Overview

The Discussion Paper identifies the main issues — but does not provide Inquiry views

This Discussion Paper details the key issues and regulatory options being considered by the Financial System Inquiry.

It does not provide preliminary or draft recommendations.

The Inquiry will provide its recommendations in its Final Report.

New technology, globalisation, changing consumer needs and new forms of competition are driving change

The financial system is undergoing continuous major change. The Inquiry is charged with analysing the factors driving this change.

New technology, globalisation, changing consumer needs and new forms of competition have long shaped the financial system. Some of these factors, particularly the rate of application of technology and the competition that technology stimulates, have accelerated in recent years in areas of particular importance to financial activities.

Such developments demand a response from regulators and have implications for government policy more generally.

Countries must focus increasingly on global competition . . .

This experience is by no means unique to Australia. Other countries are facing similar changes and are also considering appropriate regulatory and policy responses. With most countries seeking the benefits of increasing exposure to global trade and investment, the need to ensure that financial systems contribute to the competitiveness of national economies demands world-best practice in the regulatory framework.

. . . and capturing the potential benefits of new technology . . .

The application of new technology may revolutionise our financial system more quickly than some expect. Most of the foreseeable developments involve existing technologies. Their impact in some other countries is already more advanced than in Australia.

The need to adapt Australia's regulatory system to new technologies does not depend on an ability to predict precisely the pace or nature of change — what is needed is the flexibility to take the greatest possible advantage from the potential that new technologies unleash.

. . . and ensuring greater efficiency in financial systems

The financial system stands between savings and investment, and its cost and performance help determine the gains Australia makes from the processes of saving and capital accumulation. With the future incomes of Australia's retired population increasingly dependent upon returns on superannuation investments, the need for improved performance and efficiency in the financial system is further emphasised.

Achieving greater efficiency while preserving safety and performance is the key

For three reasons, the Inquiry sees as its key goal the identification of means to increase the efficiency of the Australian financial system, without compromising its safety and performance:

- the need to compete globally;
- the need to obtain the benefits of new technology; and
- the need to increase investment returns through more efficient management of financial resources.

In important areas, Australia is behind the market performance of some other nations:

- many products and services are more expensive than those abroad; and
- rapid innovation is occurring in some but not all areas.

A timely review . . .

Together, these considerations confirm the timeliness of this Inquiry. While policy has emphasised safety and protection, there is a clear need to facilitate further competition and innovation.

. . . to achieve 'best practice' efficiency

The keys to increased financial system efficiency are:

- greater competition and contestability in financial sectors — among existing participants and through new participants; and
- more efficient regulation.

The potential benefits for customers are tangible

There is potential for increased efficiency to provide much greater benefits for customers through:

- lower-cost financial intermediation adding to the returns to savers or reducing costs to borrowers;
- increased economic growth;
- greater choice in products, with improvements in quality; and
- easier access to services through a much wider array of distribution channels.

Priority issues

In its Final Report, the Inquiry will make recommendations on the regulatory arrangements for the financial system. The Discussion Paper identifies the main issues for this task.

Stimulating competition and innovation

Can competition and innovation in the Australian financial system be stimulated by widening access for new entrants to traditional banking activities (including the payments system)? For example, could policies be more supportive of contestability in markets, without compromising the safety of the financial system, by:

- allowing direct non-bank access to the payments settlement system, subject to appropriate prudential tests;

- better accommodating financial conglomerates;
- allowing an increased range of institutions to provide a wider array of financial services; or
- relaxing some of the ownership restrictions on financial institutions?

Achieving a more competitive financial market in Australia

Is Australia maximising opportunities for the development of a globally competitive financial market and system? Could a more competitive system be achieved by:

- improving arrangements for the co-ordination of policies affecting the development of markets in securities and financial derivatives;
- establishing new mechanisms to ensure that policies for the development and introduction of new communications and information technologies take account of requirements for achieving the most competitive and innovative financial markets;
- removing regulatory inhibitors to the further development of securitisation, unitisation and other processes which maximise the potential role of the financial markets;
- ensuring there are no regulatory impediments to the further development of equity and debt securities markets in meeting the financial needs of businesses, including small and medium sized enterprises (including rural enterprises);
- ensuring that market regulation is set in a framework which keeps its cost proportional to its benefits, perhaps by reversing the trend to increased regulation and licensing in wholesale markets; or
- establishing a clearer separation between structures and regulations aimed at consumer protection and those aimed at systemic stability?

Achieving more cost-effective consumer protection

Is Australia's consumer protection regime for the financial system focused on what matters most? What can be done to streamline current arrangements and reduce cost, while ensuring the attainment of key objectives, in particular ensuring that regulation delivers the intended benefits to consumers?

Could a more cost-effective consumer protection regime in the financial sector be achieved by:

- introducing a single or harmonised regulatory regime for similar products;
- establishing under Commonwealth jurisdiction a single consumer protection regulator for the financial system;
- establishing a regime of co-regulation where statutory provisions provide the enforcement and broad principles for regulation, but the details are left to more flexible industry-based codes and dispute resolution arrangements; or
- amending the provisions in existing laws to make penalties proportionate to losses incurred through code breaches?

Similarly, should it be recognised that cross-subsidies in banking may no longer be sustainable and may be acting to restrain innovation and competition which would benefit consumers?

Preserving systemic stability and clarifying depositor protection

Under a more open, global and competitive financial system, how can any new threats to systemic stability best be met, and how can the scope of the protection afforded by prudential regulation to depositors or other investors be clarified?

Would these goals best be met by:

- establishing a single prudential regulator (whether or not within the central bank) to cover all prudential regulation purposes; or

- alternatively, establishing two or more different regulators, one charged with the more intense regulation of institutions where systemic risk and/or investor protection requirements are strongest, and the other or others, perhaps in concert with other regulatory functions, providing less intense prudential regulation in the remaining areas; and
- amending the laws for depositor protection to clarify that there is no government guarantee in any area of the financial system or, alternatively, establishing means for making any guarantees and their funding explicit?

Maintaining industry structures for competition and efficiency

The priority concern of the Inquiry is to increase competition in the financial system, while maintaining its safety. The Inquiry is not charged with assessing particular mergers or merger scenarios; hence it will neither endorse nor recommend against particular merger possibilities.

Rather, the principal task of the Inquiry in this area is to make recommendations on the regulatory arrangements under which mergers in the financial sector are assessed. These recommendations may extend to the implications of mergers for prudential regulation. In addition, the Inquiry may make some observations on the implications of industry structure for the efficiency and competitiveness of the financial system. This will reflect the analysis the Inquiry is undertaking of the forces for change in the financial system and their implications.

Key questions in this context are:

- whether an economy-wide policy such as the trade practices law alone provides the best framework for deciding on the competition implications of mergers in the financial system;
- whether prudential considerations, in particular a need to prevent concentration of risk, argue for an additional process of assessment;

- whether there are any public policy grounds for restrictions on foreign acquisitions in the banking or insurance industries; and
- whether the forces now acting for change in the financial system require different approaches, now or in the future, to the assessment of competition in financial markets.

Achieving better performance and co-ordination of the regulatory arrangements

In pursuing best practice, how can we ensure that the different elements in the regulatory system are responsive, efficient, fully resourced, well co-ordinated and accountable?

Are these goals best achieved by:

- combining all of the regulatory functions in the financial system in a single mega-regulator;
- creating a smaller number of regulators, each with a single function, co-ordinated through mechanisms such as common board membership, a co-ordinating agency or other means; or
- within the existing regulatory framework, establishing a number of additional co-ordinating mechanisms with more specific functions, such as councils for consideration of issues relating to the development of financial markets, or a financial sector technology co-ordination unit.

Final Report

The Inquiry will accept further brief submissions in response to this Discussion Paper (no later than 13 January 1997), undertake further discussions with participants and continue to conduct its own analysis of the issues.

The Inquiry's Final Report is due for submission to the Treasurer by the end of March 1997.