention or suasion.

Recommendation 96: Governments should examine alternative means of providing low-cost transaction services.

Governments should expedite the examination of alternative means of providing low-cost transaction services for remote areas and for recipients of social security and other transfer payments.

11.6 Improving Market Information

This section considers a range of measures to address market information problems which potentially reduce efficiency in two areas:

- finance for small and medium sized enterprises (SMEs); and
- privacy legislation.

11.6.1 Finance for Small and Medium Sized Enterprises

The availability and cost of capital for SMEs was considered by the Campbell Committee and by a number of subsequent inquiries.[22] These inquiries generally found that SMEs have adequate access to debt finance, but access to equity finance is more problematic.[23] Similar concerns are found in most OECD countries.

There are several reasons why SMEs may experience more difficulties than larger firms in obtaining funds.

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22 Bureau of Industry Economics 1987; House of Representatives Standing Committee on Industry, Science and Technology (Beddell Report) 1990; House of Representatives Standing Committee on Finance and Public Administration (Martin Committee) 1991; Industry Commission 1991; Marsden Jacob Associates 1995.

23 For example, Marsden Jacob Associates reported an equity financing gap between the funding provided by private investors (so called 'business angels') who typically invest up to $500,000 and the usual minimum investment of venture or development capital firms of $2 million.

- Scale — more than 90 per cent of SMEs seeking growth finance require less than $500,000.[24] The fixed costs involved in searching, assessing and monitoring a loan or investment make it disproportionately more expensive to provide funds to a SME.
- Risk — SMEs are perceived to be higher risk propositions. Start-ups and high-growth firms often lack a track record. One bank told the Inquiry that its internal risk assessment models suggest that the Basle capital adequacy requirements substantially understate the amount of capital needed to cover the true risk of SME loans.
- Reporting — SMEs frequently have difficulty providing good quality information, and media or stockbroker reports are rarely available.

In addition, some types of SMEs, such as primary producers, have special financing needs owing to the seasonal nature of their business.

The Inquiry did not review government programs which target the availability of SME finance.[25] Nor did it examine claims that farmers or other SMEs are inherently worthy of finance because they create employment, generate innovation or promote exports. The Inquiry considers that government assistance provided for broader economic or social reasons is more appropriately delivered directly rather than through the finance sector.

The Inquiry examined three aspects of the markets for SME finance:

- debt finance;
- equity finance; and
- information provision.

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24 Yellow Pages 1995, p. 1.

25 For example, Management and Investment Companies scheme (discontinued 1991); Pooled Development Fund scheme; Export Market Development Grants Scheme; Austrade International Trade Enhancement scheme and the Telecom Product Development Fund.

Debt Finance

SMEs remain heavily reliant on bank loans (see Chapter 10) and submissions to the Inquiry raised concerns about the availability, cost and conditions placed by banks on SME loans.

In regard to availability, the Inquiry notes that some intermediaries may have been reluctant to lend in the 'flight to quality' following the early 1990s recession. However, it found no evidence that large numbers of SMEs have difficulty obtaining debt.[26]

There is some evidence that SMEs face higher borrowing costs and more onerous loan conditions than larger businesses. RBA figures show that SMEs have higher borrowing costs than other firms (see Figure 11.3). At least in part, this can be attributed to the greater risk and smaller scale inherent in SME lending.[27] A further factor is that SMEs make greater use of more flexible, and hence more costly, forms of debt such as overdraft facilities.

The Inquiry did not find evidence of serious deficiencies in SME debt markets. While SMEs face higher costs and more onerous conditions, this is at least partly explained by their smaller scale and higher risk characteristics. The Inquiry sees improving competition in the banking sector as an important discipline on financial intermediaries which will help deliver cheaper and more flexible credit to SMEs (see Chapter 10).

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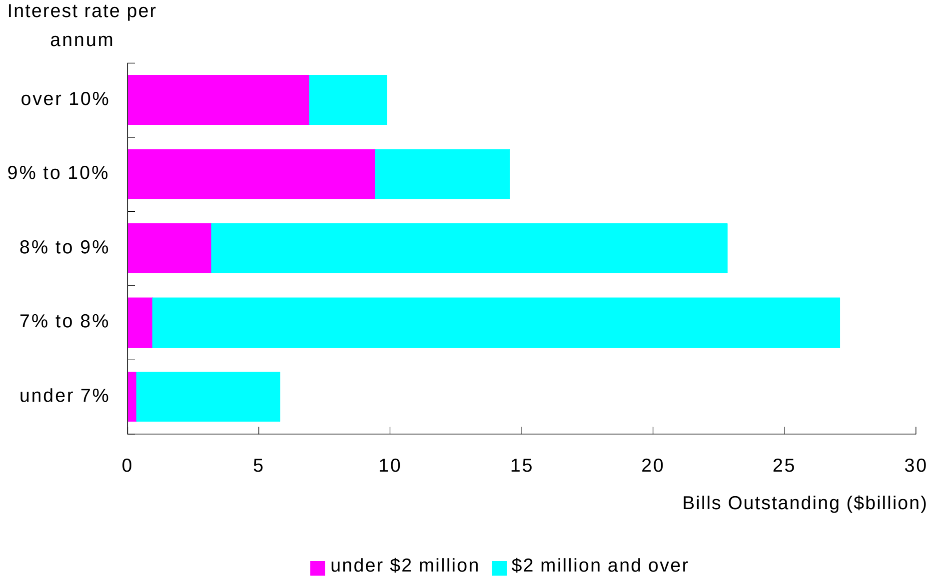
26 The Australian Business Chamber, Supplementary Submission (No. 41, p. 10) notes that all major banks claim that over 90 per cent of SME loan applications are now approved, up from 70-80 per cent a decade ago.

27 Industry Commission 1991, p. xvii.

Small Business Loans cost more than Large Loans . . .

Figure 11.3: Cost of Bill Finance by Loan Size, September 1996



Note: Loan size is used as a proxy for firm size.
Source: RBA 1996, *Reserve Bank of Australia Bulletin*, December edition.

Equity Finance

The provision of equity finance to SMEs appears to be more problematic.

Many SMEs are not suitable candidates for outside equity because they lack growth potential or managements are unwilling to accept any dilution in control. In addition, many firms are not 'investment ready' because, for example, they have not separated their business and personal affairs.[28]

For those firms which are candidates for equity, the most likely source is informal direct investment from a private investor (often called a 'business

28 The Government has commissioned a separate report on making firms 'investment ready'.

angel') or a venture capital firm. The Productivity Commission estimates that business angel investment in Australian businesses totals $1 billion (an average of $146,000 per business) and that some of an estimated $4 billion managed by venture capitalists has been invested in SMEs.[29]

Submissions addressing the availability of SME equity generally focused on possible amendments to the prospectus provisions (see Chapter 7) or tax laws. Section 11.3 identifies those taxation provisions which affect Australia's international competitiveness. The remainder of this section considers measures to improve the flow of equity to SMEs more specifically.

Investment by Fund Managers in SMEs

Some submissions noted the growing pool of managed funds, and suggested that superannuation fund investment in SMEs should be mandatory.

At present there is relatively little superannuation investment in SMEs either directly or through specialist managers. While SMEs are not a suitable investment for many smaller funds, there is evidence that some larger funds are investing in vehicles specialising in smaller investments.[30] The Inquiry believes that these specialist managers are likely to develop in response to commercial demand as the pool of superannuation assets grows.

The Inquiry believes that requiring financial institutions to place a specified percentage of their investments in a particular asset class would have a detrimental impact on capital market efficiency. For this reason, it does not believe that superannuation funds should be required to invest in SMEs.

Some submissions suggested that fund trustees are overly cautious owing to their legal obligations. However, the Inquiry endorses the approach taken in the *Superannuation Industry (Supervision) Act 1993* (SIS) which requires trustees to invest prudently in a properly diversified portfolio. The SIS

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29 Data provided to the Inquiry by the Productivity Commission informal venture finance project.

30 SME investments typically have low liquidity and require greater monitoring and are an unsuitable investment for most small superannuation funds. For a more detailed analysis of superannuation investment in SMEs see Marsden Jacob Associates 1995, pp. 51-54.

regime also introduced a requirement for equal member representation which resulted in many people becoming trustees for the first time. The Inquiry considers any initial caution on the part of these trustees is likely to diminish as they become more experienced.

Recommendation 97: Superannuation funds should not be required to invest in small and medium sized enterprises.

Superannuation funds should not be required to invest in a particular asset class, including small and medium sized enterprises (SMEs). Superannuation investment decisions should continue to be a matter for the trustees of the fund concerned, subject to the requirements of the *Superannuation Industry (Supervision) Act 1993* that they invest prudently in a properly diversified portfolio.

Alternative Equity Markets

Some submissions to the Inquiry suggested that lack of liquidity is a major deterrent for institutional investors and that an alternative equity market would provide a solution. Against this, the ASX argued that problems for SMEs raising capital related more to conditions in primary markets than to any need for a second board or Australian style NASDAQ.[31]

Figure 11.4 shows that smaller fundraisings on the ASX cost considerably more than larger listings.[32] This can be largely attributed to the fixed costs associated with fundraisings, particularly float management and accounting fees. This scale problem is primarily a characteristic of small firms, rather than a flaw in the market which could be addressed by an alternative exchange or regulatory action.

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31 NASDAQ is a US screen based automatic quotation system for equities, which has specialised in high technology stocks. See Australian Stock Exchange, Supplementary Submission No. 135, pp. 7-8 and pp. 33-38.

32 The cost of larger listings on the ASX is comparable with that in overseas countries. NASDAQ (1996) suggests that the direct cost of a US $25 million initial public offer on NASDAQ represents around 9 per cent of the total amount raised.

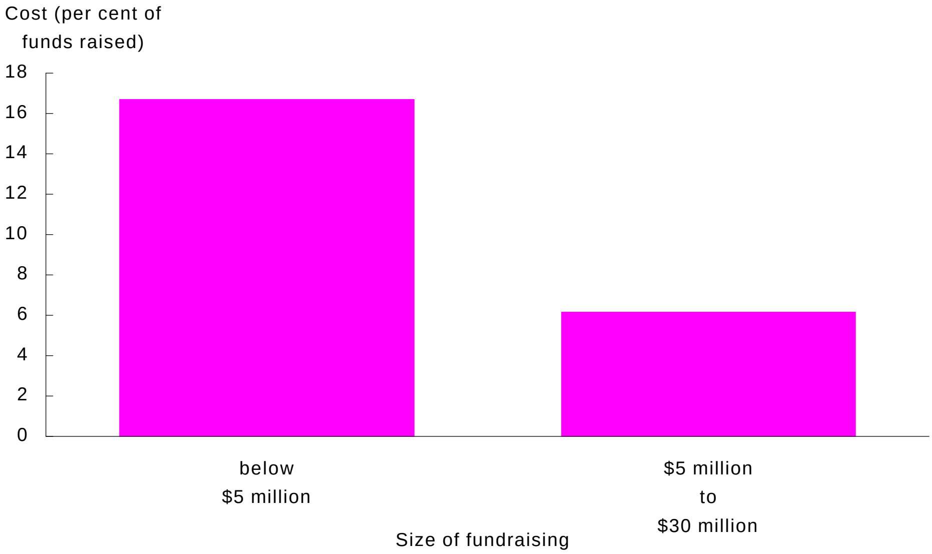
The Commonwealth Government has commissioned a study on alternative equity markets which is due to be completed later in 1997. While the Inquiry did not duplicate this study, it is sceptical that an alternative equity market will provide a solution for many firms. It observes that such markets have failed to reach their objectives in most countries, apart from the United States.[33] Even in the United States, which has a well-developed secondary market, acquisitions by a third party occur three times more often than listings.[34]

Investors are likely to be cautious about placing funds in an alternative equity market. This is partly due to the lack of probity associated with some companies using the second boards which operated in Australia between 1984 and 1992. However, investor caution also relates to the more fundamental concern that stocks with low market capitalisation generally lack liquidity and have volatile share prices.

Small Business Listings are More Costly . . .

33 OECD 1995, p. 15.
34 Golis 1993, pp. 176-177.

Figure 11.4: Cost of Fundraising on the ASX



Note: Based on the cost experience of 21 smaller companies listing on the ASX between 1994 and 1996. Costs include underwriting costs; advisory, legal and accounting expenses; prospectus printing and distribution; and ASX and ASC charges.
Source: Data provided to the Inquiry by the Australian Stock Exchange.

Information made available to the Inquiry suggests that commercial rather than regulatory impediments have held back the development of an alternative market in Australia. Despite press speculation about various proposals, no commercial organisation has yet approached the ASC for a formal approval as a stock market to trade stocks not currently listed on the ASX.[35]

Matching Services

In the absence of a formal market, seekers and providers of capital are obliged to find and deal directly with each other. This can be a time consuming and costly process. The Inquiry was advised of a number of commercial business matching services and directories which are working to reduce these costs. Both Commonwealth and State governments have provided seed funding for business matching services.

In January 1997, the Australian Securities Commission (ASC) moved to provide relief from the prospectus and advertising provisions of the Corporations Law to facilitate two matching services for investments up to $5 million. The ASC plans to release a general class order for matching services.[36] The Inquiry endorses these steps to facilitate the operation of matching services.

Improving Information about SMEs

Compared with the United States, where venture capital is an established asset class, Australia lacks benchmarking and performance measurement data on SME investment pools. The Inquiry believes those specialist fund managers and venture capitalists seeking to develop SME based investments have sufficient commercial incentive to produce the necessary benchmarking and performance data.

A further information issue is the collection and dissemination of government information about SMEs. Recent government measures aimed

35 The ASC's Policy Statement 100 issued in 1995 relaxed its approach to considering applications for alternative equity markets.

36 ASC 1997.

at reducing business costs would also reduce publicly available information on SMEs. The ASC has scaled back the financial information collected from most SMEs following recommendations made by the Corporations Law Simplification Task Force. On the other hand, the Australian Bureau of Statistics recently expanded its SME statistical collections.[37]

Recommendation 98: Data collection on SMEs should consider the needs of rating agencies and fund managers.

The CFSC and Australian Bureau of Statistics should take into account the specific requirements of credit rating agencies and fund managers when reviewing SME data collection.

11.6.2 Balancing Privacy Considerations

The collection, storage, retrieval and use of data electronically will increase as technologies such as electronic commerce, stored value cards and the Internet generate information about individuals. This information may have a significant commercial value for businesses seeking to tailor their products and services or marketing activities to a relevant sector of the community, and hence also for consumers of these services. Developments in data mining techniques are enabling more cost-effective access to such information for purposes such as direct marketing and credit risk analyses.

The public’s concerns about privacy, and privacy laws, may restrict businesses’ ability to use such information for commercial purposes. While the giving of personal details is a part of everyday life, confidentiality of such information is an important social issue. Polls on privacy conducted by the Privacy Commissioner in Australia between 1990 and 1994 show that

37 The first results from a joint ABS/Productivity Commission longitudinal survey of small business performance were published in September 1996, ABS Cat. no. 8141.0.

individuals are placing increasing importance on maintaining the confidentiality of their personal information.[38]

The *Privacy Act 1988* is the primary legislation for the protection of the privacy of individuals. Its scope is limited to the information handling practices of Commonwealth and ACT government agencies, those who use and hold tax file numbers, and credit providers and credit reporting agencies. While there is currently no general application of the Act to the private sector, the Commonwealth is working in consultation with the States and Territories to extend the privacy regime more broadly.

The Privacy Act is based on the Information Privacy Principles, which encompass internationally recognised tenets of privacy protection. These include the principles that personal information may be used only for the purpose for which the information was collected (Principle 9) and that an information keeper may not disclose information relating to an individual unless the individual concerned has consented to the disclosure (Principle 11).

Such restrictions do, or could increasingly, affect financial institutions' ability to exploit the benefits of improved information about their customers to provide financial services more efficiently. The general issue in this area is how to strike an appropriate balance between the valuable use by the finance sector of information against individuals' desire for privacy. More specific issues are:

- whether world class systems to assess consumer credit risk may be introduced without compromising fundamental privacy principles; and
- under what conditions information sharing among groups within a conglomerate should be permitted.

Positive Credit Reporting

Currently, credit reporting is restricted to negative reporting relating to delinquencies. The Privacy Act prevents banks from reporting good credit

38 Privacy Commissioner 1995, pp. 7-8.

behaviour ('positive credit reporting') to credit reference agencies. There is a delay in obtaining information on delinquencies as negative credit reporting provides information on credit which is already more than 90 days in arrears. The absence of positive credit reporting may deny access to finance to customers who should obtain it.

Positive credit reporting is widely used in the United States and Canada and is being used increasingly in several European countries. This practice may contribute to greater competition by enabling consumers with a good record of meeting their commitments to obtain finance more readily from institutions with which they do not have an existing banking relationship. Enabling institutions to assess credit risk more accurately, may reduce the number of consumers defaulting and reduce interest rates.[39]

Information on how positive credit information contributes to credit risk assessment is limited. American research suggests that positive credit reporting may make it possible to identify the lower risk customers within the group who have a negative credit history, thus enabling lenders to expand the availability of credit to this previously underserviced group.[40]

However, positive credit reporting raises privacy concerns. A study by MasterCard International showed that people were generally most concerned if organisations had access to information relating to their finances, particularly information about everyday banking transactions and major financial transactions.[41]

As acknowledged by the Privacy Commissioner, the right to privacy is not absolute as there are other interests that need to be balanced against the claim to privacy. The question is therefore whether the benefits of positive credit reporting in terms of efficiency outweigh the costs in terms of privacy. Parliament decided this issue when it passed the credit reporting amendments to the Privacy Act in 1990. To alter this arrangement would be to change the level of information collected on the financial status of

39 Information assembled by the Credit Reference Association provides some support for the Association's assertion that positive credit reporting could reduce interest rates for consumer lending by one percentage point.

40 Credit Reference Association of Australia, Supplementary Submission No. 42, p. 3.

41 MasterCard International 1996, p. 11. After finances, most concerns related to access to information on medical history and home address.

consumers as the credit reporting agency would effectively become a central clearing house of information about the current financial commitments of all Australians. The main concern is about the relevance and necessity of this kind of detailed information being centrally held and reported on. According to the Privacy Commissioner, the collection of financial profiles of customers 'opens up the potential for a wider range of judgments to be made about a person's character, history and interests as well as their assets and personal wealth'.[42]

The Inquiry was not in a position to assess whether the benefits of positive credit reporting outweighed the costs, but considers the potential benefits warrant a complete review of the issue.

Recommendation 99: A working party on positive credit reporting should be established.

The Attorney-General should establish a working party, comprising representatives of consumer groups, privacy advocates, the financial services industry and credit reference associations to review the existing credit provisions of the *Privacy Act 1988*. The purpose of this review should be to identify specific restrictions which prevent the adoption of world best practice techniques for credit assessment, and evaluate the economic loss associated with these restrictions against the extent to which privacy is impaired by their removal.

Information Sharing

Financial institutions are increasingly expanding the range of financial products and services they offer their customers. More and more financial institutions are becoming financial conglomerates which can offer the customer banking services, insurance, investment services and advice, finance or treasury services for business and personal requirements, superannuation, and stockbroking. In many cases, regulation dictates that

42 Privacy Commissioner, Supplementary Submission No. 85, p. 3.

the businesses offering those products to the same individual need to do so through different corporate entities.

The common law duty of confidentiality prevents entities within a company's group from sharing information about an individual unless the individual has provided consent. Even without this duty, the privacy principles would be likely to prohibit information sharing.

The limitation on information sharing depends on the interpretation of the word 'consent', in particular whether it refers to:

- positive consent — where the customer must take some action or opt in to indicate consent; and
- negative or implied consent — where the customer must take some action to indicate refusal of consent.

The constraints of the obligation of confidentiality on each individual corporate entity may cause difficulties and additional costs and inconvenience to the customer and the institution. It is inefficient both for the customer and for the group if the same information must be collected by each entity. This process prevents customers from having a single relationship manager within a group handling all their dealings.

A legislative requirement that each entity separately secure the customer's positive consent to use personal information to complete the transaction would be quite restrictive. Advice from ANZ indicates that it is difficult and/or very costly to induce customers to take an action, such as to complete a survey, in response to a request.[43] This suggests that many individuals who would not have any objection to, and indeed would benefit from, the sharing of information within the group may not opt in merely because of complacency.

It would be impractical for financial service providers to attempt to collect positive consent in relation to many transactions which are instigated over the phone, often at short notice. Limitations on the sharing of information within a group may constrain the development and take up of more efficient delivery channels. It is claimed that operating efficiencies through

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43 ANZ 1996.

centralisation of services are also constrained without exchanges of customer information.

The Inquiry recognises the privacy concerns raised by the use of information. On balance, it considers there would be merit in allowing negative consent arrangements to be used to satisfy the requirement that customers' consent be obtained.

Recommendation 100: Information sharing among group entities should be allowed unless the customer withdraws consent.

Extension of the privacy regime and future codes of conduct should specifically allow the sharing of information among entities within a group unless the customer has taken some action to indicate refusal of consent. The opportunity to exercise a right of refusal must be easily and readily available to consumers.

Form of Privacy Laws

The Inquiry does not intend to make detailed recommendations on the nature of specific rules in this area. Processes are currently examining this issue in detail, and recommendations will be made to the Attorney-General on regulatory changes in this area. However, given that any changes to privacy laws could have a major effect on the efficiency of the financial system, the Inquiry had an interest in this matter. A number of principles should be considered in extending the privacy regime.

Privacy codes should be developed to apply to all those who supply financial services (ie on a functional basis rather than an institutional basis, given the trend towards non-financial institutions providing financial services).

Businesses continually develop uses for information which will enable them to better serve customers' needs, with the objective of retaining customers and making them increasingly valuable to the business. It would assist if the information could be collected for more than one purpose. Privacy legislation should allow general description of purpose.

One consequence of the extension of the privacy regime would be that customers would be entitled to access personal financial information held by institutions. Significant changes will be required to financial institutions' systems and business processes for this information to be efficiently retrieved. Therefore it is important that adequate time be allowed in which to implement system and process changes which are necessary for efficient compliance with any privacy legislation.

The European regime recognised practical difficulties in implementation of the European Directives and allowed 12 years for the implementation of the articles relating to quality and processing of data with respect to information maintained in manual filing systems.

It is also vital that any extensions to privacy laws apply only at a national level. Considerable additional costs and inefficiencies could be imposed on the financial system if the States and Territories took uncoordinated action in this field.

The Inquiry considered the question of which agency should administer the privacy regime in relation to the financial sector — the universal regulator (ie the Privacy Commissioner) or the agency responsible for consumer protection in the financial system.

The financial system consumer regulator would bring to bear greater expertise and understanding of the financial system in applying the privacy principles. This option would also reduce the number of regulators with responsibility in the financial system, and hence reduce the scope for inconsistent approaches to drive up costs of compliance.

Against these considerations, regulation by the Privacy Commissioner would:

- enable an economy wide perspective to be brought to bear in applying privacy principles, thereby minimising the danger of regulatory capture;

- ensure a level playing field in enforcement and protection was maintained across all sectors of the economy; and
- avoid the problem that with the convergence of financial and non-financial sectors, possible breaches of privacy regulations may fall between financial and non-financial aspects.

On balance, the Inquiry supports the administration of privacy laws in the financial system by the Privacy Commissioner rather than by the financial system consumer regulator.

Recommendation 101: The extension of the privacy regime should follow a number of principles.

The approach to privacy regulation which emerges from the current consultative process should:

- strike an appropriate balance between consumer protection, consumer choice and the effective and efficient delivery of financial services to consumers;
- be carried out in a way which enables it to adapt to the changes accruing in the market, including convergence in financial service providers and products
  - this suggests that any laws or codes of practice should apply to the function of financial service provision rather than to financial institutions;
- be administered for the financial system by the Privacy Commissioner on a national basis;
- avoid or eliminate any duplication of coverage between existing privacy protection, including credit reporting provisions of the *Privacy Act 1988* and financial sector codes of conduct, and the proposed privacy codes; and
- ensure appropriate transitional arrangements are introduced for information which was obtained prior to the introduction of the proposed privacy regime.

11.7 Neutrality in Mortgage Markets

Securitisation plays a valuable role in contributing to the competitiveness of the Australian finance sector, and its long-term success will be a function of the extent to which it provides a sustainable cost advantage over other forms of financing. Chapter 4 discusses these issues in detail.

Mortgage insurance is the principal means for securitisers and traditional mortgage lenders to shift the risk of default in home mortgage markets to another party. For this reason, the solvency of mortgage insurers is critical to the continued smooth functioning of the securitisation industry.

The market leader in mortgage insurance is the government owned Housing Loans Insurance Corporation (HLIC), with 40 per cent of the market. Borrowings by the HLIC are Commonwealth guaranteed and the HLIC pays a borrowing charge to the Government in recognition of the advantage that the guarantee confers in capital markets. Private sector insurers argue that the Commonwealth guarantee of HLIC's borrowings confers a competitive advantage on the public insurer because the borrowing charge undervalues the guarantee. Drawing on the principles of the National Commission of Audit, the Inquiry considers that there is no public interest rationale for continued government ownership of the HLIC.[44]

Recommendation 102: The Housing Loans Insurance Corporation should be privatised.

To ensure that the mortgage insurance market operates on competitively neutral terms, the Housing Loans Insurance Corporation should have its government guarantee withdrawn and be privatised, notwithstanding any increase in insurance premiums that may ensue due to the loss of privileged status.

44 National Commission of Audit 1996.