

Chapter 14 Summary . . .

Stocktake: Historical Perspective

Overview

- This chapter describes the evolution of the Australian financial system from the late 1930s to the present day. The recommendations of the Campbell Committee and the status of those recommendations are described. The chapter then presents the Inquiry's findings regarding the overall impact of deregulation on Australia's financial system.

Key Findings

- Tight control of the banking system in the post World War II era encouraged the growth of non-bank financial institutions. Banks established subsidiaries to overcome strict regulation of their own lending and borrowing activities.
- By the late 1970s, pressure for regulatory reform was mounting through a combination of inflation, exogenous shocks and the declining effectiveness of monetary policy reliant on control of banks' balance sheets.
- The Campbell Committee was established in 1979 and reported in 1981. The recommendations of the inquiry were targeted at both improving the efficiency of macroeconomic management and at the abolition of direct interest rate and portfolio controls on financial institutions. Although the Campbell Committee was concerned to remove barriers to entry to the financial system, its recommendations included strengthened prudential measures to preserve system stability. By the time that the current Inquiry was

announced in mid-1996, the majority of the Campbell recommendations had been implemented.

- In the period since Campbell, other reforms have occurred. Governments have exited increasingly from direct ownership of financial institutions, and there has been substantial economy wide microeconomic reform. These developments, in parallel with financial deregulation, make the task of assessing the effects of deregulation a difficult one.

Stocktake: Historical Perspective

14.1 Introduction

In the five decades since the end of World War II, there have been marked changes in the regulation of Australia's financial institutions and markets. These changes have followed developments in the financial system as well as changes in the philosophy of economic policy formulation.

The Inquiry is required under its Terms of Reference to report on the results of implementing the recommendations of the Australian Financial System Inquiry 1981 (Campbell Committee) during the 1980s. An appreciation of the historical background to deregulation is useful in reaching a balanced assessment of the outcomes.

This chapter provides a chronology of major changes in the Australian financial system from the late 1930s to the present. Changes resulting from the implementation of the Campbell Committee recommendations are highlighted and their impact described. Specific issues raised under items 1(a) to 1(d) of the Terms of Reference are addressed in Chapters 15 to 17.

The chapter describes:

- the evolution of the Australian financial system from the late 1930s to the early 1970s (see Table 14.1);
- changes in the domestic and international economies during the 1970s which profoundly affected the Australian financial system and influenced the Campbell Committee in its deliberations;
- the main findings and recommendations of the Campbell Committee; and

- broad developments in the Australian financial system and financial policy since the final report of the Campbell Committee in 1981.

Table 14.1: Selected Events in the Evolution of the Australian Financial System

1937	Report of the Napier Royal Commission into the Monetary and Banking System
1941	Banks became licensed and came under the influence of the Commonwealth Bank acting in the capacity of central bank. Profits were explicitly restricted to pre war levels.
1942	Interest rates ceilings were imposed.
1945	The <i>Banking Act 1945</i> gave legislative backing to pre war banking regulations (except restrictions on profits). The <i>Life Insurance Act 1945</i> was passed providing for supervision of life companies.
1947	The Commonwealth Government attempted to nationalise banks.
1960	The new Reserve Bank of Australia (RBA) commenced operations under the <i>Reserve Bank Act 1959</i> . The RBA was to aim for currency stability, maintenance of full employment and prosperity for Australians in undertaking its central banking functions. The first Australian futures market opened, trading greasy wool on the Sydney Greasy Wool Futures Exchange.
1961	The '30/20' rule for life companies and superannuation funds was introduced, requiring minimum investments in government securities.
1963	Savings banks were allowed to offer personal loans.
1965	The RBA lifted qualitative guidelines on bank lending, no longer restricting banks to lend to particular classes of borrower.
1966	Decimal currency was introduced.
1970	Provisions in the <i>Banks (Shareholdings) Act 1972</i> applied from this time, limiting maximum individual shareholdings to less than 10 per cent of a bank's capital.
1971	The A\$ and NZ\$ became linked to the US\$ instead of £Sterling.
1972	Trading banks were given increased freedom to negotiate interest rates on deposits greater than \$50,000, subject to a maximum rate, for terms between 30 days and four years. The first of the State credit acts was introduced in South Australia.
1973	The <i>Insurance Act 1973</i> was passed providing for the supervision of general insurance companies.

Table 14.1: Selected Events in the Evolution of the Australian Financial System (continued)

1974	<p>The <i>Financial Corporations Act 1974</i> contained provisions which could have enabled federal control of a range of financial institutions other than banks, including finance companies and general financiers. Provisions for direct regulation of non-bank financial institutions (NBFIs) (Part IV) were not proclaimed however, although the Act still required reporting of NBFI data to the RBA.</p> <p>Bankcard was launched.</p>
1975	Sixteen building societies in Queensland were rescued through establishment of Suncorp, a government owned building society.
1976	The Australian options market commenced trading.
1977	The first automated teller machine was installed in Australia.
1979	<p>The Treasury Note (T-Note) tender system was introduced to replace the 'tap' system for the sale of these government securities. Price for these securities was now market determined for each issue.</p> <p>The Australian Financial System Inquiry (Campbell Committee) was established.</p> <p>ANZ Banking Group took over the troubled Bank of Adelaide, after problems with Bank of Adelaide's finance company subsidiary.</p>
1980	<p>The first cash management trust was established in Australia.</p> <p>Interest rate ceilings on trading bank and savings bank deposits were dismantled from this time; some limits on minimum and maximum terms on fixed deposits remained.</p> <p>The Australian Law Reform Commission Report, <i>Insurance Agents and Brokers</i>, was published. The report recommended that insurers should be responsible for the conduct of their agents, but not brokers with whom the insurer deals.</p>
1981	<p>The final report of the Campbell Committee was tabled.</p> <p>The Commonwealth Government agreed to the mergers of the Bank of New South Wales with the Commercial Bank of Australia and the National Bank of Australasia with the Commercial Banking Company of Sydney.</p>
1982	<p>Savings banks were allowed to accept deposits of up to \$100,000 from trading or profit making bodies.</p> <p>The minimum term on trading bank fixed deposits was reduced from 30 to 14 days for amounts greater than \$50,000, and from 3 months to 30 days for amounts less than \$50,000.</p> <p>The Treasury Bond (T-Bond) tender system was approved.</p> <p>The Trade Practices Commission (TPC) granted interim authorisation for stock exchanges, previously exempt under anti-monopoly provisions of the <i>Trade Practices Act 1974</i>.</p> <p>The Australian Law Reform Commission Report, <i>Insurance Contracts</i>, was published. The report's recommendations included the adoption of standard cover for some types of policy.</p>

Table 14.1: Selected Events in the Evolution of the Australian Financial System (continued)

1983	<p>The Commonwealth Government announced that it would allow entry of 10 new banks, including foreign banks.</p> <p>The A\$ was floated and most exchange controls were abolished.</p> <p>The Treasurer announced the formation of the Martin Committee of Review to assess the Campbell Report.</p>
1984	<p>The Martin Committee of Review endorsed the Campbell Report.</p> <p>The '30/20' rule was abolished for life companies and superannuation funds.</p> <p>All remaining controls on bank deposits were removed. The restrictions that were lifted included minimum and maximum terms on deposits, savings bank exclusions from offering chequeing facilities, and the prohibition of interest on cheque accounts.</p> <p>New taxation arrangements for lump sum superannuation payments were introduced.</p> <p>Foreign investment guidelines on ownership of merchant banks were relaxed.</p> <p>Australian stock exchanges and the securities industry were deregulated.</p> <p>The Australian Payments System Council (APSC) was established. Credit Union Services Corporation (Australia) Limited established a mechanism for credit unions to issue cheques on an agency basis.</p>
1985	<p>Sixteen foreign banks were invited to establish trading operations in Australia — the first foreign bank began operations in the last quarter.</p> <p>Electronic funds transfer at point of sale was introduced.</p> <p>Capital gains tax was introduced.</p>
1986	<p>The first award based superannuation schemes were established.</p> <p>The electronic funds transfer code of conduct was developed.</p> <p>The <i>Cheques and Payments Order Act 1983</i> was amended to allow NBFIs to issue payment orders and to formalise agency arrangements for cheque issuing.</p> <p>The cessation of double tax on company dividends was announced.</p>
1987	<p>The dividend imputation system took effect from mid-year.</p> <p>The Australian Stock Exchange (ASX) commenced operations, amalgamating state exchanges. The ASX established the Stock Exchange Automated Trading System to allow electronic trading of securities.</p> <p>A world stock market crash occurred.</p> <p>The Insurance and Superannuation Commission (ISC) was established.</p> <p>The <i>Occupational Superannuation Standards Act 1987</i> commenced.</p>

Table 14.1: Selected Events in the Evolution of the Australian Financial System (continued)

1988	<p>The Commonwealth Government announced new arrangements for superannuation, including earlier taxation of end benefits, superannuation fund access to dividend imputation and changes to Reasonable Benefit Limits.</p> <p>An issues paper <i>Towards a National Retirement Incomes Policy</i> (Cass Report) recommended measures to establish superannuation as an integral component of the retirement income system.</p> <p>The RBA introduced consolidated risk-weighted capital requirements for banks, consistent with Bank for International Settlements' proposals.</p> <p>Perth based merchant bank Rothwells collapsed.</p>
1989	The Australian Banking Industry Ombudsman scheme was initiated.
1990	<p>ANZ and National Mutual announced plans to merge; the Commonwealth Government opposed the merger on competition grounds. The Commonwealth Government announced the 'six pillars' policy.</p> <p>The Pyramid Building Society failed.</p> <p>A Judicial Manager was appointed for the liquidation of the Regal and Occidental life insurance companies.</p> <p>The National Companies and Securities Commission froze funds of mortgage trust, Estate Mortgage.</p>
1991	<p>The Commonwealth Bank of Australia acquired the State Bank of Victoria.</p> <p>Commonwealth Bank shares were offered to the public for the first time.</p> <p>A twelve-month freeze on redemptions in unlisted property trusts was announced.</p> <p>The Commonwealth Government announced a Superannuation Guarantee Charge effective from 1 July 1992.</p> <p>The House of Representatives Standing Committee on Finance and Public Administration (Martin Parliamentary Committee) released a report recommending a feasibility study of direct payments system access for NBFIs, establishment of a high-value electronic payments system, a formal Prices Surveillance Authority (PSA) brief to examine the profitability of the credit card business and the establishment of a code of banking practice.</p> <p>The Australian Securities Commission (ASC) became the regulator for corporations and for securities and futures markets under <i>Corporations Law</i>.</p> <p>The General Insurance Enquiries and Complaints Scheme and the Life Insurance Complaints Service were established.</p>
1992	<p>Authorised foreign banks were allowed to operate branches in Australia, but were not allowed to accept retail deposits. Limits on the number of new banks that could be established were removed.</p> <p>The Commonwealth Government <i>One Nation</i> package introduced pooled development fund and offshore banking unit concessionary taxation arrangements.</p> <p>Mortgage originator 'Aussie Home Loans' was established.</p>

Table 14.1: Selected Events in the Evolution of the Australian Financial System (continued)

1992 (cont)	<p>The Australian Financial Institutions Commission (AFIC) was established to administer the new Financial Institutions Scheme.</p> <p>The Australian Payments Clearing Association was established.</p> <p>The TPC report on the Life Insurance and Superannuation industry was released. The report criticised, amongst other matters, the quality of financial advice given by agents and the industry's remuneration systems for agents.</p>
1993	<p>The Commonwealth Government Banking Policy Statement was announced, which included changes to the interest withholding tax arrangements and a call for the PSA to monitor credit card interest rates and fees.</p> <p>The Australian Bankers' Association released the code of banking practice to be monitored by the APSC.</p> <p>The <i>Superannuation Industry (Supervision) Act 1993</i> was passed.</p>
1994	<p>The NSW Government sold the State Bank of NSW to the Colonial Mutual Life Association.</p> <p>The Insurance Council of Australia introduced the general insurance code of practice. The code encouraged the raising of standards of practice and service for personal lines of business in the insurance industry.</p> <p>The Superannuation Complaints Tribunal commenced operations.</p> <p>Two Special Services Providers were issued exchange settlement accounts by the RBA.</p>
1995	<p>The TPC allowed the Westpac acquisition of Challenge Bank, and elucidated market definition criteria for the sector.</p> <p>The South Australian Government sold the State Bank of South Australia to Advance Bank.</p> <p>The first international stored value card trials were conducted in Australia.</p> <p>The Commonwealth Government allowed acquisition of a majority interest in the National Mutual Life Association of Australia by AXA SA, contingent on the demutualisation of National Mutual and formation of a new holding company for the National Mutual group.</p> <p>The <i>Life Insurance Act 1995</i> enhanced the ISC's powers to obtain reports and to conduct on-site inspections. The life insurance code of practice was launched.</p>
1996	<p>The Financial System Inquiry was announced.</p> <p>Banks, building societies, credit unions and life companies were allowed to provide a retirement savings account product from mid-1997.</p> <p>Commonwealth Bank shares were offered to the public for the second time.</p> <p>The Queensland Government announced the merger of Metway Bank and the government owned SUNCORP insurance and finance group.</p> <p>The <i>Uniform Consumer Credit Code</i> applied from November.</p>
1997	<p>St. George Bank merged with Advance Bank.</p>

14.2 Evolution of the Australian Financial System

14.2.1 From the Napier Royal Commission to the Campbell Committee

The Great Depression of the early 1930s showed how severely general economic conditions could be affected by developments in financial markets. The near collapse of the banking system drew attention to the need to ensure stability in financial arrangements. Not only was there widespread dissatisfaction with the performance of banks during the Great Depression but, as a result of the hardship brought on by economic distress, the climate of economic policy making also became more interventionist.

In November 1935, the Commonwealth Government established a Royal Commission, chaired by Justice Napier, to inquire into the monetary and banking system in Australia. This was the first major inquiry into the Australian financial system. The Royal Commission concluded that the financial system should be subject to wide ranging intervention in order to ward off instability and to facilitate the operation of monetary policy.

The key recommendations of the Royal Commission included the licensing of banks, direct control of interest rates and the volume of credit, and the vesting of central banking powers in the Commonwealth Bank of Australia. The Royal Commission observed:

*The most desirable banking system in the present circumstances of Australia is one which includes privately-owned trading banks . . . [and] in which a strong central bank regulates the volume of credit and pays some attention to its distribution . . .*¹

1 Royal Commission into the Monetary and Banking System 1937, para. 669.

The Commonwealth Bank was to conduct monetary policy and to:

*take control of the affairs of any bank which is unable to meet its immediate obligations, and . . . be given any additional powers which it may require for this purpose.*²

The main recommendations of the Royal Commission were adopted, but not at a single stroke. The outbreak of war and a change of government drew attention away from financial regulation issues for a time. In August 1939, comprehensive exchange controls were introduced, requiring permission from the Commonwealth Bank for all foreign exchange transactions. In November 1941, emergency national security regulations were used to license banks. Licensing obliged banks to hold minimum amounts in special accounts with the Commonwealth Bank. Interest was paid on these accounts but at a level low enough to prevent bank profits from exceeding their pre war levels. In February 1942, the Commonwealth Bank was endowed with powers to impose a maximum interest rate limit.³ Most of these controls became law when the *Banking Act 1945* was passed.

Following a challenge to these amendments in the High Court, the Commonwealth Government tried to nationalise banks in 1947. Bank nationalisation became a heated political issue but was effectively removed from the political agenda with a change of government in 1949.⁴

Through the 1950s, financial policy maintained its focus on the tight control of banks. A typical bank balance sheet of the period saw almost half of a bank's assets invested in government securities or in special accounts with the central bank. By varying amounts held in special accounts—subsequently replaced by Statutory Reserve Deposits (SRD)—the central bank could influence the volume of funds available for lending to the private sector. Under the Liquid Assets and Government Securities (LGS) convention, banks agreed to hold a minimum proportion of their free assets in the form of liquid assets and government securities. With interest rates

2 Royal Commission into the Monetary and Banking System 1937, para. 617.

3 House of Representatives Standing Committee on Finance and Public Administration 1991, para. 2.36.

4 House of Representatives Standing Committee on Finance and Public Administration 1991, para. 2.38.

controlled but entry to the sector tightly restricted, bank profitability grew steadily through the 1950s and 1960s.⁵

Between 1956 and 1972, the larger private banks established savings bank and finance company subsidiaries, partly in an effort to avoid some of the regulatory restrictions they faced. Their savings bank subsidiaries were also licensed and required to hold minimum ratios of reserves and government securities, but the finance companies were only lightly regulated. However, even ignoring their subsidiaries, trading banks were clearly the dominant financial institutions in the Australian financial system until the 1960s (see Table 14.2).

During the 1950s, the private trading banks became increasingly dissatisfied with the Commonwealth Bank's dual role as trading bank and central bank. In recognition of these concerns, the Commonwealth Bank was divided in January 1960 into the new Commonwealth Banking Corporation (a commercial bank) and the Reserve Bank of Australia (RBA), the latter charged with undertaking central banking functions.

In addition to trading banks, the major institutional players in the 1960s were the life companies. They held assets around 80 per cent of the value of those held by trading banks, including substantial holdings of residential mortgages. Life companies enjoyed concessional tax treatment relative to that faced by banks. This was extended in 1961, when the superannuation business of life companies became entirely tax free, on condition that life companies held 30 per cent of the assets securing their superannuation business in the form of government securities, 20 per cent to be in the form of Commonwealth securities. This so-called '30/20' rule remained in force until it was abolished in September 1984, on the recommendation of the Campbell Committee.

The decade of the 1950s saw the beginnings of the deregulatory pressures that were to emerge more fully in the 1960s.⁶ By the late 1950s, policy makers had begun to realise that greater interest rate variability was essential for effective monetary policy.⁷ The authorities also recognised that

5 Edey & Gray 1996, p. 23.

6 Grenville 1991, p. 11.

7 Grenville 1991, p. 12.

qualitative lending guidance was unpopular, both in the market and within the central bank.

Historical Dominance of Trading Banks . . .

Table 14.2: Assets of Financial Institutions (per cent of total financial sector assets)

Year	1929	1939	1948	1960	1970
Institution					
Central Bank	5.7	7.5	24.0	13.8	8.2
Trading banks	40.6	36.7	32.1	25.4	21.8
Savings banks	25.8	20.9	25.0	20.6	19.3
Other banks			0.4	0.7	1.2
Total banks (excluding central bank)	66.4	57.6	57.4	46.7	42.3
Life companies and pension funds	16.5	21.7	10.9	20.2	22.7
Non-life insurance	3.7	4.0	2.0	3.1	4.6
Pastoral finance companies	4.7	4.2	2.4	2.4	1.7
Building societies	1.4	1.7	1.2	3.1	4.6
Credit unions					0.3
Finance companies		1.4	1.0	7.4	9.0
General financiers					0.5
Merchant banks				0.1	2.1
Money market dealers				1.0	1.7
Investment companies and unit trusts	0.1	0.2	0.1	1.3	1.5
Friendly societies	1.4	1.5	0.8	0.6	0.7
Other financial institutions	0.3	0.2	0.1	0.1	0.1
Total	100	100	100	100	100

Source: Lewis & Wallace (eds) 1985, p. 2.

As a result, in the 1960s, the balance between the SRD and LGS ratios was altered, allowing larger holdings of LGS assets returning market related rates of interest. Institutional changes to facilitate a larger bank share of financing also occurred: for example, the Australian Resources Development Bank was established in 1960. The development of the bank accepted

commercial bill market, beginning in the mid-1960s, was yet another attempt to stem the tide of finance sourced outside the banking system.⁸

14.2.2 The Rise of Non-Bank Financial Institutions

Tight control of the banking system encouraged the growth of non-bank financial institutions (NBFIs). This began in the 1950s and continued through the 1960s. Life companies were actively engaged in mortgage lending to satisfy demand unmet by banks, which were constrained by quantitative lending guidelines.⁹ Instalment credit grew outside the banks' traditional lending areas, as banks were typically not involved in personal lending.

In the 1950s, there was significant demand for hire purchase finance for household consumables.¹⁰ Specialist finance companies were the source of some of this credit but, by 1959, each of the private trading banks had acquired an interest in a finance company in response to the growth of this source of less regulated finance.

Building societies also benefited from the competitive disadvantage financial regulations imposed on banks. An observer noted in the early 1970s:

The building societies are able to charge and pay higher rates because savings banks have been unable to satisfy the demand for housing finance and have often resorted to rationing which [has] led borrowers to enter complicated and expensive second mortgage commitments. The market has thus intruded through the back door.¹¹

The building societies benefited particularly from the government requirement that savings banks hold more government securities than housing advances, and from the provision of housing mortgage insurance after 1958.¹²

8 Grenville 1991, p. 12.

9 Edey & Gray 1996, p. 3.

10 House of Representatives Standing Committee on Finance and Public Administration 1991, para. 2.47.

11 Sanders 1972, pp. 162-63.

12 Grenville 1991, p. 13.

The rise of merchant banks, many foreign owned, was initially encouraged by unmet demand for financing of new resource projects in the 1960s.¹³ This shift in market share away from banks in favour of other institutions continued through the 1960s. In 1970, finance companies and building societies together held 14 per cent of the assets of all financial institutions, compared with only 2 per cent in 1948 (see Table 14.2).

14.3 Forces for Change in the 1970s

The postwar period up to the start of the 1970s was one of gradual evolution. Financial services changed little and were delivered largely by institutions insulated from competition by regulations designed to promote stability, albeit at the cost of efficiency. While the regulatory constraints imposed on banks had spawned the growth of less heavily regulated specialist financiers, the system was still relatively sheltered from competition, both domestically and internationally. In the 1970s, a number of related developments produced marked changes in the business environment.

14.3.1 The Onset of Inflation

A sharp increase in oil prices in 1973 put immediate upward pressure on inflation as well as pressure on governments worldwide to accommodate price increases to mitigate their impact on unemployment. With both prices and quantities of financial services constrained by regulation, the banking system lacked the flexibility needed to meet rapidly changing consumer needs in the mid and late 1970s. For example, in an inflationary environment, consumers demanded savings products that would at least maintain the real value of their savings; this was not possible for banks, which were unable to pay market rates of interest because of interest rate ceilings imposed on their deposit liabilities.

13 Grenville 1991, p. 14.

The immediate impact on regulated financial institutions was an erosion of their competitive position relative to institutions with greater capacity to price flexibly. Inflation lowered the real return on savings instruments whose nominal interest rates were capped by regulation. For example, with nominal interest rates on savings bank deposits capped at 3.75 per cent, real returns became substantially negative. Thus, the long-term downward trend in the market share of banks, which had begun in the early postwar period, continued unabated into the 1970s. By the late 1970s, the market share of banks had reached historically low levels (see Figure 14.1).

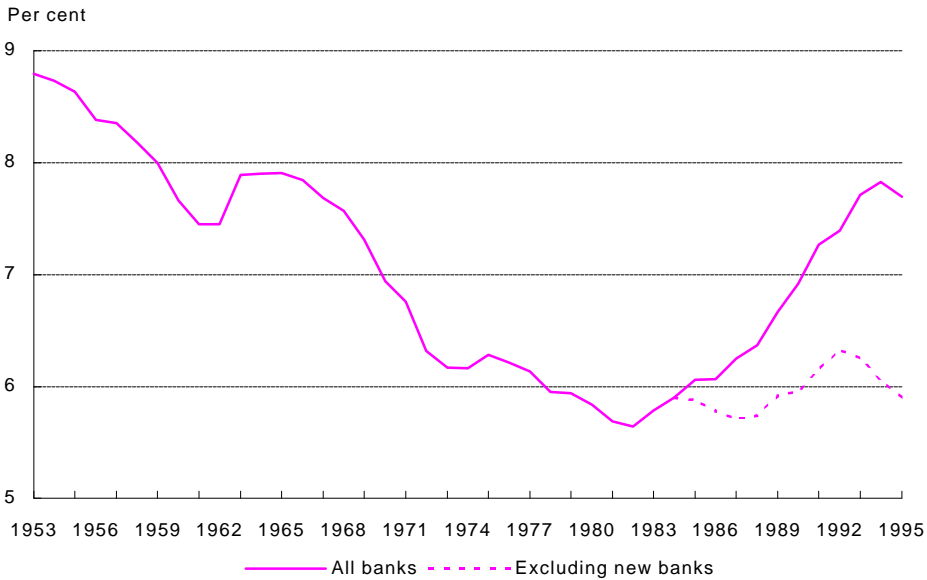
Inflation in the 1970s also heightened uncertainty about the future value of financial assets. Savers became more conscious of differences in financial returns and more willing to seek out means of protecting their savings from the corrosive effects of inflation. Thus inflation stimulated a shift in investor preferences away from financial assets with fixed nominal returns.

The market disruptions of the early 1970s also had a profound impact on the Commonwealth Government's fiscal position. Faced with rising unemployment, the Commonwealth ran large fiscal deficits. At the same time, the RBA attempted to contain the growth of the money supply to counter inflation. The combination of loose fiscal policy and tight monetary policy resulted in the need to sell substantial quantities of Commonwealth Government securities.

This imperative conflicted with the Government's approach to regulation of the financial system. Indeed, the ability of the RBA to implement monetary policy became increasingly compromised during the 1970s.

Banks' Asset Share Reached Historic Lows in the Early 1980s . .

Figure 14.1: Banks' Share of Assets of Financial Intermediaries



Assets of financial intermediaries are defined as the combined assets of banks (excluding the RBA) and NBFIs (comprising permanent building societies, credit cooperatives, authorised money market dealers, money market corporations, finance companies, pastoral finance companies and general financiers).

Source: Edey & Gray 1996, p. 5.

14.3.2 The Declining Effectiveness of Monetary Controls

In the late 1960s and early 1970s, it was recognised that direct regulation of the banking system was not achieving its objectives. In particular, direct controls on banks were thwarting rather than serving the effective operation of monetary policy.

Of primary concern was the growth of non-bank financial intermediation. To the extent that financial activity took place outside the banking sector, efforts by the monetary authorities to administer monetary policy via the banks were frustrated. Attempts to constrain financial activity by lowering the volume of bank lending, for example, were increasingly offset by matching

increases in lending by non-banks. Regulations on banks were recognised as a primary source of the growth of NBFIs.

In order for policy to influence financial activity in aggregate, a mechanism whose reach extended beyond the banking sector was needed. This suggested a move towards ‘market oriented’ intervention and away from direct controls on the banking system. Market transactions by the RBA operate to change the level of market prices (ie interest rates) rather than the volume of bank lending. By influencing interest rates rather than the growth of bank balance sheets, the impact of monetary tightening or easing is felt throughout the financial system rather than by banks alone.

At the same time, the intellectual climate was shifting away from the interventionist focus of the previous three decades as the high point of confidence in Keynesian ideas subsided. Thus the stage was set for financial deregulation.

14.3.3 Changes in Mechanisms for Issuing Government Securities

Prior to 1979, Commonwealth Treasury Notes (T-Notes) and Treasury Bonds (T-Bonds) were sold through a ‘tap’ system. The interest rate (price) of the securities was set by the Government and buyers could purchase as many or as few as they pleased. If the interest rate was set too low, fewer securities would be sold than were needed to finance government expenditure in a manner consistent with low inflation.

As inflation rates rose during the mid to late 1970s, investors demanded correspondingly higher rates of interest on Commonwealth paper. While it was possible to raise interest rates on Commonwealth securities, the process required protracted negotiation with the States, whose own budgetary positions depended on rates of interest set by the Commonwealth. With interest rate alterations becoming more frequent in the face of increasingly high and variable rates of inflation and with the requirement to sell even more securities, the Commonwealth recognised the need to change the system.

In 1979, a tender system was introduced for the sale of T-Notes. A similar system for the sale of T-Bonds was established in 1982. The sale of Commonwealth securities at tender allowed interest rates on official paper to find market clearing levels. This placed further pressure on banks, which were prohibited by regulation from offering market rates of interest on deposits. In any event, deposit interest rate ceilings imposed on trading and savings banks began to be abolished from December 1980.¹⁴

14.3.4 Technology

The adoption of electronic data processing technology by financial institutions began in earnest in the 1970s. This included the introduction of automated processes in both ‘back office’ and ‘front office’ functions. Australia’s first automated teller machine was brought into service in 1977 by the NSW Teachers’ Credit Union. NBFIs, most notably building societies and credit unions, tended to adopt new technology more quickly than banks. Innovation among these NBFIs may have been encouraged by the fact that these institutions had no access to the established payments system infrastructure.

In wholesale markets, the growth of technology served to integrate capital markets across national borders. In Australia, the foreign currency hedge market operated as a ‘shadow’ forward foreign exchange market in an environment in which the official spot and forward foreign exchange rates were managed by the RBA. The influence of capital market developments outside Australia was transmitted to domestic markets via the currency hedge market, in spite of the existence of comprehensive exchange controls. The existence of the currency hedge market owed a great deal to the development of computer links and trading systems which spanned countries and time zones.

¹⁴ Maximum and minimum maturities on fixed deposits remained until 1984, being progressively removed over the preceding four years. For example, in 1982 the minimum term on trading bank fixed deposits was reduced from 30 days to 14 days for amounts greater than \$50,000, and from 3 months to 30 days for amounts less than \$50,000.

14.3.5 International Developments

The collapse of the Bretton Woods system of fixed exchange rates in the early 1970s destabilised regimes of financial regulation in Australia and elsewhere. Capital flowed more freely around the world, especially into and out of the United States. Increased capital mobility frustrated efforts by the Australian Government to manage the exchange rate for the Australian dollar at a time when it was seeking to control domestic monetary conditions. Attempts to tighten domestic monetary policy by selling government securities stimulated capital inflow which, in turn, produced easier monetary conditions as the RBA exchanged Australian dollars for the foreign currency supplied by foreign investors.

Towards the end of the 1970s and into the early 1980s, the case for floating the exchange rate gained momentum, despite initial opposition by the monetary authorities. Proponents argued that a freely floating Australian dollar was essential for the RBA to regain a measure of control over monetary conditions.

Floating the Australian dollar meant abandoning exchange controls and permitting the free movement of foreign capital into and out of Australia. Recognising the inevitability of a market determined exchange rate for the Australian dollar was a key step on the road to deregulation. A floating exchange rate could not be combined with heavy controls on domestic financial markets without precipitating sudden adverse movements of the exchange rate.

Developments in Australia were consistent with those elsewhere in the developed world. Liberalisation of financial markets followed the combined impact of inflation, increased public sector borrowing, technological innovation and greater international capital mobility. Most countries began the process of liberalisation in the late 1970s.¹⁵

¹⁵ Hviding 1995, p. 30.

14.4 The Campbell Committee

By the end of the 1970s, it was clear to most observers that bank regulation was not achieving its public policy objectives and was creating serious distortions and inefficiencies. In particular, the declining market share of banks was a source of concern for both the banks themselves and the monetary authorities. Tight regulation of the banking system was recognised as a major contributor to the falling market share of banks.

It was against this backdrop of growing dissatisfaction with the performance of financial regulation that the Australian Financial System Inquiry (known as the Campbell Inquiry) was announced in 1979. The Campbell Inquiry was given a wide ranging brief to recommend changes to the regulatory structure of the financial system so as to promote efficiency and stability.

The final report of the Campbell Committee (the Campbell Report) contained some 260 recommendations, covering all aspects of the existing regulatory structure. While the Campbell Committee recommended the removal of many regulations imposed on the financial system, it did not seek to abandon government intervention altogether. The committee considered the involvement of government in various aspects of the financial system as both proper and desirable.

Specifically, the Campbell Report recommended the strengthening of regulations designed to uphold prudential standards observed by financial institutions in a newly deregulated financial environment. Thus the Campbell Committee did not evince the single-minded focus on financial deregulation that is often claimed.

The recommendations of the Campbell Committee may be grouped into four broad categories:

- changes affecting the mechanisms of macroeconomic management, including foreign exchange controls and the implementation of monetary policy;
- abolition of direct controls on interest rates and portfolio composition;
- strengthening of regulations aimed at preserving system stability; and

- removal of barriers to entry to the financial system.

The Campbell Committee was especially critical of the negative influence of intrusive regulation on the efficiency of the Australian financial system. Many of its recommendations were aimed at increasing the scope for market forces to determine financial market outcomes with appropriate levels of regulatory oversight. The Campbell Committee was concerned to ensure the stability of the financial system and was keenly aware of the potential conflict between the objectives of efficiency and stability.

Table 14.3 presents some of the main recommendations of the Campbell Committee, grouped under the above categories.¹⁶

It is a distinctive feature of the Campbell Report that the great majority of its recommendations were implemented, although a significant number not until the late 1980s or 1990s. Recommendations relating to macroeconomic management, direct interest rate controls and the easing of bank entry restrictions were adopted first. Some deregulatory moves had been made even prior to the release of the Campbell Report in 1981, including:

- easing of surveillance on capital inflows from July 1980;
- removal of interest rate ceilings on savings and trading bank deposits in 1980; and
- easing of maturity controls on certificates of deposit in August 1981 to allow 30-day issue (down from a minimum of three months).

Foreign exchange controls, the remaining quantitative lending controls and restrictions on access for foreign institutions were removed within two to three years of the Martin Review Group's endorsement of the Campbell Committee's recommendations.¹⁷

Many of the recommendations for stricter prudential regulation were adopted much later and for reasons not directly related to the circumstances which spawned the Campbell Inquiry. For example, the failure of the Pyramid Group in the early 1990s precipitated the introduction of tighter

16 Australian Financial System Inquiry 1981, pp. 758-822.

17 Australian Financial System Review Group 1984, pp. 358-61.

prudential controls on NBFIs, the need for which had been foreshadowed in the Campbell Report 10 years earlier.

Most Campbell Recommendations were Implemented . . .

Table 14.3: A Selection of Campbell Committee Recommendations

Policy Area	Final Report Recommendation	Status and Date of Implementation
Changes to policy affecting macroeconomic management.	Adopt a tender system as the preferred system for the issue of government securities.	Approved for T-Bonds in June 1982.
	Remove lending controls through the Loan Council for 'commercial' local and semi-government authorities, that are subject to market disciplines.	Loan Council lifted controls from large semi-government authorities in July 1983. Currently, some 'commercial' authorities exempted, provided that they meet strict commerciality criteria.
	Dismantle the institutional arrangements for fixing the exchange rate and dismantle exchange controls. RBA intervention in the forward foreign exchange market to be consistent with principles for intervention in the spot foreign exchange market.	Implemented from October to December 1983. Since the floating of the \$A in December 1983, the RBA has intervened in spot and forward markets for the dollar 'in the spirit of a floating rate system'. ¹⁸
	Abolish 30\20 rule which specified minimum holdings of government securities for life companies and superannuation funds.	Implemented in September 1984.
	Use broader monetary and credit aggregates as alternatives to M3 monetary policy target.	Monetary targets were abolished in January 1985.
Removal of regulations imposing direct controls on interest rates and portfolio	Abolish quantitative lending controls which place ceilings on interest rates that could be charged to borrowers.	Quantitative controls were largely removed in June 1982, although a cap of 13.5 per cent applied to pre-existing housing loans until 1986.

18 Macfarlane 1994, p. 13.

composition.		
--------------	--	--

Table 14.4: A Selection of Campbell Committee Recommendations

Policy Area	Final Report Recommendation	Status and Date of Implementation
Removal of regulations imposing direct controls on interest rates and portfolio composition.	A near market interest rate to be paid on non-callable deposits (NCDs) with the RBA.	In 1993, the interest rate payable on NCDs was aligned with the 13 week T-Note rate (previously T-Note less 5 per cent). In 1995, the below market interest rate was re-introduced. The NCD interest opportunity cost is a revenue-raising impost by the Commonwealth Government and does not relate to the direct cost of regulation.
	Abolish maturity controls, including removal of minimum and maximum terms on trading and savings bank deposits.	Implemented in August 1984.
	Remove portfolio controls.	The savings bank specified asset requirement was reduced to allow a free choice tranche of loans in August 1982. Prime Assets Ratio (PAR) replaced LGS convention in May 1985, expanding the range of assets that qualified for inclusion in the PAR ratio.
Strengthening of regulations to preserve stability.	Conduct periodic in-depth examinations of banks as part of the RBA's supervisory effort.	RBA announced that external auditors would be used in the supervision task in April 1986.
	Subject individual banks to appropriate capital requirements, with bank capital to be assessed on a consolidated basis.	RBA introduced consolidated, risk weighted capital requirements for banks in August 1988.
	Amend the <i>Banking Act 1945</i> to allow introduction of prudential requirements by regulation.	<i>Banking Act 1945</i> amended in December 1989.
	Establish national framework for prudential supervision of State based non-bank deposit taking institutions.	Financial Institutions Scheme commenced and AFIC established by the States and Territories in July 1992 for the prudential supervision of building societies and credit unions throughout Australia.

Table 14.5: A Selection of Campbell Committee Recommendations

Policy Area	Final Report Recommendation	Status and Date of Implementation
Strengthening of regulations to preserve stability.	Increase prudential supervision of superannuation funds, linking the ability to rebate contributions to minimum prudential requirements.	Implemented under the <i>Superannuation Industry (Supervision) Act 1993</i> .
	Establish cooperative scheme to achieve uniformity in the regulation of consumer credit providers, with credit legislation applying to all institutional providers of consumer finance.	The <i>Uniform Consumer Credit Code</i> applied from November 1996.
	Maintain disclosure standards for life companies no less onerous than those applying under the (then) Companies Act.	<i>Life Insurance Act 1995</i> requires life companies to produce financial statements substantially in a form required by the <i>Corporations Law</i> , which identifies policyholders' interests separately from shareholders' interests and the profitability of operations.
Removal of entry barriers.	Repeal <i>Bank (Shareholdings) Act 1972</i> to permit larger individual shareholdings.	Not implemented.
	Remove the embargo on entry of foreign banks, and regulation of new entrants that is no more onerous than for incumbents.	Sixteen new licences issued to foreign banks in 1985, with Chase-AMP becoming the first of the foreign banks to commence operations in September of the same year.
	Allow foreign banks to establish agencies which would be restricted to offshore lending.	Foreign branches permitted to undertake all banking activities other than the taking of retail deposits from 1992. Foreign bank branches could raise funds in overseas capital markets using a non-bank subsidiary from December 1993, removing a competitive disadvantage relating to withholding tax exemption.

14.5 Other Policy Developments since the Campbell Report

Recommendations flowing from the Campbell Inquiry have not been the only changes to affect the financial system during the period since 1981. Other changes include the introduction of a formalised retirement incomes policy, the sale or privatisation of government owned financial institutions and initiatives in microeconomic reform. It is therefore not possible to link outcomes in the period following 1981 uniquely to the recommendations of the Campbell Committee.

14.5.1 Retirement Incomes Policy Changes

One of the major policy developments in the decade following the release of the Campbell Report was the introduction of a formalised retirement incomes policy. The advent of award superannuation in 1986 was the first instance of superannuation being formally included in industrial awards as an element of wage earners' remuneration. The Australian Conciliation and Arbitration Commission (subsequently re-named the Australian Industrial Relations Commission) approved an agreement to contribute wage increases up to 3 per cent to approved superannuation funds. This benefit was gradually incorporated into employment awards as they were renegotiated over subsequent years.¹⁹

This commission ruling was followed by the release in 1988 of the Social Security Review Issues Paper entitled *Towards a National Retirement Incomes Policy* (Cass Report), which recommended the inclusion of superannuation as a component of an equitable and sustainable retirement income system. In 1989, the Commonwealth Government released its own retirement incomes policy in a report entitled *Better Incomes: Retirement Incomes Policy into the Next Century*. This report confirmed occupational superannuation and the age pension system as the twin planks of the Commonwealth Government's retirement support plan.

¹⁹ Edey & Gray 1996, p. 26.

By 1992, the Government had introduced a superannuation guarantee charge mandating a timetable for increasing employer contributions up to 9 per cent by the year 2002. Further policies announced in 1995 specified a schedule for employee supplementary contributions of 3 per cent, with matching Commonwealth Government contributions, lifting the total contributions to a rate of 15 per cent by 2002.²⁰ The most recent changes to the retirement incomes policy were those announced in the August 1996 Federal Budget: from mid-1997, banks, building societies, credit unions and life companies will be allowed to provide superannuation without a trust structure, in the form of retirement savings accounts.

14.5.2 Government Exit from Ownership of Financial Institutions

Consistent with the recommendations of the Campbell Report, governments at both State and federal levels have gradually withdrawn from direct ownership of financial institutions in the period since 1981.

The Commonwealth Government has progressively privatised the Commonwealth Bank, with an initial public offering in 1991, and a subsequent float of the remaining equity in July 1996. State governments have also sold or privatised State financial institutions, including: in 1991, the Victorian Government sold the State Bank of Victoria to the Commonwealth Bank; in 1992, the NSW Government finalised the sale of the NSW Government Insurance Office and, in December 1994, sold the State Bank of NSW to Colonial Mutual Life; and, in 1995, the South Australian Government sold the State Bank of South Australia to Advance Bank.

14.5.3 Economy-wide Microeconomic Reform

Microeconomic reform since the Campbell Report has not been limited to the financial system. A number of more general economic reform initiatives were undertaken from the mid-1980s through the 1990s, including:

²⁰ Edey & Gray 1996, p. 27.

- industrial relations reform, beginning with the series of Government-Australian Council of Trade Unions industrial ‘Accords’, and including legislation such as the *Industrial Relations Act 1988*, the *Industrial Relations Reform Act 1994*, and the *Workplace Relations Act 1996*, all of which were introduced to facilitate workplace bargaining arrangements;
- industry policy reforms to encourage export orientation and improve economy wide resource allocation, including the 1985 Passenger Motor Vehicle Plan and progressive reductions in manufacturing tariff levels;
- changes to foreign investment rules, including the suspension in 1986 of the ‘net economic benefits’ test and cessation of Australian equity requirements for the manufacturing, tourism and non-bank finance sectors;
- gradual exposure of government business enterprises (GBEs) to more commercial environments by easing controls on GBE operations, and allowing greater autonomy and altered accountability and monitoring arrangements;
- the introduction of economy wide taxation changes such as dividend imputation in 1987 and wholesale tax changes on business inputs in 1991;
- sectoral reform initiatives to increase competition and efficiency, including abolition in 1990 of Telecom’s statutory monopoly from July 1997, and deregulation of the South-East Australian electricity market; and
- National Competition Policy reforms agreed to by the Council of Australian Governments in April 1995.

14.6 The Financial System since Deregulation: A Broad Assessment

The overriding aim of the Campbell Committee was to promote efficiency in the Australian financial system without compromising stability. To this end, the Campbell Committee recommended removal of regulations which

undermined efficiency (eg interest rate and portfolio controls on banks) and strengthening of regulations which preserved stability (eg prudential controls). In addition, it noted that a move away from direct controls towards market oriented controls would improve the effectiveness of monetary policy.

Assessing the outcome of this process focuses attention on both the microeconomic and macroeconomic dimensions of the performance of the financial system. The changes implemented following the Campbell Report were expected to improve the choice, quality and cost of financial services available to Australians. The changes were also expected to improve the performance of the financial system at an aggregate level, including its ability to transmit monetary policy, the overall efficiency and competitiveness of the system, its capacity to innovate and its ability to facilitate higher rates of employment and economic growth.

Although the ‘financial deregulation scorecard’ is mixed (see Table 14.4), on balance the financial system and the wider Australian economy have enjoyed benefits consistent with the aims of those deregulatory reforms. The evidence presented in the following chapters affirms that consumer choice has increased, the quality of services has improved and the aggregate cost of providing financial services has fallen since deregulation. Deregulation has also improved the productivity and competitiveness of the financial system as well as the effectiveness and transparency of monetary policy.

The benefits of deregulation have not been realised without cost. During the 1980s, the combination of heightened competitive pressure on financial institutions and adverse developments in international financial markets contributed to an asset price boom and subsequent collapse. Loan losses realised by banks and other financial institutions rose substantially. In the 1990s, at the microeconomic level, the unwinding of cross-subsidies in retail financial services has meant that particular groups of consumers have faced higher costs to conduct basic financial services.

Competition has also increased the variety and sophistication of financial products, leaving some consumers confused, and inducing others to make expensive mistakes. Problems for consumers have included the well-publicised loan losses by customers who had entered into foreign currency loans and the sale of inappropriate life insurance products to

consumers in the late 1980s. There is evidence that poor selling practices in the insurance industry increased in the late 1980s, leading to poor quality advice and a deterioration in the industry’s reputation amongst consumers.²¹ Given these examples, it is clear that some consumers have suffered both from their own and from providers’ inexperience in a deregulated financial environment.

Financial Deregulation Delivered Success and Disappointment . . .

Table 14.6: Financial Sector Scorecard

Successes So Far	Disappointments
<p>Greater choice and availability of finance at all levels.</p> <p>Increased product innovation including a wide variety of retail products delivering higher returns to savers.</p> <p>More flexible financial services, indicating improved quality.</p> <p>Closer integration with international capital markets and their positive influence on allocative efficiency.</p> <p>Improved dynamic efficiency manifested as continuing capital investment in the financial system.</p> <p>Improved cost efficiency in domestic markets and institutions.</p> <p>Deeper financial markets, evidenced by the range of traded instruments and the growth of markets for foreign exchange, interest rate products and derivatives.</p>	<p>Excessive credit expansion in the mid to late 1980s, coupled with declining lending standards and resultant loan losses - contributed to the severity of the early 1990s recession.</p> <p>A rise in poor selling or ‘wrong selling’ practices for some financial products, such as life insurance products.</p> <p>Uneven levels of competition between sectors with some sectors, such as home mortgage lending, seeing significant price competition only recently, more than a decade after the Campbell reforms were announced.</p> <p>Failure of foreign banks to have a competitive impact on the dominant position of the Australian banks in the retail and small and medium enterprises market.</p> <p>Persistent gaps in the ‘financial fabric’ still present, eg issuance and trading of corporate bonds remains relatively small.</p> <p>Perceived stability issues following the late 1980s and early 1990s crises with NBFIs and unlisted trusts leading to a build-up of prudential regulation.</p>

21 TPC 1992, pp. 4-8.

14.7 Conclusion

From a pre-Campbell financial system with a heavily regulated banking sector, Australia has progressed to the current system, with many of the reforms suggested by the Campbell Inquiry having been implemented progressively over the 15 years since the report was completed.

It is difficult to identify deregulation as the sole cause of changes in the financial system since the release of the Campbell Report, as many other policy changes occurred simultaneously and subsequently. It is possible to conclude that, although the scorecard is mixed, on balance and in aggregate the benefits of financial deregulation have outweighed its costs. There have been improvements in the choice and quality of financial services, and increased efficiency within the financial system since the early 1980s. Consumers have benefited in aggregate, although some groups now pay more, albeit for an expanded range of services.

In the period immediately following the major Campbell Committee reforms in the mid-1980s, both suppliers and customers were forced to adapt to a newly deregulated environment. During the adjustment phase, costs were incurred both by consumers and by financial institutions. Gaps still remain in the information and advice available to consumers to support the wider range of choices in a deregulated financial system.

The following three chapters discuss these findings in detail.