

Regulation of Financial Markets

Introduction

5.1 This chapter considers the regulation and development of Australian financial markets in the light of the Inquiry's Terms of Reference that direct it to propose regulatory arrangements that:

best promote the most efficient and cost effective service for users, consistent with financial market stability, prudence, integrity and fairness; and

ensure that financial system providers are well placed to develop technology, services and markets and that the financial system regulatory regime is adaptable to such innovation.

5.2 The financial markets play a critical role in raising and allocating capital, providing avenues of investment, facilitating risk management, providing liquidity and facilitating international trade. Internationally competitive, efficient and liquid financial markets are therefore vital to Australia's economic well-being.

5.3 The chapter addresses 3 main issues:

- first, whether arrangements for regulating financial market integrity facilitate the development of internationally competitive and innovative markets;
- secondly, the development of efficient and liquid financial markets, in particular whether there are any impediments to the process of securitisation or secondary trading of financial instruments; and
- finally, the effectiveness of the financial markets in providing debt and equity capital to small and medium sized enterprises (SMEs).

5.4 Other issues relating to the competitiveness of Australian financial markets and measures to promote Australia as a regional financial centre are considered in Chapter 9.

5.5 The financial markets considered in this chapter have been defined very broadly. They encompass markets for debt, equities and foreign exchange, which can be further divided into:

- primary markets—where financial instruments such as bonds, shares and trust units are initially issued to raise capital;
- secondary markets—where financial instruments are priced and traded; and
- derivatives markets—involving futures or other contracts whose value is derived from a separate underlying asset, rate or index.

5.6 These markets may be classified as being conducted:

- on approved exchanges—primarily the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE);
- in over the counter (OTC) markets—conducted on a bilateral basis principally between wholesale market participants; or
- in retail markets—between financial institutions and their customers.

Market Integrity Regulation

5.7 Market integrity regulation refers to the legislative and self-regulatory arrangements which aim to ensure that markets are efficient, orderly and fair. Such regulation aims to improve the efficiency of financial markets in pricing, allocating capital, managing risk and avoiding fraud. From an economic perspective, market integrity rules fall into two broad categories:

- disclosure rules—which attempt to address information gaps so that investors take appropriate risks on the basis of good quality information (eg prospectus requirements for fundraising, financial reporting rules and accounting standards); and

- conduct rules — which aim to promote orderly and efficient price discovery, trading and settlement (eg rules applying to the approval and oversight of exchanges and their members, and legal prohibitions on unfair trading and market manipulation).

5.8 Market integrity is often seen as a factor in promoting investor confidence and attracting foreign investment. At the same time, regulation imposes costs and restrictions on market participants. Consequently, there is a balance to be struck between setting high market integrity standards and imposing excessive costs or unnecessary activity restrictions that hamper the competitiveness and efficiency of Australian financial markets.

5.9 While this chapter is concerned with market integrity rather than prudential regulation, there is an important link between the two since market integrity can reduce systemic risk. Financial disturbances are more likely to be contained where financial markets are underpinned by good information, a sound legal framework and robust settlement systems (see Chapter 4 for a discussion on systemic risk.)

Existing Arrangements

5.10 The existing scheme of market integrity regulation in Australia includes a mix of government regulation, co-regulation and self-regulation as shown in Tables 5.1 and 5.2.

Australian Securities Commission and the Corporations Law

5.11 Financial market integrity in Australia is primarily regulated by the Australian Securities Commission (ASC) under the *Corporations Law*. The *Corporations Law* is a national scheme based on a 1990 agreement between the Commonwealth, States and Northern Territory. Under the *Corporations Law*, the ASC takes a direct role in registering prospectuses, licensing securities dealers and futures brokers, monitoring financial markets and enforcing market integrity rules. The ASC is also responsible for licensing investment and futures advisers (see Chapter 8) and for general company regulation.

Table 5.1: Australian Wholesale Markets: Disclosure Regulation

Regulatory field	Government legislation & oversight	Co-regulation	Self-regulation
Issues of securities	<p>Corporations Law</p> <ul style="list-style-type: none"> ◆ ASC registration of prospectuses ◆ financial reporting rules ◆ prohibition on false & misleading statements <p>Trade Practices Act</p> <ul style="list-style-type: none"> ◆ prohibition on false & misleading statements 	<p>Approved exchanges</p> <ul style="list-style-type: none"> ◆ ASX listing rules 	n.a.
Company annual reports	<p>Corporations Law</p> <ul style="list-style-type: none"> ◆ financial reporting rules 	<p>Approved exchanges</p> <ul style="list-style-type: none"> ◆ ASX listing rules 	n.a.

Table 5.2: Australian Wholesale Markets: Conduct Regulation

Regulatory field	Government legislation & oversight	Co-regulation	Self-regulation
Securities, Futures and Options Exchanges	<p>Corporations Law</p> <ul style="list-style-type: none"> Treasurer's approval to conduct an exchange, amend market rules ASC enforcement of market manipulation prohibitions <p>Trade Practices Act</p> <ul style="list-style-type: none"> ACCC approval of anti-competitive arrangements 	<p>Approved exchanges</p> <ul style="list-style-type: none"> business/listing rules surveillance of members and trading obligation to report wrongdoing to the ASC 	<p>Australian Investment Management Association</p> <ul style="list-style-type: none"> corporate governance Code of Ethics & practice notes standard management contracts
OTC Financial Markets	<p>Corporations Law</p> <ul style="list-style-type: none"> Treasurer's approval to conduct exempt stock and futures markets ASC enforcement of market manipulation prohibitions 	n.a.	<p>Australian Financial Markets Association</p> <ul style="list-style-type: none"> voluntary code of conduct and market conventions <i>Aussie ISDA</i> swaps & derivatives documentation
Securities & Futures Clearing & Settlement	<p>Reserve Bank</p> <ul style="list-style-type: none"> RITS 	<p>Authorised exchanges</p> <ul style="list-style-type: none"> CHES SFE Clearing House 	<p>Private clearing/settlement</p> <ul style="list-style-type: none"> Austraclear BITS
Professional Market Participants	<p>Corporations Law</p> <ul style="list-style-type: none"> ASC securities dealers & futures brokers registration <p>Banking (Foreign Exchange) Regulations</p> <ul style="list-style-type: none"> Reserve Bank registration of foreign exchange dealers 	<p>Authorised exchange members</p> <ul style="list-style-type: none"> ASX members SFE floor, associate and local members 	<p>Australian Financial Markets Association</p> <ul style="list-style-type: none"> OTC market participants

5.12 Two other bodies formed under the Corporations Scheme have direct relevance to financial market integrity. Members of both bodies are appointed by the Treasurer.

- The Companies and Securities Advisory Committee (CASAC) advises on Corporations Scheme laws and market developments. Of relevance to the Inquiry is CASAC's recent work on regulating derivatives.¹
- The Australian Accounting Standards Board is charged with developing a conceptual framework for accounting standards and reviewing proposed standards.

5.13 Chapter 7 of the *Corporations Law* deals with securities, and Chapter 8 sets out similar but not identical provisions for futures contracts. Broadly, securities and futures must be traded by licensed intermediaries on exchanges which have been approved by the Treasurer. Securities and futures markets may be conducted outside exchanges only where they are specifically exempted in the *Corporations Law* or the Treasurer has declared an exempt market. (See later discussion on OTC markets.)

5.14 While the *Corporations Law* treatment of securities is broadly similar to that of futures contracts, there are a number of key differences:

- prospectuses are required for issues of securities, but not for futures contracts;
- securities dealers may conduct transactions off-exchange (ASX listing rules impose some limits), whereas generally futures brokers may not deal off-exchange; and
- securities advisers have specific obligations to disclose commissions and have a reasonable basis for securities recommendations (the 'know your client' rule). There are no equivalent provisions for futures advisers.

1 Companies and Securities Advisory Committee 1996, and 1995.

Australian Competition and Consumer Commission

5.15 The Australian Competition and Consumer Commission (ACCC) has a role promoting market integrity under the *Trade Practices Act 1974* (TPA) provisions which:

- prohibit misleading or deceptive conduct (s.52); and
- give the ACCC power to authorise arrangements which might otherwise be considered anti-competitive (s.88).

Co-regulation of On-Exchange Financial Markets

5.16 The *Corporations Law* takes a co-regulatory approach to exchanges.² The Treasurer's approval is required to conduct an exchange, and the Treasurer has power to disallow amendments to its business or listing rules. Aspects of an exchange's business can also require authorisation by the ACCC under s.88 of the TPA. ASC surveillance and enforcement programmes cover the conduct of both exchange trading and exchange members. However, approved exchanges are responsible for their day to day management and supervision of members.

5.17 There are two major approved exchanges currently operating in Australia.

5.18 The ASX ranks tenth in the world, with its domestic market capitalisation of \$347 billion. It represents around 1.6 per cent of the Morgan Stanley Capital International Index.³ Turnover on the ASX was less than one per cent of the total turnover in Australian financial markets in 1995-96.⁴ The ASX operates a national electronic order-driven market in Australian equities, foreign equities and options called the Stock Exchange Automated Trading System (SEATS). It also operates the Clearing House Electronic Sub-register System (CHESS) for exchange-quoted securities. In addition, the ASX owns the Securities Exchanges Guarantee Corporation, which operates a

2 While the ASX and the SFE are frequently called self-regulatory organisations, the framework is actually a co-regulatory combination of government approvals and oversight plus exchange rules and surveillance.

3 Australian Stock Exchange, Submission No. 65 to the Financial System Inquiry, p.7.

4 Securities Industry Research Centre of Asia-Pacific 1996, p.38.

National Guarantee Fund to guarantee completion of contracts in the event of default by a member firm. ASX members voted to demutualise the exchange in October 1996.

5.19 The SFE originally traded commodity futures, but financial futures and options have become a major part of its business in the past decade. The SFE is the thirteenth largest futures market in the world, with a nominal annual turnover of \$6.8 trillion in 1995.⁵ Turnover on the SFE represented 28 per cent of the total Australian financial market turnover in 1995-96.⁶ The SFE owns the Sydney Futures Exchange Clearing House, which guarantees the completion of SFE futures and options contracts and operates an indemnity fund.

Self-Regulation of OTC Markets

5.20 OTC markets represented over 70 per cent of Australian financial market turnover in 1995-96.⁷ These markets fall into two categories:

- exempt securities or futures markets — under the *Corporations Law*, the Treasurer may declare exempt securities and futures markets. This declaration exempts these markets from the general rule that securities and futures must be traded on approved exchanges. Other *Corporations Law* rules such as those prohibiting market manipulation and insider trading continue to apply. Exempt markets have been declared for such diverse products as public sector bonds and the New South Wales Electricity Swap Market.
- other OTC markets — which are not subject to the *Corporations Law* because they fall outside the legal definition of a ‘security’ or ‘futures contract’. These include markets for foreign exchange and certain derivatives where one party is a bank.

5 *Sydney Futures Exchange Yearbook 1995*, p.56.

6 Securities Industry Research Centre of Asia-Pacific 1996, p.38.

7 Securities Industry Research Centre of Asia-Pacific 1996, p.39.

5.21 Self-regulatory initiatives play an important role in promoting market integrity in OTC markets. Steps taken by the Australian Financial Markets Association (AFMA) to promote market integrity and consistency with international practices are outlined in Table 5.2.

5.22 While OTC transactions can be settled bilaterally, many OTC transactions are cleared and settled through the Reserve Bank Information and Transfer System (RITS), the Bank Interchange and Transfer System (BITS) and Austraclear.

Corporations Law Simplification Task Force: Fundraising

5.23 Under the *Corporations Law*, a prospectus is generally required for company fundraisings (initial public offers and rights issues) and continuous offers (such as debentures and trust units). However, a prospectus is not required for:

- small-scale private offers where a company makes up to 20 personal offers of securities in a rolling one-year period; or
- individual offers over \$500,000. This exclusion is aimed at sophisticated investors who are considered to have sufficient resources and bargaining power to evaluate investments without a formal prospectus requirement.

5.24 The Corporations Law Simplification Task Force is reviewing fundraising requirements, including matters such as short-form prospectuses and civil liability for statements made in prospectuses. The Task Force is also reviewing the interaction between the *Corporations Law* and the TPA, which apply to fundraising documents in different ways.⁸

- The *Corporations Law* sets out a positive duty to issue a prospectus containing ‘all such information as investors and their professional advisers would reasonably require and reasonably expect to find in a prospectus’. The law imposes civil liability for false or misleading

8 Corporations Law Simplification Task Force 1995.

statements and omissions, but allows a defence for persons who have made reasonable inquiries or exercised due diligence.⁹

- Section 52 of the TPA is a general provision prohibiting misleading and deceptive conduct in trade or commerce. The TPA does not impose a duty to disclose, and no due diligence defence is available for misstatements or omissions.

International Co-operation

5.25 The ASC is a member of the International Organisation of Securities Commissions (IOSCO), which aims to promote mutual assistance and high regulatory standards, especially for international securities transactions.

5.26 The 1995 collapse of Barings as a result of trading on the Singapore futures exchange has been a catalyst for strengthening international co-operation. The result has been two agreements. The first was the 1995 Windsor Declaration by key regulators including the ASC. The second was the 1996 Boca Raton agreement signed by major futures exchanges, options exchanges and regulators including the ASC and SFE. Both agreements focus on increased co-operation, information sharing, customer protection and procedures in the event of major defaults and market emergencies.

5.27 The ASC also seeks to facilitate cross-border corporate activity and financial market trading through harmonisation or mutual recognition.

- Harmonisation is a process by which the laws in a jurisdiction are amended to conform to the laws of another jurisdiction.
- Mutual recognition involves recognising the laws of another jurisdiction as adequate for domestic purposes.

9 Sections 1022, 1006 and 1008 of the *Corporations Law*.

Views Presented in Submissions

5.28 Market integrity issues raised in submissions fell broadly into four groups:

- whether the *Corporations Law* deals adequately with product convergence and provides an appropriate basis for competition between financial markets;
- the impact of prospectus rules;
- the impact of regulation on financial market costs and competitiveness; and
- the regulatory structure for market integrity.

Product Convergence and Financial Market Competition

5.29 A number of submissions questioned whether the *Corporations Law* deals adequately with product innovation which has led to convergence of products traded in both exchange and OTC markets.

5.30 Submissions pointed out that new financial instruments such as equity options and deliverable share futures do not fit neatly within the legal definitions of a ‘security’ or ‘futures contract’ under the *Corporations Law*. In addition, some OTC products fall outside these legal definitions and are not covered by the *Corporations Law* at all. As a result, there can be considerable legal uncertainty about the treatment of new products.

5.31 Futures contracts are generally regarded as a category of derivative since the contract value is based on some other underlying asset, rate or index. Submissions recognised that the *Corporations Law* term ‘futures contract’ is now too narrow as a result of rapid growth in OTC derivatives markets. There was broad support for the concept of extending futures regulation to cover derivatives contracts more generally.

5.32 There are a number of factors which have contributed to separate regulation of securities and futures in Australia. Traditionally, these instruments have been traded on different exchanges. The existing *Corporations Law* definitions of ‘security’ and ‘futures contract’ are based on

the traditional view that there are fundamental differences in the roles of securities and futures exchanges.

5.33 This view was supported by the SFE, which said that the unbundling of trading and settlement services is blurring the distinction between exchange and OTC markets. It argued that the wisdom of having different regulatory regimes for physical and derivatives markets would become apparent as this unbundling gathers pace. The SFE claimed that proposals to harmonise regulation of securities and derivatives gloss over significant differences between these products.

5.34 Several submissions opposed this view, arguing that traditional distinctions between securities and derivatives may no longer be appropriate.

5.35 The Department of the Treasury argued that the traditional functional distinction between securities (delivery of title) and derivatives (risk management) is breaking down. It cited equity options and deliverable share futures as examples of derivative transactions which lead to a transfer of title when held to maturity. Treasury proposed replacing the existing definitions with a broader concept of 'financial instrument' which would include securities, units in collective investment schemes, financial and commodity futures contracts, swaps and options. Treasury argued that this would standardise regulation, remove incentives for regulatory arbitrage and promote competition.

5.36 The ASX said that product convergence may make it increasingly difficult to maintain the distinction between securities and derivatives. The ASX argued against a regulatory structure which demarcates products on the basis of risk, product type, or the market on which products are traded. It said that regulation based on these criteria will interfere with competition, result in anomalies for investors and distort economic decision-making.

5.37 Submissions suggested that market trends required a reassessment of the role of traditional exchanges and the appropriate regulation of OTC and exchange markets.¹⁰ Factors which call the existing regulatory framework

¹⁰ See for example Department of the Treasury, Submission No. 143 to the Financial System Inquiry, p.49.

into question are product convergence, the emergence of electronic markets, increased competition among institutional investors and the globalisation of capital markets.

5.38 Both the ASX and SFE said they faced high levels of regulation compared with competitor markets. The ASX also argued that its price discovery and settlement are not free public goods and that its competitors should not free ride on ASX information. The SFE said it was subject to more intense supervision than OTC markets.

5.39 Finally, several submissions raised the dual regulatory approvals required where financial exchanges establish anti-competitive market rules or arrangements. To date, the ACCC has granted a number of approvals relating to the ASX's articles, business rules, clearing and settlement systems under s.88 of the TPA. The ASC and ASX both suggested that there should be rationalisation of the ACCC's role. The ASX said market rules should be approved by the Treasurer only, while the ASC suggested that it could approve market rules subject to consultation with the ACCC. The ACCC considers that existing arrangements are satisfactory.

Prospectus Requirements

5.40 Market participants expressed very strong support for the *Corporations Law* principle-based approach to prospectus rules.

5.41 However, submissions did argue that the law must facilitate technological advances such as electronic prospectuses and also raised concerns about the application of the TPA to prospectuses.

5.42 Market participants said the overlap between *Corporations Law* and TPA disclosure rules imposes unnecessary cost and uncertainty, and stressed the importance of allowing a due diligence defence for statements required under the *Corporations Law*. Bankers Trust Australia, the Commonwealth Bank and others recommended that the TPA cease to apply. This approach has also been proposed by the Corporations Law Simplification Task Force.¹¹

11 Corporations Law Simplification Task Force 1995, pp.18-21.

In contrast, the ACCC and the Australian Consumers' Association said there should be no exemptions or amendments to the TPA.

Costs and Competitiveness

5.43 Globalisation of capital flows has increased direct and portfolio investment flows as well as opening up international financial markets to Australian companies.

5.44 Submissions addressing the issue said Australia should work towards adopting international accounting standards.¹² They acknowledged that international accounting standards are not yet fully developed, but said their development should be a high priority. The accounting bodies also strongly supported greater harmonisation of Australian accounting standards with those of the International Accounting Standards Committee and other countries.¹³

5.45 Reflecting the number of federal and state laws governing financial reporting obligations, the Australian Society of Certified Practising Accountants recommended a generic financial reporting Act. It said this could overcome inconsistent financial reporting and auditing obligations, inconsistent application of accounting standards and unnecessarily high financial reporting costs. The Australian Society of Corporate Treasurers and AFMA recommended that there be a convergence with international reporting standards.

5.46 A number of submissions expressed concern that Australian regulatory standards could be set too high and fail to recognise changing market dynamics. AFMA estimated that reporting requirements of OTC financial markets were very expensive, with a collective total cost of

12 See for example National Mutual, Submission No. 32; Australian Stock Exchange, Submission No. 65; International Banks and Securities Association, Submission No. 146 and International Accounting Standards Committee, Submission No. 195 to the Financial System Inquiry.

13 Joint submission from The Institute of Chartered Accountants in Australia and the Australian Society of Certified Practising Accountants, Submission No. 187 to the Financial System Inquiry, p.3.

\$19.6 million (or 900 person hours per year for each organisation).¹⁴ Survey respondents agreed that reports to different government agencies often contain the same or similar information.

5.47 A common theme in submissions was the view that the growing size and complexity of cross-border financial flows pose major challenges for setting and enforcing regulatory standards. Submissions agreed that Australian regulatory standards should aim to be broadly consistent with international standards. The ASC said:

*Australia cannot afford to be too far out of line with internationally accepted standards of regulation if our markets are to be recognised or market participants are to gain recognition in other jurisdictions.*¹⁵

5.48 Steps towards international regulatory harmonisation taken by IOSCO were welcomed. However, the limitations of this approach owing to long lead times and negotiations required to reach international agreement were also recognised.

Structure for Market Integrity Regulation

5.49 While there was general support for ASC regulation of financial market integrity under the *Corporations Law*,¹⁶ a number of submissions addressed the organisational arrangements for regulating financial market integrity.

5.50 Several submissions said there were synergies between market integrity and general company regulation which suggested these should be the responsibility of a single agency. The fact that Australia has a single regulator for corporations, securities and futures was viewed as a particular strength.

14 Estimate based on survey results. Australian Financial Markets Association, Submission No. 129 to the Financial System Inquiry, p.28.

15 Australian Securities Commission, Submission No. 60 to the Financial System Inquiry, p.52.

16 The Australian Stock Exchange did, however, suggest that the Australian Securities Commission put more focus on market development and could be downsized by outsourcing non-core activities. It also said the simplification project currently under way was insufficient to reduce the length and inflexibility of the Corporations Law.

5.51 A number of submissions said that regulatory arrangements should recognise the links between market integrity and consumer protection, which both aim to influence the conduct of market participants. For example, the ANZ Banking Group suggested that the ASC is well suited to taking a consumer protection role because it has a strong market focus and sound knowledge of the financial industry. Bankers Trust and the ASC also claimed that a combined market integrity and consumer protection regulator would be better placed to balance the interests of business and consumers.

5.52 In contrast, some submissions advocated a separate consumer protection regulator on the basis that this would give greater priority and focus to consumer protection issues (see Chapter 8). Other submissions considered that responsibility for market integrity should be included in the ambit of a prudential regulator or a mega-regulator (see Chapter 10).

5.53 A large number of submissions said the regulatory framework needs to distinguish between wholesale and retail markets. They stressed that consumer protection of retail markets should not be extended to wholesale markets. While a number of market participants expressed this view,¹⁷ the case was put most strongly by AFMA, which said:

*The regulation of wholesale participants is severely impacting on the competitiveness of Australia in the international context.*¹⁸

5.54 That said, there was no clear view on the criteria which should be adopted in the regulatory framework to distinguish between wholesale and retail customers. National Australia Bank suggested this should have regard to the monetary size of the transaction, the nature of the risk being faced and the nature of the investor. Other submissions supported simple but arbitrary dollar limits to distinguish between retail and wholesale markets—for example, the rules requiring a prospectus for offers under \$500,000.¹⁹

17 See for example Bankers Trust Australia, Submission No. 136; joint submission from the Australian Investment Managers' Association, the Life, Investment and Superannuation Association and the Investment Funds Association, Submission No. 157; and the Australian Mutual Provident Society, Submission No. 97 to the Financial System Inquiry.

18 Australian Financial Markets Association, Submission No. 129 to the Financial System Inquiry, p.3.

19 For example Bankers Trust Australia, Submission No. 136, p.29.

Approach of the Inquiry

5.55 The Inquiry intends to examine the regulatory framework and its impact on the international competitiveness of Australian financial markets. In doing so, the Inquiry recognises the need to maintain financial market integrity while striving for international competitiveness.

5.56 The Inquiry will consider how the regulatory arrangements for market integrity might affect the cost of capital for business and the degree of competition and pace of innovation in financial markets.

5.57 The Inquiry recognises measures under way to bring Australian regulatory standards into line with prevailing international practice. Standards which are significantly out of line with international practice can impose unnecessary costs on Australian financial firms and markets. Appropriate mutual recognition and harmonisation of regulatory and accounting standards should promote international competitiveness and appear to enjoy broad support.

5.58 In relation to financial markets and exchanges, the Inquiry intends to examine whether product convergence and the emergence of screen-based markets necessitate a reassessment of the regulatory framework. Key issues for the Inquiry include:

- whether a regulatory framework focused on product definitions or functions is likely to best facilitate product innovation, regulatory certainty and cost-effective regulation;
- the roles of approved exchanges and the scope for further competition in trading and price discovery, clearing and settlement;
- the appropriate level of regulation of OTC and exchange markets;
- whether licensing of foreign exchange dealers, securities dealers and futures brokers should be maintained; and
- the role of the Treasurer, the ACCC and the ASC in approving the market rules and operations of financial exchanges.

5.59 In making recommendations on prospectus rules, the Inquiry does not intend to duplicate the review of fundraising provisions by the Corporations Law Simplification Task Force.

5.60 Finally, few submissions raised substantive concerns with the current oversight by the ASC. However, there was a widespread disposition towards lighter regulation of wholesale financial markets. In examining the organisational arrangements for regulating market integrity, the Inquiry will consider:

- the need to ensure that the regulatory framework facilitates efficient and innovative trading in financial markets, while still maintaining market integrity;
- whether there are particular synergies between regulating market integrity and general company regulation or consumer protection; and
- how the regulatory framework might distinguish between wholesale and retail market participants and transactions.

Development of Financial Markets

5.61 This section considers areas where there may be impediments to the development of efficient and liquid financial markets.

- The first relates to the development of securitisation—the issue of marketable debt securities backed by a portfolio of otherwise illiquid assets.²⁰
- The second relates to the creation and trading of unit trusts including superannuation investments.
- The third relates to secondary trading of financial instruments more generally.

20 Other usages of the term ‘securitisation’ which are not commonly adopted in Australia refer to:

- ‘on-balance’ sheet securitisation used in Europe to sell mortgage cash flows, without transferring title; and
- business borrowers switching from traditional bank loans to commercial paper issued in financial markets (disintermediation).

Existing Arrangements

Securitisation

5.62 The most common form of securitisation in Australia involves the issue of ‘mortgage-backed securities’ to fund residential mortgages. However, other assets such as credit card receivables or car leases can be used to issue ‘asset-backed securities’.

5.63 Securitisation has been used in Australia as a source of funding for:

- specialist loan originators;
- financial institutions removing loans from their balance sheet; and
- State Government-sponsored housing programmes.

5.64 Securitisation potentially leads to cost savings, better products and higher service standards.

- In traditional intermediated lending, the lending institution handles all aspects of the intermediation process, including loan origination, credit assessment, administration and funding. Securitisation allows functional specialisation in different aspects of the lending transaction as shown in Table 5.3.
- Lending institutions are required to hold capital against their loan portfolios because they are highly geared institutions primarily funded by deposits. By transferring loan assets to another class of investor, securitisation can reduce the amount of capital held and may lower the cost of funding the portfolio.

Table 5.3: Participants in a Typical Securitisation Process

Borrowers	<ul style="list-style-type: none"> ◆ Borrow money under a mortgage or other agreement. Securitisation is most viable for a pool of standardised loans such as residential mortgages or credit card receivables with predictable patterns of cash flows.
Loan Originator	<ul style="list-style-type: none"> ◆ Markets and establishes loans which are sold into a special purpose vehicle.
Loan Manager or Servicer	<ul style="list-style-type: none"> ◆ Manages administration, payments and defaults of a loan portfolio.
Special Purpose Vehicle	<ul style="list-style-type: none"> ◆ Company or a trust used to isolate the loan portfolio and associated cash flows from the originator. ◆ May restructure portfolio cash flows (eg swap transactions to transform floating interest rates paid by borrowers into fixed rates preferred by investors). ◆ Arranges any credit enhancement — investors rely primarily on loan portfolio cash flows to meet interest and principal payments. This may be supplemented by: <ul style="list-style-type: none"> — credit enhancement from external parties; — providing additional collateral (eg placing more loans in the repayment pool than is needed to support contractual payments or setting aside a cash deposit to cover shortfalls in expected payments); or — transaction structuring (eg, securities issued in tranches with the senior tier carrying lower default risk than subordinated tranches). ◆ Issues securities.
Credit/Liquidity Enhancers	<ul style="list-style-type: none"> ◆ Mortgage insurers — insures the lender for the risk of default by borrowers. ◆ Governments or financial institutions — provide letters of credit or guarantees on the securities issued.
Warehousing	<ul style="list-style-type: none"> ◆ Facility provided by a financial institution to fund originated loans until such time as the portfolio reaches a sufficient size for securities to be issued. ◆ Financial institution may also provide management of cash flows.
Rating Agencies	<ul style="list-style-type: none"> ◆ Review the quality of the loan portfolio, loan management, legal documentation and credit enhancement. ◆ Assign a rating to securities issued.
Investors	<ul style="list-style-type: none"> ◆ Buy securities. ◆ In some cases, trade securities in the secondary market.

5.65 The first large-scale securitisation programmes in Australia were State Government mortgage-backed securities (eg, FANMAC and Victorian Housing Bonds) issued in the 1980s. However, private sector securitisations have grown rapidly in the past three years and now overshadow State Government programmes. Securitised bonds backed by Australian assets totalled \$12.4 billion at June 1996. This comprised private sector mortgage-backed securities (46 per cent), Government mortgage-backed securities (26 per cent), and other private sector securitisations (28 per cent).²¹

5.66 The expansion of the securitisation market is closely linked to the emergence of mortgage originators such as Aussie Home Loans and Registered Australian Mortgage Securities (RAMS).

5.67 Mortgage originators have made a tangible contribution to competition in home lending over the past few years. The extent of this competition is evidenced by their rapid gains in market share and the high proportion of loans which are refinancings of bank loans. To date, most of this gain in market share has been at the expense of banks, particularly in urban areas of New South Wales and Western Australia.²² According to RAMS, nearly half of the loans written by mortgage originators are refinancings of existing bank mortgages.

5.68 Most of the loans written by mortgage originators are funded through securitisation programmes such as those managed by PUMA Management Limited or RAMS.

5.69 Securitisation has also been used by superannuation funds to enter the home lending market. Securitised bonds backed by home loans made to members of industry superannuation funds were issued for the first time in 1994-95. Banks, building societies and credit unions have also used securitisation to fund loans, and submissions suggested that securitisation may become a more important funding source.

21 Based on unpublished data provided by Standard & Poor's Structured Finance. Data excludes securitisations of financial securities where a portfolio of liquid financial instruments (ie, bonds) are purchased, repackaged and then securitised. In this case, the securitisation transforms an already liquid asset into another liquid form.

22 Australian Association of Permanent Building Societies, Submission No. 43 to the Financial System Inquiry, p.15.

5.70 To date, securitisation issues have been marketed almost exclusively to wholesale investors. Over 70 per cent of securitised bonds currently on issue are backed by mortgages.²³

5.71 Securitisation has allowed mortgage originators to compete in the home lending market because it provides access to wholesale financial markets, eliminating the need to raise deposits or hold capital. Westpac Banking Corporation suggested other factors which have enabled mortgage lenders to gain market share are:

- their ability to concentrate on loan origination with the funding being done by other institutions;
- the impact of technology on their ability to assess credit risk and monitor loans;
- their ability to use low-cost, flexible delivery channels, such as phone marketing and mobile lending; and
- the existence of wide margins in home mortgage lending, driven by the cross-subsidisation of other banking services such as transaction accounts and corporate lending.²⁴

5.72 Growing size and liquidity in securitised bond markets have reduced securitisation costs. According to the Australian Securitisation Forum, margins on mortgage-backed securities have fallen from 150 basis points to 30 basis points above a market benchmark over the past decade. In essence, investors have repriced securitised bonds relative to other debt securities.

5.73 According to the Reserve Bank of Australia (RBA), the banks initially responded to the competition posed by mortgage originators by redesigning some of their mortgage products and more recently by cutting interest margins.²⁵ In addition, the Inquiry notes that some banks have now begun to securitise their own mortgages.

23 Based on unpublished data provided by Standard & Poor's Structured Finance.

24 Westpac Banking Corporation, Submission No. 90 to the Financial System Inquiry, p.68.

25 *Reserve Bank of Australia Bulletin*, June 1996, pp.1-5.

Securitisation: Comparison with Overseas Markets

5.74 Securitisation is relatively new in Australia compared with the United States (where a much larger and wider range of assets have been securitised) and some European markets (where securitised bonds are marketed to retail customers).

5.75 Securitisation emerged in the United States in the 1970s with Federal Government-sponsored issues of mortgage-backed securities. These bonds now total more than US\$1.7 trillion, making them the second largest category of debt securities in the United States after Treasury Bonds. The private securitisation market is also more developed in the United States than in other countries. According to OECD over 55 per cent of residential mortgages are securitised in the United States.²⁶

5.76 Securitisation is much less developed in Canada despite a significant programme of government support for mortgages and despite close links to United States financial markets. The OECD attributes this to the Canadian tradition of variable-rate (rather than fixed-rate) mortgages, a comparatively small number of nationwide banks, and a banking system which has been under less strain than in the United States.²⁷

5.77 European securitisation markets are also less developed than those in the United States.²⁸ The United Kingdom is the largest market outside the United States, with securitised assets (principally mortgages) totalling around £19 billion at the end of 1994. There are signs that the European market is developing rapidly. In September 1996, NatWest announced a major change in its funding strategy with plans to securitise large corporate loans totalling £3.2 billion. In addition, France and Spain have removed legal impediments to securitisation.²⁹

26 OECD 1995, p.40.

27 OECD 1995, p.52.

28 Apart from 'on balance sheet' securitisation of residential mortgages or communal bonds which have been sold to retail customers in some European countries for many years.

29 OECD 1995, pp.47-50.

5.78 There are a number of factors which have led to securitisation developing further in the United States than in other countries.

- Government guarantees of securities initially attracted investors to the sector.
- There is a large and well-established pool of institutional investors in the United States which are legally separate from the banking system. Securitisation provides a funding conduit between securities houses and lending institutions.
- The United States has a large number of local banks with portfolios concentrated in a small geographic area. Securitisation allows these banks to diversify their exposures by selling loans made in the local area and purchasing securities based on loans made elsewhere.
- Securitisation provides a means for banks to manage interest rate risk. In addition, institutional investors generally prefer long-term debt in the form of fixed-interest bonds. Securitisation issues of fixed-interest bonds may be more feasible where the bonds are backed by fixed-rate mortgages (compared to variable-rate mortgages typical in Australia).
- The large size of United States financial markets provides economies of scale and pooling of risks. This has facilitated securitisation of a wider range of financial instruments, including car leases, accounts receivable, hire purchase agreements and personal loans. The size of the United States market may also have facilitated the development of securitisation technology and skills.
- Finally, troubled United States banks and thrift institutions have used securitisation to strengthen their capital positions and/or sell portfolios of impaired loans.

Secondary Trading in Unit Trusts

5.79 Like securitisation, illiquid assets can be made more marketable through the process of unitisation. In this case, a pooled investment vehicle issues investors with units representing an indirect interest in the underlying assets of a trust. This also allows investors to diversify their risk by pooling their assets to acquire a wider range of investments.

5.80 Many pooled investment vehicles are structured as unit trusts established under a trust deed that provides for both a manager and a trustee. The latter has a common law fiduciary duty to protect the interests of investors and is subject to State trustee legislation. A unit trust (other than a superannuation unit trust) is classified as a ‘prescribed interest’ under the *Corporations Law*, which requires that public offers be accompanied by a prospectus.

5.81 Unit trusts may be listed (so that units are traded in a secondary market) or unlisted (where investors may redeem their units and are repaid from the assets of the fund). A number of unlisted property trusts transferred to ASX listing in the early 1990s. However, most public offer investment trusts are unlisted, as shown in Table 5.4.³⁰

Table 5.4: Investment Funds Management Industry at September 1996

	Unlisted Funds Retail		Unlisted Funds Wholesale		Listed Funds & Investment Companies	
	No.	Assets \$m	No.	Assets \$m	No.	Assets \$m
Property & mortgage	68	3,856	24	1,728	27	12,200
Equity — domestic	104	5,827	28	883	5	469
Equity — international	60	5,277	40	2,085	3	154
Fixed interest	43	1,537	34	2,084	0	0
Cash management	516	8,510	12	1,407	0	0
Diversified	197	8,308	33	1,215	0	0
Public offer superannuation & rollover funds	493	25,956	102	11,517	0	0
Other	28	2,694	13	1,081	0	0
Total	1,509	61,966	286	21,999	35	12,823

Source: Investment Funds Association.³¹

30 Redemptions from unlisted property trusts were suspended in 1991. At the time, these trusts were experiencing severe liquidity problems as a soft property market made it difficult to dispose of assets to meet a high rate of redemptions.

31 Data represents approximately 90 per cent of the retail funds management industry and 60 per cent of the wholesale funds management industry.

5.82 Recent developments in the quotation and trading of unit trusts include the establishment of AUSMAQ, which provides a trading and settlement system for unlisted entities such as unit trusts, securitised bonds and certificates of deposit.³² Investment Link provides price information on unit trusts, but provides no facilities for trading trust units.

5.83 As shown in Table 5.4, public offer superannuation investments represent around 40 per cent of the managed funds industry. Most superannuation funds are also pooled investment vehicles which are legally constituted as trusts. These funds are regulated under the *Superannuation Industry (Supervision) Act 1993* rather than the *Corporations Law*. Investment in a regulated superannuation fund is subject to a considerable body of legislation, including limitations on:

- the type of person who may contribute to superannuation—broadly, superannuation contributions may be made only by a person in the paid workforce or their employer;
- initial choice of superannuation fund—employers making compulsory contributions for employees may choose the superannuation fund subject to any limitations in industrial awards (there are no constraints on choice of fund by self-employed people);
- switching to another superannuation fund—employees can generally only transfer to another superannuation fund after they leave an employer; and
- choice of investment strategy—superannuation funds are presently permitted, but not obliged, to provide members with a choice of investment strategy (eg growth, capital stable, etc).³³

5.84 These restrictions have precluded secondary trading in superannuation fund units. However, the Government has announced intentions to relax these requirements, raising the possibility that secondary trading of superannuation units could be possible in future. The planned introduction of Retirement Saving Accounts held on balance sheet by

32 The sale of AUSMAQ to the National Australia Bank was announced in November 1996.

33 This restriction is not relevant to defined benefit superannuation funds where the fund member bears no investment risk.

financial institutions is likely to add a further dimension to choice and competition in superannuation.

Secondary Trading in Other Instruments

5.85 A feature of Australian financial markets is the limited development of secondary trading in long-term financial instruments other than equities and government debt.

5.86 Australian companies have made limited use of borrowing through issues of long-term debt securities. Only 13 per cent of aggregate corporate balance sheets is financed by debt securities.³⁴ In this respect, Australia differs from other economies, particularly the United States and the United Kingdom, where debt securities represent a sizeable proportion of overall corporate sector funding.

5.87 To the extent that Australian corporates have issued debt securities, they have favoured issues of short-term commercial paper or Eurobonds issued outside Australia. The Australian corporate bond market is relatively small and lacks liquidity. Turnover in corporate bonds represents less than 2 per cent of total secondary bond trading.³⁵

5.88 Similarly, the infrastructure bond market is a new and relatively small market in Australia. Private sector involvement in the provision of infrastructure facilities increased in the late 1980s when State Governments introduced formal procedures and controls on this activity. In 1992, the Commonwealth Government introduced tax benefits for private financing of infrastructure through borrowings. The Economic Planning Advisory Commission *Private Infrastructure Task Force Report* in 1995 noted that private sector infrastructure now accounts for 20 per cent of new infrastructure projects.³⁶ Since 1995, Invest Australia has certified as eligible for tax concessions 14 infrastructure projects with borrowings of \$3.5 billion.

34 Westpac Banking Corporation, Submission No. 90 to the Financial System Inquiry, p.61.

35 *Reserve Bank of Australia Bulletin*, May 1996, p.5.

36 Economic Planning Advisory Commission 1995, p.6.

Views Presented in Submissions

Securitisation

5.89 Issues raised in submissions relating to securitisation fell into three broad categories:

- the effect of competition from mortgage originators on lending standards;
- the appropriate regulatory framework for mortgage originators and securitisers; and
- regulatory impediments to loan origination and securitisation.

Effect of Competition from Mortgage Originators on Lending Standards

5.90 While submissions were unanimous that securitisation had led to greater competition in home lending, there were mixed views on whether this had affected lending standards. Mortgage originators claimed they have adopted high standards of credit appraisal. However, the Australian Association of Permanent Building Societies (AAPBS) cautioned that aggressive mortgage selling techniques have unknown implications for home lending standards.

Regulation of Mortgage Originators and Securitisers

5.91 Mortgage originators and securitisers all argued very strongly against regulation of their industry, claiming that it would jeopardise competition and impose unnecessary costs.³⁷ They argued that:

- prudential regulation is not warranted since they do not take deposits, and failure of an originator would not have significant ramifications for investors or the wider financial system — the RBA

37 Aussie Home Loans, Submission No. 176; Austral Mortgage Corporation, Submission No. 38; Australian Securitisation Forum, Submission No. 204; Registered Australian Mortgage Securities, Submission No. 128; Macquarie Bank, Submission No. 115 and Mortgage Industry Association of Australia, Submission No. 216 to the Financial System Inquiry.

and the Credit Union Services Corporation of Australia Ltd (CUSCAL) also agreed that prudential supervision of mortgage originators is not necessary;

- lending activities are adequately protected through property, trade practices and fair trading law, and the Mortgage Industry Association of Australia's Code of Ethics and dispute resolution scheme — this has been supplemented by the Uniform Consumer Credit Code, which took effect from 1 November 1996; and
- securitised bond issues are adequately regulated under the *Corporations Law* (although the Australian Securitisation Forum did recommend *Corporations Law* amendments which could further assist the securitisation market).

5.92 Submissions also raised concerns about competitive neutrality between mortgage originators and deposit-taking institutions.

5.93 The building society and credit union industries said the regulation imposed on them hampers their ability to compete with mortgage originators. The AAPBS said this should lead building society regulators to streamline supervision in order to 'level the playing field somewhat' vis-a-vis securitisers.³⁸

5.94 In contrast, Aussie Home Loans said banks hold a privileged position, including an implicit government guarantee which gives them an unfair advantage. It also argued that restrictions on using the term 'bank' should be relaxed so that mortgage originators can call themselves 'mortgage banks', as occurs in the United States.

Impediments to Loan Origination and Securitisation

5.95 Submissions raised a range of impediments to the further development of securitisation relating to consumer protection, prudential and *Corporations Law* requirements.

38 Australian Association of Permanent Building Societies, Submission No. 43 to the Financial System Inquiry, p.16.

Consumer Protection Regulation

5.96 Many lending institutions expressed grave reservations about the new Uniform Consumer Credit Code. While the general structure and operation of this Code are discussed in Chapter 8, a number of points relate specifically to mortgage originators.

- The Mortgage Industry Association argued there is no evidence that home loan borrowers need any greater protection and said some relief from provisions of the Code would be appropriate.
- The Australian Securitisation Forum noted that the trustee of a securitisation vehicle will be considered to be the credit provider under the Code. The trustee will be liable for breaches of the Code by loan originators and managers, but will no longer be able to obtain an indemnity from them.
- The Australian Securitisation Forum said powers to reopen contracts under the Code will add uncertainty to estimating securitised cash flows.

5.97 Both industry associations said the Uniform Consumer Credit Code will not resolve continuing inconsistencies in State licensing and registration of financial brokers and credit providers. These differences were said to raise costs and impose unnecessary delays on interstate expansion.

Corporations Law

5.98 To date, securitisation programmes have largely been sold to institutional investors under the *Corporations Law* prospectus exemption for offers over \$500,000. The Australian Securitisation Forum proposed that the *Corporations Law* be amended to:

- specifically regulate securitisation issues separately from managed funds;
- accommodate a securitisation structure used in the United States involving tranches of both debt and prescribed interests; and
- facilitate issues to retail investors.

5.99 The Forum also argued that requirements for external directors and custodians are unnecessary for highly rated securitisation schemes subject to close review by rating agencies.

Prudential Requirements

5.100 The RBA imposes a range of disclosure and capital requirements on banks involved in securitisation activities. The Australian Bankers' Association and Westpac claimed these rules are overly complex, and should be confined to disclosure rules making it clear to investors that there is no recourse to the bank concerned. The Commonwealth Bank said RBA capital requirements for bank facilities supporting securitisation programmes are too onerous and should be harmonised with equivalent rules in major OECD countries.

5.101 CUSCAL argued that securitisation, which can improve the capital and liquidity position of a financial institution, should not be impeded. It outlined a case where a proposed securitisation of existing credit union loans did not proceed because of objections raised by the Victorian State Supervisory Authority.

5.102 Finally, the Australian Securitisation Forum and RAMS criticised RBA rules which impose a 100 per cent risk-weighting on bank holdings of residential mortgage-backed securities. This compares to a 50 per cent risk-weighting for residential mortgages held directly, and is higher than requirements in the United States, the United Kingdom, Canada and Japan. The RBA has since announced proposals to provide a concessional risk-weighting in some circumstances.

Other Impediments to Securitisation

5.103 Industry participants have told the Inquiry that government ownership of a major mortgage insurer, the Housing Loans Insurance Corporation, has constrained development of the mortgage insurance market.

5.104 Other proposals to promote securitisation involved stamp duty, interest withholding tax and the elimination of regulatory requirements for paper documentation rather than electronic evidence.

Secondary Trading in Unit Trusts

5.105 Submissions did not raise any issues relating to secondary trading in unit trusts. However, a number of submissions addressed the question of choice in superannuation.

5.106 There was general support for the Government's plans to introduce greater choice for superannuation fund members. For example, Treasury acknowledged there are some concerns with introducing greater choice but argued that greater competition should put pressure on funds to improve returns.

5.107 Submissions said the regulatory environment should not constrain competition or favour any particular form of superannuation product or provider.³⁹ They also stressed the need to ensure that investors have sufficient information to allow them to make informed choices in a more competitive environment.⁴⁰ The Association of Superannuation Funds of Australia (ASFA) said that funds would need to adopt electronic commerce solutions if they are to control costs and manage the administration associated with greater choice. ASFA also said that investors would need effective consumer protection and prudential control where choice becomes more widely available.

5.108 The Insurance and Superannuation Commission and Treasury both supported greater choice, but noted that it could make funds more vulnerable to withdrawals and liquidity pressures or lead them to make shorter-term investments. While these concerns would not arise if superannuation investments could be traded in the secondary market, no submissions raised this option.

39 See for example the Australian Bankers' Association, Submission No. 126; the Association of Superannuation Funds of Australia, Submission No. 50 and the Australian Friendly Societies Association, Submission No. 92 to the Financial System Inquiry.

40 See for example the Superannuation Practice Committee of the Institute of Actuaries of Australia, Submission No. 144 to the Financial System Inquiry, p.4.

Secondary Trading in Other Instruments

5.109 Several submissions canvassed reasons why corporate and infrastructure bonds remain relatively undeveloped in Australia.

5.110 Westpac suggested that the small corporate bond market reflected the fact that the growth of financial markets to date has been primarily related to their risk management function. The RBA argued that the small corporate bond market might be attributed to the relatively small size of the Australian economy and small number of Australian companies that would be considered large on an international scale. It may also be that the large volume of public sector fixed-interest securities throughout the 1980s and 1990s acted as a constraint on the development of the corporate debt market.

5.111 Submissions noted that the absence of a well-developed corporate debt market in Australia has led major companies to issue directly overseas into deeper, more liquid and more sophisticated markets. Submissions did not propose measures to foster the Australian corporate bond market, apart from criticising the application of interest withholding tax.

5.112 The International Banks and Securities Association pointed to successes in developing the infrastructure bond market. It claimed that further market development will depend partly on the Government's willingness to make technical adjustments and introduce policy measures.

Approach of the Inquiry

5.113 The Inquiry's interest in the development of markets for tradeable financial instruments has a number of facets.

- These markets provide a rival to traditional forms of financial intermediation and their development can therefore increase competition in the financial system as a whole.
- The growth of superannuation and other managed investments as a proportion of household saving makes it necessary to consider the factors which drive the performance of that sector. These factors include the inter-related issues of the scope for choice, increased liquidity of investments and more transparent and efficient pricing.

Secondary markets for securities and units may play a critical role in all of these areas.

- Deeper financial markets may reduce the cost of financial services and so increase the international competitiveness of Australia's financial system but also other sectors of our economy which use the financial system.

Securitisation

5.114 The Inquiry recognises that securitisation has contributed to more competitive loan markets and to the liquidity and depth of financial markets. This has undoubtedly reduced interest rates for residential borrowers. It views securitisation as a key to facilitating new entry of non-traditional competitors, and a means of promoting specialisation and efficiency in the intermediation process. Securitisation may also contribute to greater sophistication in credit scoring and loan administration. Taken together, securitisation developments could ultimately lead to more efficient pricing, capital allocation and risk management in the financial system.

5.115 The Inquiry intends to examine, and make recommendations on, impediments to the further development of securitisation in Australia, including:

- consumer protection, *Corporations Law* and prudential issues raised in submissions; and
- the interaction of privacy requirements with the need to make credit information available to facilitate the securitisation process.

5.116 The Inquiry will also examine whether there are any impediments to outsourcing and functional specialisation in the financial sector more generally.

5.117 Finally, a key task for the Inquiry is to consider the boundaries of systemic risk in the Australian financial system. In examining this issue, it will consider securitisation developments which have implications for the solvency of financial institutions as well as for the consequences of disturbances in financial markets.

Secondary Trading of Unit Trusts

5.118 A further issue is whether there are any regulatory or other impediments to secondary trading in unit trusts. The Inquiry considers that such trading can play a valuable role in pricing and managing capital and risk.

5.119 While the Inquiry will not duplicate the work of the Collective Investments Review which is being considered by the Government, it will examine the *Corporations Law*, ASX listing rules and any other constraints on the creation and trading of trust units. It will examine:

- whether the state-based legislation governing the formation and operation of trusts involves any inconsistencies or inefficiencies for public unit trusts offered nationally;
- whether *Corporations Law* and/or ASX listing rule provisions relating to takeovers should be amended to facilitate listing of public unit trusts;
- whether any other provisions of the *Corporations Law* or ASX listing rules should be amended to facilitate continuous issues of units in public unit trusts; and
- whether State legislation and/or *Corporations Law* provisions should be amended to facilitate mergers between public unit trusts.

5.120 The Inquiry may also consider prospects for secondary trading of superannuation investments.

Secondary Trading in Other Instruments

5.121 While some market participants have sought to promote the supply of corporate bonds and investor demand for these securities, these attempts have met with limited success to date. The Inquiry will review the reasons that corporate and infrastructure bond markets have remained relatively undeveloped in Australia. Its focus will be to establish whether there are any regulatory impediments (other than taxation arrangements) that should be removed.

Small and Medium Sized Enterprises (SMEs)

5.122 This section considers the role of financial markets in providing debt and equity capital to SMEs.

5.123 There is no standard definition of SMEs. The Australian Bureau of Statistics defines small businesses as manufacturing firms with fewer than 100 employees and other businesses with fewer than 20 employees. Small businesses account for approximately 97 per cent of all private sector businesses and 51 per cent of all private sector business employment.⁴¹ Almost all of the net 1.2 million new jobs in Australia over the past decade have been created in the SME sector, which produces about one third of Australia's GDP.⁴² As both an employer and a producer, the SME sector is therefore vitally important to national well-being and economic growth.

5.124 A survey of small businesses by the Yellow Pages found that 55 per cent of firms used personal capital as a primary source of start-up funds while 43 per cent used bank finance, usually secured by the family home. Established, growing firms relied more heavily on bank finance than on personal funds. The family home was provided as security for around one third of bank loans used by established small businesses.⁴³

Existing Arrangements

5.125 SMEs can be incorporated under the *Corporations Law* or unincorporated. Typically, unincorporated entities are involved in small-scale retail trade or services and the owner-principal is frequently the entity's only employee. While complete data are unavailable, it has been

41 Australian Bureau of Statistics 1995, cat. no. 1321.

42 Bureau of Industry Economics data quoted in Department of Industry, Science and Tourism, Submission No. 243 to the Financial System Inquiry, p.45.

43 Yellow Pages 1995, pp.3, 6.

suggested that SMEs have around \$46 billion debt finance⁴⁴ and that institutional equity investment in SMEs probably does not exceed \$2 billion.⁴⁵

5.126 Under the *Corporations Law*, companies wishing to raise equity funds from the public must register a prospectus with the ASC. The prospectus rules do not apply to some small-scale offers (made to fewer than 20 persons in the preceding 12 months) or to wholesale investors (individual offers over \$500,000).

5.127 Policy Statement 100 of the ASC limits the formation and development of second tier markets or second boards.⁴⁶ In the 1996 Budget, the Government announced that it will commission a study on the viability of an alternative equity market in Australia for SMEs.

5.128 The ASX listing rules set out prerequisites for companies wishing to list on the ASX. Under these rules, a company must:

- have at least 500 shareholders, each with a shareholding valued at a minimum of \$2,000;
- have a minimum issue price of at least 20 cents for each share; and
- satisfy either a profit test or net tangible assets test.

5.129 In December 1995, the RBA announced changes to prudential guidelines to allow banks to make long-term equity investments in non-financial firms. The guidelines limit the size of individual equity investments (0.25 per cent of a bank's tier 1 capital) and total equity investments (5 per cent of tier 1 capital). To date, banks have placed relatively little equity investment in SMEs.

44 The Hon Geoff Prosser MP, Minister for Small Business and Consumer Affairs cited in the Council of Small Business Associations of Australia, Submission No. 231 to the Financial System Inquiry, p.1.

45 Thinkbank, Submission No. 121 to the Financial System Inquiry, p.1.

46 Australian Securities Commission 1995, Policy Statement 100 *Stock Markets*.

Views Presented in Submissions

5.130 Issues raised in submissions centred around five broad inter-related themes:

- information problems which cause market failure in SME finance;
- proposals to amend the *Corporations Law* to improve the availability of capital to SMEs;
- the costs of new SME debt and equity;
- the scope for securitisation of SME debt; and
- prospects for establishing secondary markets for SME equity.

Do Information Problems Cause Market Failure in SME Finance?

5.131 A number of submissions suggested that information problems in financial markets for SMEs constitute a market failure. These problems with SME access to capital have both supply and demand dimensions.

5.132 On the demand side, submissions noted that many SMEs do not yet appreciate the market value of quality information or may not have an appropriate corporate governance structure.⁴⁷

5.133 On the supply side, the market has not delivered mechanisms to capture, process and deliver information widely. In equity financing, for example, both the ASX and Thinkbank pointed to the lack of research into SME companies and the preference of institutional investors for listed companies or those rated by the ratings agencies. Another information problem was the difficulty faced by non-listed companies and potential equity investors in identifying each other. These views were echoed by the Commonwealth Bank.

5.134 Thinkbank and the Council of Small Business Organisations of Australia (COSBOA) both pointed to inadequate information in the public arena about SMEs.

⁴⁷ See for example Thinkbank, Submission No. 121 and Department of Industry, Science and Tourism, Submission No. 243 to the Financial System Inquiry.

5.135 Thinkbank argued that the ASC has not been used appropriately as an information resource and that the cost recovery arrangements for funding ASC operations impaired the efficient operation of financial markets. It was suggested that the cost of reviewing the company database for 5 years in order to identify suitable SMEs, analysing data and undertaking comparative analyses of SMEs would be in excess of \$100 million. This was contrasted with the Securities and Exchange Commission in the United States, which provides free access to its database over the Internet in order to keep the market informed.

5.136 COSBOA was concerned about the lack of accurate, impartial information on business lending. It considers that the RBA has not adequately informed public debate by providing data on business finance.

5.137 A recent study by Marsden Jacob Associates found that SMEs have difficulty attracting equity investment, principally because they are not 'investment ready'. That said, Marsden Jacob Associates identified a gap in the supply of equity finance in the \$0.5 million to \$2 million range. It recommended that this gap be addressed by lowering the search, information and transaction costs for equity finance, facilitating matching services and developing alternative equity exchanges.⁴⁸

5.138 For debt finance, the primary source of funding remains the banking sector. This reflects the comparative advantage that banks presently have in information gathering and credit analysis for SMEs. The Australian Business Chamber said that innovation and competition among the major banks, and between major and regional banks, were occurring in business lending. These developments have been to the benefit of SMEs. For example, the Australian Business Chamber suggested that 90 per cent of all SME loan applications are now approved, up from 70 to 80 per cent a decade ago. It also said that a number of new products and services are offered by regional banks as well as non-bank financial institutions.

5.139 In summary, the evidence in submissions suggests that banks have access to superior financial information about SMEs compared to other participants in financial markets. This is principally due to the ongoing

48 Marsden Jacob Associates 1995, pp.1-3.

customer–banker relationship between banks and their SME customers. This implies that a key issue is the cost and availability of reliable financial information about SMEs. If financial market participants can obtain access to such information, there is some potential for SME securitisations to become a new source of competitive pressure on banks (as has already occurred for mortgage financing).

Corporations Law

5.140 A number of submissions recommended that the *Corporations Law* be amended to make it easier for SMEs to access equity markets and for managed funds to invest in SMEs.

5.141 Thinkbank and Austock Brokers were among those which argued that *Corporations Law* prospectus rules are too onerous for SMEs. Austock Brokers recommended that the number of persons to whom an offer can be made without a prospectus should be increased from 20 to 50. It also said that the minimum amount for an excluded offer should be reduced from \$500,000 to \$250,000.

5.142 Thinkbank and Austock also suggested that s.66 of the *Corporations Law* be amended to allow securities dealers to invest without a prospectus regardless of whether they are acting as agents for their clients or as principal.

5.143 Austock Brokers also said that the ASX requirement for a minimum of 500 shareholders for listing was onerous.

5.144 Thinkbank criticised a recent *Corporations Law* amendment which means that small companies are no longer obliged to lodge their financial accounts with the ASC. Thinkbank said this could result in 98 per cent of companies becoming financially invisible to the market.

Costs of New Debt or Equity Capital

5.145 A number of submissions argued that the costs of new debt or equity were higher for SMEs than for other corporate entities.

5.146 A recent study prepared for the National Investment Council showed that SMEs faced higher underwriting and prospectus costs than larger firms because of the high fixed costs involved in public offerings. The results of the study are shown in Table 5.5.

Table 5.5: Costs of Capital Raising (by size of firm)

Capital Raising	Underwriting Costs %	Prospectus Costs %	Total Capital Raising Costs %
All Surveyed Firms			
average	3.3	3.3	6.6
over \$10 million	2.7	2.6	5.3
\$10 million and below	3.9	3.9	7.8
New Offers			
average	3.7	4.0	7.7
over \$10 million	3.3	3.3	6.6
\$10 million and below	4.6	4.7	9.3
Other offers			
average	2.8	2.3	5.1
over \$10 million	1.3	0.9	2.2
\$10 million and below	3.5	2.7	6.2

Source: Marsden Jacob Associates, 1995, p.37.

5.147 The Australian Chamber of Commerce and Industry noted that two-thirds of the respondents to a survey of its members stated that their loan arrangements were either satisfactory or very satisfactory. However, a large proportion of respondents specified the level of interest rates and the level of fees and charges as important areas where improvement could have occurred.

5.148 The Inquiry was told that existing bankruptcy laws have the effect of discouraging SME lending and investment.

Securitisation of SME Debt

5.149 DIST pointed to the United States Government Federal Guaranteed Loan Program, which facilitates SME access to credit by providing a government guarantee on private lender loans made to small firms. The

current rate of guarantee on the loan varies from 70 to 90 per cent of the loan. It has been suggested that one reason a secondary market has developed in SME debt securities in the United States is the existence of government guaranteed securities. DIST noted that SME loan guarantees may not be suitable in Australia but that securitisation of SME debt may be worthy of consideration.

5.150 Given the competition which securitisation has introduced into the mortgage lending sector, some commentators have suggested that securitisation of SME debt has some potential to reduce lending margins. The Australian Securitisation Forum said a major development needed to make this possible was the ‘commoditisation’ of credit evaluation so that intelligent systems use statistical analysis to arrive at ratings for parcels of SME debt. This would facilitate ratings of securitisation issues and the creation of a market in lenders’ insurance on SME debt.

Development of Secondary Markets in SME Equity

5.151 Submissions did not view the ASX as a prime source of funding for SMEs, but pointed to the need to develop other secondary markets in SME equities.

5.152 Austock Brokers pointed out that a secondary market for SME securities could already be established under the *Corporations Law* as an approved securities exchange or an ‘exempt’ stock market.

5.153 The Australian Business Chamber recommended that consideration be given to establishing:

- an inquiry into the feasibility of re-establishing ‘second boards’;
- a pilot programme for a ‘start-ups’ stock exchange; and
- seed-funding to establish an information registry for venture and development capital users and providers.

Approach of the Inquiry

5.154 The Inquiry will consider whether there are any regulatory initiatives which would increase the role of debt and equity securities markets in providing capital to SMEs.

5.155 SMEs have been the subject of public policy attention for some time and a number of initiatives have been undertaken. These initiatives include the Pooled Development Fund measures (see Chapter 9), the Export Working Capital Guarantee facility through the Export Finance and Insurance Corporation and a number of ‘business angels’ programmes at the State level. A Commonwealth Government study on the feasibility of an alternative equity market is expected to report next year.

5.156 In these circumstances, the Inquiry will not seek to duplicate work already completed or in progress. Instead, the Inquiry will report its findings on:

- the extent of information failures in the SME debt and equity markets;
- impediments to the development of secondary markets in SME debt and equity securities; and
- the changes which may be required to the regulatory environment and to legislation to facilitate the development of such markets.