Prudential Regulation

Introduction

7.1 This chapter discusses the organisational framework and conduct of the prudential regulation of Australia's financial system. It draws on the discussion of objectives and principles of regulation outlined in Chapter 4 and relates these to recent and prospective market developments.

7.2 The Terms of Reference of the Inquiry require it to consider how regulatory arrangements consistent with prudence can be designed so as to 'best promote the most efficient and cost-effective service for users'.[1] Implicit in this is a potential conflict between securing the objectives of prudential regulation and promoting efficiency and competition. If prudential regulation were not constrained by efficiency considerations, it would likely best meet its purpose by the application of stringent rules and through intensive intervention by regulatory agencies. The costs of such an approach would be borne ultimately by the whole community through reduced returns on their savings, a higher cost of finance and reduced competition.

7.3 The purposes of this chapter are to:

- set out the main issues and options for changes to the current organisational arrangements for prudential regulation in Australia;
- discuss whether the prudential regulator, at least in respect of banks, should be the central bank; and

1 Financial System Inquiry, Terms of Reference, Paragraph 3 (a).

- canvass some broad issues in the conduct of prudential regulation which have important implications for its effectiveness and the efficiency and competitiveness of the financial system, namely:
  - regulation of financial conglomerates;
  - restrictions on ownership;
  - participation in the payments and settlement system; and
  - recovery of the direct cost of regulation.

The Structure of Prudential Regulation

7.4 This section considers the current structure of prudential regulation and various options for the consolidation and rationalisation of regulatory agencies.

Existing Arrangements

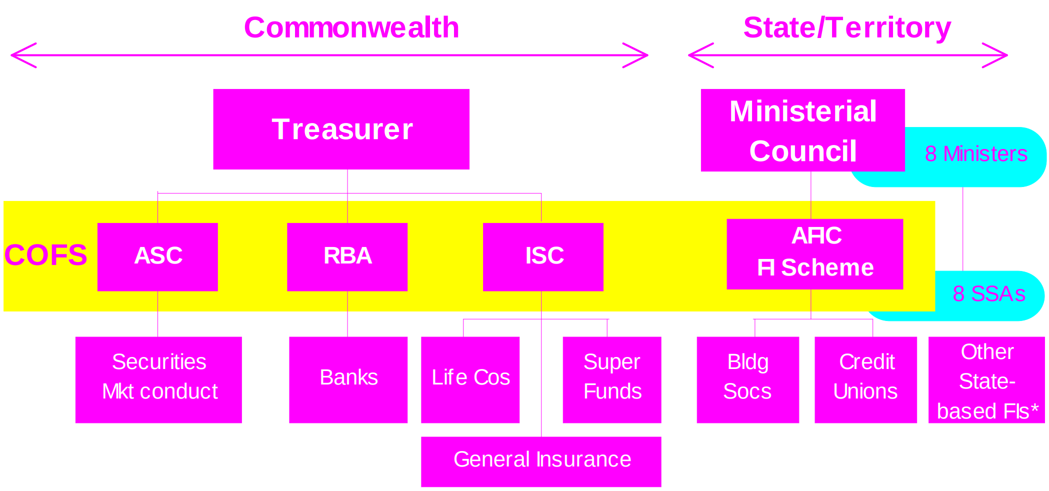
7.5 There are 4 key regimes for prudential regulation of financial institutions and functions:

- the Reserve Bank of Australia (RBA) for banks, payments settlement and overall system stability;
- the State-based Financial Institutions (FI) Scheme that incorporates the Australian Financial Institutions Commission (AFIC) and associated State Supervisory Authorities (SSAs) for the credit union and building society industries;
- the Insurance and Superannuation Commission (ISC) for life and general insurance and superannuation; and
- although not primarily a prudential regulator, the Australian Securities Commission (ASC) has a prudential role with respect to securities exchanges, securities and futures dealers and managers of collective investments.

7.6 In 1992, the Council of Financial Supervisors (COFS), comprising RBA, AFIC, ISC and ASC, was established to provide high-level co-ordination of matters affecting the financial system.

7.7 Ministerial reporting with respect to government agencies has been rationalised with the transfer of the ASC to the Treasury. AFIC reports to the Ministerial Council of Financial Institutions (MINFIN) which comprises the 8 State and Territory Ministers responsible. Each SSA reports to its State/Territory Minister. Figure 7.1 provides an overview of the main regulatory arrangements for Australia's financial institutions.

Figure 7.1: Overview of Prudential Regulatory Arrangements



*Other state-based financial institutions include friendly societies, trustee companies and state-owned financial institutions.

7.8 Appendix C provides a more detailed description of the existing regulatory arrangements in Australia. Main prudential regulators and responsibilities are described briefly below.

Reserve Bank of Australia

7.9 Licensed banks are prudentially regulated by the RBA. The RBA is a Commonwealth statutory authority reporting to the Treasurer. Its Governors and Board are appointed by the Governor-General for various terms, usually 5 or 7 years. Primary legislation for the RBA includes the *Reserve Bank Act 1959* and the *Banking Act 1959* and Regulations.

7.10 The legislation provides, among other things that:

- the banking policy of the RBA must be directed to the greatest advantage of the people of Australia;
- the RBA use its powers as will contribute best to the stability of the currency, and the economic prosperity and welfare of the people of Australia;
- the RBA protect depositors of banks (including by assuming control of a bank that may be unable to meet its obligations);
- the RBA promote sound prudential practices in banks and monitor prudential matters;
- depositors of banks rank ahead of other creditors (including the RBA) in the event of the winding-up of a bank; and
- banks must settle their obligations to other banks through accounts held with the RBA.

7.11 These provisions give the RBA an overarching responsibility for financial system stability and a key role at the centre of the payments system.

Financial Institutions Scheme

7.12 Building societies and credit unions are prudentially regulated by AFIC and SSAs under the FI Scheme. The FI Scheme was established in 1992 following agreement by all States, the Northern Territory and the ACT. It is a co-operative State/Territory-based scheme.

7.13 The key regulatory elements are:

- AFIC, a statutory authority established under state law, responsible for standard making, national co-ordination of the FI Scheme and direct regulation of industry Special Services Providers (SSPs);
- SSAs established in each State and Territory, responsible for the direct regulation of building societies and credit unions; and
- State and Territory Ministers with portfolio responsibility for building societies and credit unions in their jurisdictions (either Treasurer or Attorney-General). Each SSA reports to its Minister. Collectively, the Ministers form the MINFIN, to which AFIC reports. Members of the AFIC Board are appointed by the Queensland Governor-in-Council on the recommendation of MINFIN (with the exception of the Executive Director, who is appointed on the recommendation of the Board).

7.14 Key legislation includes the *AFIC Code* and the *FI Code*, passed in the Queensland Parliament and adopted in each other State / Territory.

7.15 The approach to prudential regulation under the FI Scheme is similar to that applied by the RBA. AFIC sets the prudential standards and has regulatory responsibility for industry-owned organisations called SSPs. Each SSA is responsible for day to day regulation, in accordance with AFIC's prudential standards, of those building societies and credit unions registered in its State.

7.16 A key feature of both the FI Scheme and the RBA's approach to prudential regulation is that an institution's board and management are responsible for the prudent operation of the institution. Prudential regulation aims at reducing, but not preventing, the likelihood of failure of regulated institutions. Neither the RBA nor AFIC (nor SSAs) guarantees deposits.

Insurance and Superannuation Commission

7.17 Insurance and superannuation are regulated by the ISC, which was established in 1987. The ISC is a statutory authority headed by a Commissioner appointed for up to 5 years by the Governor-General. The Commissioner reports to the Treasurer. Primary legislation covers regulation of life companies (*Life Insurance Act 1995*), general insurers (*Insurance Act 1973*) and superannuation funds (*Superannuation Industry (Supervision) Act 1993*).

7.18 Regulation of both the life and the general insurance industries includes licensing of entry and capital requirements, and measures for the solvency or financial soundness of individual insurance companies. The ISC monitors insurance companies through regular financial reporting and inspections. The insurance distribution system is also covered by ISC regulation through licensing and reporting requirements for insurance brokers, and rules governing standards of conduct and advice.

Life Insurance

7.19 Life insurance companies offer a range of products with various economic functions, including savings (for retirement and other purposes) and risk cover (including for the financial consequences of death or disability). Traditional life insurance policies contain both saving and risk elements. However, there has been considerable 'unbundling' over the past 15 years such that most policies today fall into one of two broad forms:

- products which undertake to pay a specified minimum nominal amount(s) to the customer at a particular time or after a particular event (eg whole of life insurance and term-certain annuities — the latter share functional similarities with term deposits); and
- products where the undertaking is to manage funds on a best endeavours basis (eg market-linked life company policies).

7.20 Most superannuation offered by life companies is in defined contribution (accumulation) plans and is invested on a best endeavours basis.

7.21 Like the approach to prudential regulation of deposit-taking institutions (DTIs), the regulation of life companies emphasises that responsibility for the prudent management of institutions rests with the boards and management of the financial institutions. In the event of liquidation of a statutory fund, policy holders have priority over other creditors. In the event of a conflict of interest between policy holders and directors, directors are required by statute to act in the interests of policy holders.

General Insurance

7.22 General insurance provides protection against various categories of commercial and household loss (eg home, motor vehicle, public liability) by pooling risk, from often highly unpredictable events. As a result, contracts tend to be short, typically for one year. Reinsurance, whereby the direct insurer passes on risks to a reinsurer, is commonly used to spread localised risks. Some longer-term risks are also covered (eg environmental, product compensation, professional indemnity and libel). Regulation is directed to ensuring that general insurers maintain a capacity to meet future claims — intensity of regulation is similar to that for capital-backed products, while recognising that claims are contingent and cover is relatively short term (ie year to year).

Superannuation

7.23 The ISC also has responsibility for superannuation funds where the size and nature of the fund also influence the intensity of regulation. The bulk of the 140,000 regulated funds are small (fewer than 5 members). This necessarily restricts the ISC's ability to maintain close and frequent contact with every fund. Accordingly, the regulatory framework relies heavily on the principle that trustees are primarily responsible for the viability and prudent operation of funds and compliance with the standards.

7.24 The ISC pays particular attention to defined benefit and public offer superannuation and approved deposit funds. Here, a relatively small number of approved trustees have fiduciary responsibility for a substantial volume of personal and small business superannuation (these trustees can be subject to minimum capital requirements and need ISC approval).

Australian Securities Commission

7.25 The ASC is not usually regarded as a prudential regulator but rather as a disclosure and consumer regulator. However, its responsibilities and approach in some areas are more in the nature of prudential regulation. The ASC is charged under its Act with promoting confidence in the integrity of the Australian securities and futures markets. While this is predominantly pursued through market conduct and disclosure regulation, more intense regulation of a prudential nature is also provided in such areas as restrictions on the activities of intermediaries as principals, the imposition of capital requirements on intermediaries, and the authorisation and regulation of markets and clearing houses.

Views Presented in Submissions

Deposit Taking

7.26 The vast majority of submissions that addressed the regulatory structure suggested that credit unions and building societies should be under the same regulator as banks. The main reason identified is that these institutions have essentially the same economic function as banks and contest many of the same markets, especially retail markets. For example, Australian Mutual Provident Society (AMP) stated that there is little basis for distinction between bank and non-bank DTIs, with the large life companies — AMP, National Mutual and Colonial Mutual Life Assurance Society Ltd (CML) — recommending rationalisation of the current DTI regulatory arrangements.

7.27 Among those favouring rationalisation of DTI regulation, there is strong support for consolidation to be achieved by transfer of FI Scheme responsibilities to the RBA. Both ANZ Banking Group and Westpac Banking Corporation argued that the RBA should be the sole prudential regulator responsible for all DTIs. Others favoured establishing a new regulator outside the RBA (discussed later). A small number went further, notably the National Australia Bank (NAB), which recommended substantial consolidation of the existing agencies.

7.28 Industry submissions by Credit Union Services Corporation (Australia) Ltd (CUSCAL) and the Australian Association of Permanent Building Societies (AAPBS) suggested that, despite lifting the prudential standing of the industries, the FI Scheme remains a source of competitive imbalance. Both identified shortcomings in the current arrangements and the difficulties of co-ordinating the 8 participating jurisdictions (plus AFIC). Other issues identified include:

- divergences in the approach to, and intensity of, regulation;

- inconsistent interpretation and application of prudential standards by SSAs;
- different supervisory levies being charged by States with costs being subsidised in some jurisdictions;
- unnecessary restrictions on activities; and
- extra liquidity and contingency fund (for credit unions) requirements and industry emergency liquidity support arrangements relative to banks.

7.29 The RBA observed that there are no grounds for building societies and credit unions to be under its wing to protect against systemic risk. However, if the aim is to minimise the number of regulators, there is a case for rationalisation.

7.30 The view of AFIC and some SSAs was that the FI Scheme has worked successfully and that building societies and credit unions are regulated more appropriately at the State level. However, both the New South Wales and Victorian Treasuries supported responsibility for prudential regulation of building societies and credit unions being transferred to the Commonwealth.

Life Insurance and Superannuation

7.31 Despite the many variations suggested for regulatory structure, a common theme in most submissions, and in many discussions with experts overseas, was that insurance and banking are different (as are the skills needed by respective regulators), suggesting that regulation should be separated. This separation may be achieved either in different agencies or in different divisions in the one agency. The ISC, the RBA, Treasury, most banks, the Insurance Council of Australia (ICA) — for general insurance — and Legal and General supported different agencies. The Life, Investment and Superannuation Association, AMP, CML, Norwich Union, CUSCAL and NAB supported different divisions within the same agency.

7.32 Beyond that, much of the discussion related to how best to structure the regulation of investment products. Key issues identified included:

- how to ensure that functionally similar investment products offered by life companies, fund managers and superannuation funds are subject to equivalent regulatory treatment; and
- which regulatory agency or agencies should be responsible for regulation.

7.33 On the first question, an important distinction is often made between products that are capital-backed (where the institution offering them carries the market risk) and products that are market-linked (where the investor carries the market risk). Many submissions (ISC, ASC, ICA, AMP, CML, Bankers Trust Australia Ltd) supported comprehensive prudential regulation of institutions offering the former (including general insurance) with only a disclosure regime applying to the latter. Treasury, on the other hand, suggested that it is desirable over time to:

- move to a disclosure only regime for life companies and superannuation funds regardless of product type;
- depend more on market discipline; and
- limit perceptions of government safe havens.

7.34 On the allocation of regulatory responsibility, submissions supported either a functional or an institutional approach.

- Bankers Trust suggested regulation could be split according to whether products are balance sheet backed (with capital or reserves) or market-linked.
- The ASC noted that superannuation funds and unit trusts are generally trust-based collective investments and suggested regulation by the same agency.
- The ISC, on the other hand, suggested there may be a public policy case to regulate superannuation more intensively. Superannuation is tax preferred, it has compulsory elements and Retirement Savings Accounts (RSAs) are to be introduced as capital-guaranteed products. Also, there are community expectations that such entitlements will be available on retirement, and there are information asymmetries for investors at time of purchase. The ISC also believed there are synergies between the regulation of superannuation funds and life companies and noted around three

quarters of life company assets are superannuation related. Consequently, the ISC believed superannuation should be separated from other market-linked products and located for regulatory purposes under the ISC with other long-term products like life insurance. A final option canvassed by the ISC would be for it to undertake regulation of all collective investments.

- An alternative proposed in a number of submissions[2] is for a new Retail Investment Commission, or the like, to be formed to regulate all retail investment products (including disclosure at point of sale), the financial advisory industry and other consumer protection functions (these options are canvassed more fully in Chapter 8 — the option for a single mega-regulator is discussed in Chapter 10).
- The Treasury observed that there is a range of options for consolidation of regulatory agencies, including a merger of the ASC and ISC. Also, it noted some options may be pursued by extending the existing co-ordination arrangements through COFS.

Broader Financial Sector Elements

7.35 A range of submissions (eg those from ISC, Australian Stock Exchange (ASX), Sydney Futures Exchange (SFE), International Banks and Securities Association, AMP, National Mutual, CML, NAB) pointed to systemic risks outside the banking and core settlements system. Some referred to the size, scope and international linkages of securities markets and suggested that participants in these markets have the potential to affect adversely other key players through counterparty exposures, including between and within conglomerate groups. Participants in derivatives markets may have particular scope to cause knock-on effects if they fail.

7.36 Several submissions also noted linkages between asset markets (equity, securities, property, etc) as a source of instability outside the banking

2 For example, submissions from Westpac Banking Corporation, Submission No. 90; National Australia Bank Submission No. 131; the Insurance and Superannuation Commission, Submission No. 53; and Australian Mutual Provident Society, Submission No. 97 to the Financial System Inquiry.

system which, if large enough, can threaten various settlement systems and thereby final settlement through accounts at central banks. This raised the issue of whether the regulator responsible for systemic risk should have oversight of all settlement arrangements involving material settlement risks (eg stock and futures exchanges). In particular, the SFE suggested that the RBA should be involved in the oversight of the SFE on these grounds. Requiring merchant banks to be licensed as banks, as suggested by the RBA, would promote much the same effect. Many merchant banks are active participants in securities, futures and derivatives markets. They also tend to be owned by foreign banks.

7.37 A number of submissions (eg those from AMP, National Mutual, ISC) made the point that difficulties experienced by any large financial sectors or firms which have significant exposures to others can have systemic effects. Against this, others suggested that the extent of the risks for some large players is limited in comparison with that of banks because many (eg life offices and other fund managers) tend to have limited liabilities at call, the bulk of their assets are usually in marketable securities, and exposures to other institutions tend to be unsettled deals for which exposures are limited to market risks (where settlements are delivery against payment).

7.38 Bankers Trust pointed out that, in some areas, systemic risk is decreasing as institutional and other arrangements are put in place to control these burgeoning exposures. Examples include the widespread move to Real Time Gross Settlement Systems for payments risk, shortening of other settlement cycles (eg for equities - Clearing House Electronic Sub-register System (CHESS), in Australia), extended within-day settlement arrangements to reduce Herstatt[3] risk, growth in legally certain netting systems, technological developments in risk management and control systems in market makers and market participants, and the move by regulatory agencies to more risk-based approaches to regulation.

3 Herstatt risk relates to delivery risks in different time zones. It derives its name from the 1974 failure of Herstatt Bank, when some of Herstatt's counterparties incurred losses as a result of irrevocable delivery of Deutschemarks to Herstatt in Frankfurt ahead of receiving counterpart US dollars in New York later the same day.

Approach of the Inquiry

7.39 The Inquiry will consider whether, and if so how, the existing regulatory arrangements should be reorganised. This will require consideration of the principles involved as well as some difficult practical matters.

7.40 The following matters would appear to be important and, where they lead to different conclusions, their relative importance will need to be weighed:

- how the intensity of concern with systemic risk or need for investor protection differs across financial institutions and activities;
- the extent to which these institutions or activities are clearly separable or (perhaps increasingly) are difficult to distinguish or are conducted jointly;
- the principle of competitive neutrality, whereby like products and markets should be subject to equivalent regulatory treatment;
- the advantages of diversity, including the need to maintain markets which are as openly contestable as possible;
- whether reorganisation has clear benefits relative to its costs, including the costs of transition;
- the effectiveness of regulatory requirements (ie intensity of supervisory process, including skills of agencies, minimisation of gaps/overlaps, international constraints);
- the need for any proposed regulatory framework to be flexible and able to meet market changes, including new products and services, organisational structures such as conglomerates and the entry of new participants; and
- transparency — in particular, all public and private undertakings being clear and understood.

The Scope of Prudential Regulation

7.41 In considering the matters set out in the previous paragraph, the Committee will consider the role and objectives of prudential regulation. As for regulation generally, it is desirable to ensure that the scope and intensity of prudential regulation be the minimum necessary for its purpose.

7.42 By its nature, prudential regulation is intrusive and costly and interferes with the operation of markets. It may also carry a moral hazard for government in that there may be an expectation of compensation for failure.

7.43 As discussed in Chapter 4, prudential regulation is directed at two key objectives for the financial system:

- minimising systemic risk; and
- ensuring that certain financial promises can be kept by provision of safe havens.

7.44 The task, then, is to indicate where in the financial system these objectives need to be pursued and to what extent.

7.45 While views vary, it is widely believed that systemic risk is most intense in the payments system, especially among institutions involved in final settlement. Beyond this, the extent of systemic risk is harder to gauge. It may still be considerable even in those parts of the deposit-taking system which are not explicitly linked to payments and may extend to securities exchanges which link to the payments system at the point of settlement of trades in stocks and securities, including derivatives and futures.

7.46 There is also a perception that securities firms in many overseas markets may carry a high level of systemic risk. This is because they are increasingly engaging in the same wholesale market activities as banks, including creating highly-leveraged operations and trading in complex over the counter (OTC) derivatives. In addition, there has been some suggestion internationally that systemic risk may extend to the large-scale reinsurance markets.

7.47 Beyond these sectors, while it is possible that a failure in virtually any part of the financial system could result in contagion effects, it is likely that this risk diminishes appreciably. One possibility is that systemic risk in these areas may be restricted to very large institutions.

7.48 The second motive for regulatory intervention is to promote confidence that certain financial promises will remain capable of being met. To some extent, the policy motivation for prudential regulation in this regard is effectively to provide a more intense form of consumer protection (to minimise the risk of loss). Another motive is to ensure that savings are encouraged through achieving a high level of confidence in the safety of the regulated savings products.

7.49 These purposes may be met by creating safe havens for household savings, particularly as many consumers may be regarded as unable to assess the current or future condition of the financial institutions with which they deal. Here the main focus of concern is generally with capital guarantees — mostly deposits and capital-backed insurance products.

7.50 Beyond this, the intensity of regulatory concern begins to moderate as there is greater acceptance that consumers are pursuing higher returns with an understanding of higher risks. Although there is a range of other products which share some of the attributes or economic functions of capital-backed products, it is arguable whether the promises are the same or the confidence effects as serious. Defined benefit superannuation contains an implicit capital guarantee but depends on the solvency of the employer sponsor (the government or its agencies in some cases). Cash management trusts tend to be capital-stable by virtue of the assets in which investors funds are placed and may have a payment function attached — however, they remain essentially a market-linked product issued under prospectus.

7.51 Most compulsory superannuation and public offer superannuation funds are also essentially market-linked. However, there may be an added public policy concern about these and other superannuation products, given their role in the Government's retirement income policy. This is reflected in requirements such as licensing and prudent investor requirements imposed on trustees.

7.52 Beyond this again, in the realm of collective investments, the intensity of regulatory concern decreases further and the response is usually limited to disclosure.

7.53 In considering the implications of these matters for the design of prudential regulation, a number of observations may be made:

- the intensity of concern with the risk of market failure in the financial system varies from one part or activity to another;
- the intensities of concern over systemic risk and the perceived need to provide safe havens are not necessarily identical or uniform across the system; and
- approaches to prudential regulation may need to take account of the different motives and strengths of concern applying in different sectors, in part to ensure that consumers understand the extent of regulation and the protection it affords them. The continuum of regulatory responses covers such matters as:
  - the extent and coverage of regulation, including licensing, entry, capital, insurance and risk management;
  - the precision of requirements, degree of constraint of behaviour once operating and the intensity and form of monitoring;
  - the consequences of failure to observe requirements, including withdrawal of license to operate, financial or other penalties; and
  - the balance between official regulation, self-regulation and market discipline.

Consistency of Prudential Regulation

7.54 Convergence of financial activities has resulted in a blurring of boundaries between institutional types. Institutions denied access to certain markets by virtue of institutional status have established subsidiaries with the necessary licences to operate in other areas of the financial system. In this way, institutions practise regulatory arbitrage by establishing operating structures that provide access to markets under the most favourable regulatory arrangements.

7.55 The proposed introduction of RSAs has sharpened the comparative regulatory debate, focusing on the most favourable regulatory regime from which to offer RSAs. The focus of this debate is usually the relative capital requirements of DTIs versus life offices proposing to offer RSAs and the point that one or other group will be delivered a competitive advantage.

7.56 The possible effects of excessive or inappropriate capital or similar regulatory requirements include:

- with industry convergence, the arbitrage of regulatory jurisdictions and restructuring of institutions to minimise the impact of regulation, especially capital requirements;
- inefficient allocation of capital, either through excessive capital being applied to the financial sector or through misallocation within the sector, and a consequent lessening of competition, at direct cost to consumers;
- fragmentation of financial industries as competitors emerge offering products and services not subject to regulatory requirements or capital constraints, creating a competitive disadvantage for more traditional providers unable to arbitrage regulation; and
- disadvantage to Australian institutions relative to international competitors.

Options for the Prudential Framework

7.57 There are 4 broad models for the prudential framework:

- the existing regulatory structure;
- a single national regulator of DTIs;
- regulation of insurance companies and/or superannuation funds combined with that of DTIs within the one regulatory agency; and
- extension of the role of that agency to include prudential regulation of any institution or activities considered to constitute a systemic risk or require safe haven status.

7.58 Whether the last of these should also be combined with consumer and market regulation, creating a single mega-regulator for the whole financial system, is discussed in Chapter 10.

A Single Regulator for Deposit-Taking Institutions

7.59 This option combines prudential regulation of banks, building societies and credit unions, transferring State responsibilities to the Commonwealth.

7.60 Benefits of this option, if adopted, may include:

- reduction of some of the costs of regulation of credit unions and building societies, for example, by removing duplication of regulatory resources, unifying information systems and approaches to regulation, and eliminating implementation differences between jurisdictions;
- simplification of policy co-ordination since proposals for legislative and prudential standard amendments would involve a single jurisdiction instead of the 8 under the FI Scheme; and
- to the extent all DTIs were issued with the same licence and the same prudential standards and laws applied, elimination of actual and perceived regulatory differences between industries.

7.61 Any consolidation of the current regulatory arrangements will create a number of important administrative issues, particularly whether a separate scheme would continue under the auspices of a DTI regulator or whether building societies and credit unions would effectively have to become banks. If the latter approach is taken, new rules for banks would need to be determined. Issues to be resolved include those relating to restrictions on ownership and types of business, the use of generic names (such as bank, building society or credit union) and cost recovery arrangements. There is a risk under this approach that institutional diversity may be difficult to accommodate.

DTI, Life Insurance and Superannuation Regulator

7.62 The Inquiry will consider whether, and if so how, prudential regulation of life insurance, general insurance and superannuation should be brought under the same body as banks (or DTIs).

7.63 The view taken on this issue will depend in particular on the judgement made as to the appropriate scope and intensity of prudential regulation. It is generally argued that the systemic risk associated with insurance and superannuation is much less than in payments and banking areas, and that the safe haven concerns may be restricted to capital-guaranteed products. At one level, this argues for a lesser form of prudential regulation under a separate regulator, a view often reinforced with claims that the nature of the business is so different that it requires quite different regulatory skills. On each count others take an opposing view, citing considerable convergence in the activities undertaken by banks and life offices in particular, and arguing that competitive neutrality considerations demand similar regulatory treatment.

7.64 The Inquiry will need to weigh these considerations and make judgements about the considerations applying to superannuation. In addition, the arrangements for friendly societies which offer investment products similar to those of life offices will be addressed.

7.65 Finally, the Inquiry will develop a view on the appropriate agency for such a role, options being the RBA, the ISC or a separate institution (see also later discussion on separation of monetary and banking regulation policy).

Universal Prudential Regulator

7.66 A third option is to move away from the institutional focus of prudential regulation towards the establishment of a single regulator to cover all prudential regulatory functions.

7.67 There are 2 variants of this option:

- a single agency could be charged with prudential regulatory responsibility in any area where this form of regulation is required; or
- a single body could be charged with dealing with any areas of substantial systemic risk, while other prudential concerns (including that for safe havens) where there are few systemic implications could be left to consumer protection or other regulators (this option falls away if the mega-regulation model is adopted).

7.68 The option of a single prudential regulator needs the scope of regulation to be established clearly. If the net is cast too widely, it may create a regulatory burden without conferring matching benefits and may distort the operation and efficiency of financial markets. If it is cast too narrowly, it will fail to meet its regulatory objectives.

7.69 Internationally, the main debate on this issue relates to whether both the banking and securities industries should be prudentially regulated on the grounds of systemic risk. The concern that some securities firms present a systemic risk arises because of their diversification, especially into traditional banking activities.

7.70 More particularly, some securities firms are taking on illiquid derivatives, complex portfolio management and counterparty positions, especially in OTC products. They may leverage operations, with the potential for risk profiles to change rapidly. Poor investment decisions or lapses in management and risk control may be exposed and have the potential for sending shockwaves into the wider system through counterparty, payments and settlement exposures.

7.71 A number of advantages claimed for a single prudential regulator are based on expectations of Australia's financial system as it develops. It is argued that a single regulator may best address:

- product convergence and institutional conglomeration;
- competitive neutrality concerns in the provision of like products by different institutions, for example, impact of capital, solvency and other regulations for different products;
- the need for flexibility to allow product innovation and to minimise unnecessary regulatory constraints;
- market changes and innovation across a range of increasingly complex financial products being offered by a number of different institutions; and
- the emergence of systemic risk in other institutions and markets.

7.72 A single prudential regulator should assist in overcoming cultural and philosophical differences between agencies within the existing framework.

7.73 Against this are concerns that:

- a single prudential regulator may confuse investors by implying that all financial products regulated have the same level of protection — this may distort the risk spectrum, have adverse allocative effects and create moral hazard;
- such an agency may create an unacceptably high concentration of power; and
- large government bodies can suffer diseconomies of scale or bureaucratic inefficiencies. Also, benefits may be illusory if different agencies merely become different divisions within a single agency, with separation maintained because different regulatory approaches and skills are needed for different parts of conglomerate groups (eg banking, insurance and funds management). In particular benefits need to be weighed against transition costs.

The Central Bank and Prudential Regulation

7.74 This section considers the role of the central bank in prudential regulation, especially of banks, and whether this function should be organisationally separated from the conduct of monetary policy.

Existing Arrangements

7.75 In Australia, the RBA as the central bank has responsibility both for the conduct of monetary policy and for preserving financial system stability. Related to this, it has oversight of the final settlement of payments obligations and responsibility for the prudential regulation of banks. Arrangements around the world vary, depending on historical and cultural factors, but nearly all central banks have the first 3 functions. Roughly half of the world's central banks, including the RBA, have sole responsibility for the prudential regulation of banks. Where this is not the case, prudential regulation of banks is conducted by a separate agency, which is sometimes also responsible for the prudential regulation of insurance companies. Even where the central bank is not formally responsible for the prudential regulation of banks, there are close links between the central bank and the regulatory agency to enable the central bank to meet obligations to maintain financial system stability.

Views Presented in Submissions

7.76 On the role of the central bank, submissions fell into 2 broad categories.

- One group, including several major life companies (eg AMP, National Mutual, CML) and the NAB, saw value in moving to a framework involving a mega-regulator or universal prudential regulator, and envisage responsibility for prudential regulation moving outside the central bank.
- The other group saw the monetary policy, system stability and payments settlement responsibilities of the central bank as having synergies with prudential regulation of banks (and usually other DTIs). This view was supported by most banks, a number of industry associations, and regulatory agencies, including the RBA.

7.77 Beyond this dichotomy, there were many variations on:

- how these objectives may best be achieved;
- the extent to which other objectives should play a role (eg efficiency and competitive neutrality); and
- the implications of these for appropriate prudential responsibilities of the central bank (institutional or market coverage) and co-ordination with other regulatory agencies.

7.78 The range of suggestions for changes to the future role of the RBA is outlined below.

- Decreased responsibilities:
  - — regulation of banks (and in some submissions the system stability role) transferred to a specialist prudential regulator outside the central bank — these are usually models based on variations of the mega-regulator or universal prudential regulator proposals;

— variations on the narrow banking theme which would see safe haven status afforded to a core part of banks' balance sheets, possibly with strict controls on the counterpart assets;

— concentration on major DTIs on systemic risk grounds with responsibility for other banks (and DTIs) transferred to a mega-regulator; and

— removal of the licensing regime for participants in the foreign exchange market (suggested by the RBA).

➢ Increased responsibilities:

— settlement/collateralisation arrangements for exchanges such as the SFE in recognition of their possible contribution to systemic risk;

— for other DTIs (credit unions, building societies and possibly merchant banks — which, where applicable, might be required to convert to bank status);

— for all institutions requiring prudential regulation (life offices and possibly some or all superannuation funds or products);

— for all non-bank financial institutions.

➢ No change:

— essentially retaining responsibilities only for bank regulation.

7.79 A number of submissions, including those of the major life companies and banks (and their industry associations), the Treasury, ISC and RBA, discussed moving regulation of banks outside the responsibility of the RBA. Most life companies and the NAB considered the weight of evidence in favour of separation. Most banks, the ISC and the RBA considered the balance the other way. The Treasury saw advantages in an evolution towards separation as part of a strategy to minimise moral hazard to government and promote market discipline.

7.80 Arguments in favour of separation canvassed in many of the submissions include the following.

➢ There is a conflict of interest in the conduct of policy for monetary and financial system stability and in particular there is a risk that a central bank will put too much emphasis on financial stability to the detriment of price stability. This might involve restraining an increase in interest rates or promoting an earlier decrease in rates than appropriate to assist an ailing banking sector. Concerns about necessary information on the health of the banking system being available for monetary policy purposes can be covered by clear allocation of responsibilities and appropriate co-ordination arrangements.

- The central bank might be tempted to use prudential policy for monetary policy purposes (Treasury).
- The central bank may suffer reputational damage from its regulation activities that may affect its credibility in conducting monetary policy.
- Central bank independence may be compromised if government financing is needed for any large rescue.
- Central bank involvement as a regulator increases moral hazard as it provides banks and their non-bank subsidiaries with a considerable competitive advantage through the implied backing of government. Moving banks to a separate regulator would serve to decrease moral hazard and reduce the perception that banks (or by association their subsidiaries) cannot fail.
- If there is to be a bailout of problem institutions at taxpayer expense, the decision should be made by the government or a body reporting directly to it.
- Many existing problems in the regulatory structure could be addressed by a single prudential regulator, but it would be inappropriate for many non-bank areas to be regulated by a central bank with its predominantly banking culture.

7.81 Arguments in favour of continued bank regulation by the RBA include the following.

- With the RBA's responsibility for system stability and the payments system, concern extends to banks because of their predominant role in payments, their importance for stability, their susceptibility to runs and contagion, and their role as lender to small and medium sized enterprises.

- Central banks have credibility in crisis situations. The RBA is the only institution capable of injecting liquidity into the financial system, or into a distressed institution, when time is of the essence. The RBA would be involved anyway in any systemic problem, and if bank solvency is an issue it is in a strong position to act quickly to arrange a merger or orderly closure.
- The RBA participates in the financial markets daily and knows the markets and the participants well. If problems are sourced outside the banking system but with potential to spread, the central bank will need the skills and knowledge of a financial markets specialist as well.
- In an efficient financial system it is important that poorly managed institutions be allowed to fail. Despite this, failure can be seen as incompetence on the part of a regulator and there is a risk that a stand-alone regulator would see its role narrowly and act accordingly. A central bank has wider objectives and responsibilities and is less likely to have the narrow perspective of a single purpose regulator. This provides offsetting benefits to risk of reputation loss.
- The RBA would monitor the solvency of banks anyway, shadowing the work of the regulatory agency. If this were not to happen, other arrangements (eg government guarantees, effective security) would need to be put in place to enable advances in case of need to solvent but illiquid banks. While the RBA could do all things necessary on the advice of another agency, such arrangements would be clumsier and likely to be less timely.
- A stand-alone regulator is more likely to develop a rules-based culture with lawyers and accountants predominant. A central bank will have to argue the case with colleagues who are predominantly economists and financial market specialists, tending to soften the dependence on rules and to increase market friendliness (RBA).
- Central banks have credibility internationally, well-established formal and informal international lines of communication, and an understanding of international financial markets. These are important in circumstances where disturbances are increasingly likely to have an international element and require international solutions. It is also important for the standing of banks which

operate internationally. There are international constraints to a radical change to regulatory arrangements.

7.82 Most proposals included suggestions for co-ordination structures for the prudential framework, to address competitive neutrality, flexibility, information sharing and cost effectiveness objectives.

Approach of the Inquiry

7.83 The Inquiry will consider whether or not the central bank should continue to regulate banks and, should it not do so, what the most effective structure would be. This will involve weighing many competing views and available empirical evidence.

7.84 In considering these, the Inquiry will have regard to the principles for regulation which it set out in Chapter 4. In particular, the following considerations are important:

- the required intensity of regulation of markets and products in the light of market failure on the grounds of systemic risk and information imbalance;
- competitive neutrality, which suggests that, where possible, like products and markets should be regulated alike;
- the importance of the risk spectrum for allocative efficiency and the need for transparency in the extent of any government backing of products, markets or institutions;
- flexibility of the arrangements to keep up to date with market developments and allow innovation; and
- the benefits of any changes relative to their costs, including transition costs.

Financial Conglomerates

7.85 There is a growing trend for many financial institutions in Australia and overseas to diversify and provide a wider range of financial services. This is resulting in some blurring of traditional boundaries between different types of financial institutions such as banks and insurance companies.

7.86 In some cases, the widening range of activities is provided through the one legal entity (such as a bank or insurance company) while, in others, separate legal entities are established to undertake the different activities within a corporate group (in many cases, this decision is heavily influenced by taxation and regulatory requirements).

7.87 The latter response results in the creation of financial conglomerates. These are groups of companies under common control whose predominant activities consist of providing at least 2 different classes of financial services.[4] This has created a number of issues for prudential regulation.

7.88 Conglomerates can affect prudential regulation in at least 3 broad ways:

- they can facilitate regulation by simplifying the business of the entity which is subject to regulation by specialist regulators so that, for example, banking business is conducted in one entity and insurance business in another; or
- in contrast, they may complicate regulation by raising the prospect of contagion risk (eg communication of financial distress from unregulated entities to regulated entities within the group); or
- to the extent that prudential regulation is restricted to specific members of the group, conglomerate structures can narrow the scope of regulation, thereby enabling the company to engage in unregulated business through other entities. This is likely to improve the competitiveness of the entity as a whole, although it is also likely that such groups will be able to engage in regulatory

4 Tripartite Group of Securities, Insurance and Bank Regulators 1995.

arbitrage — conducting business through whichever entity faces the least burdensome regulation.

7.89 There are both positive and negative aspects of financial conglomeration. The Inquiry is concerned to establish which arrangements would best balance the competing considerations.

Existing Arrangements

7.90 In Australia, the regulation of financial conglomerates has been under consideration by the COFS for some time. Internationally, regulatory agencies are considering the same issues through a Joint Forum established to follow up the work of a Tripartite Group of Securities, Insurance and Bank Regulators which reported in 1995.

7.91 To date, the regulatory response to the emergence of these diversified groups has differed from sector to sector, depending on prudential policy and legislative arrangements. In most cases, the approach has been to impose limits on the nature and scope of financial conglomerates.

Banking

7.92 The power vested in the RBA to regulate banks applies under the Banking Act to entities which are licensed as banks under that Act. To ensure that this power is applied to the whole of a group which includes a banking business, banking licences have (in most cases and until recently) been granted only where the bank is the holding company.

7.93 Any general and life insurance, financial planning, finance company, superannuation or other funds management activities are required to be conducted by subsidiaries of the bank. The RBA has imposed prudential limits on subsidiary operations involved in borrowing and lending and also requires that any subsidiary not be overly large in relation to the parent bank. Subsidiaries are also required, in normal circumstances, to be involved in the business of financial intermediation or to have a clear relationship to banking operations. Thus, subject to limited exceptions, banking groups may not include non-financial businesses. This effectively bars entry into banking by industrial companies.

7.94 With few exceptions relating to transitional arrangements in cases of merger, banking groups have not been granted more than one banking authority. The single licence restriction is to ensure that all depositors in a group will be treated equally under any activation of the statutory depositor preference. For these same reasons, banks are not permitted to own building societies.

7.95 The RBA regulates and requires capital to be held on a consolidated basis. The exception is in relation to trust-type business, insurance, funds management and securitisation. Here the RBA requires that the capital supporting the operations and the associated assets be excluded from the calculation of the risk-weighted capital adequacy requirement for the banking operation.

7.96 The purchase of the State Bank of New South Wales in 1995 by CML resulted in a significant review of policy on financial conglomerates. For the first time, a significant banking operation was purchased by a non-bank entity. The agreed structure is that CML establish a holding company structure, with insurance and banking activities conducted through separate subsidiaries. While the banking business is smaller than the insurance arm, the RBA will be the lead regulator, taking a group-wide perspective. The ISC will continue to regulate insurance activities and the ASC will continue to regulate collective investment, securities and dealer licensing, capital raising and similar activities or businesses. These arrangements have been established by agreement between the agencies involved and the Treasurer in the special circumstances of this case. The Government has indicated that it will consider the possibility of a broader policy change after it receives the Final Report of this Inquiry.

Life Insurance

7.97 Unlike the case in banking, life insurance laws are more permissive of conglomerate structures through 2 mechanisms.

- While the Life Insurance Act states that a life company must only carry on life insurance business, diversification into financial and other activities can be achieved through statutory fund investments in subsidiaries such as building societies, mortgage origination business, brokerage, financial planning and non-financial subsidiaries. However, new solvency standards are expected to encourage life companies to limit large exposures and investments in related group assets.

- Rules for ownership of life companies are more permissive than those for banks, thereby enabling conglomerates to be established where the holding company is not a life office. Parent entities of Australian life companies include industrial companies, foreign companies, general insurance companies and governments, and there is less sensitivity to other operations under the holding company than with the RBA approach. This results from the ISC's assessment that statutory funds effectively quarantine assets and liabilities from other activities of the group.

Building Societies and Credit Unions

7.98 Building societies and credit unions (together referred to as 'societies') are regulated by SSAs according to prudential standards set by AFIC under the FI Scheme.

7.99 The legislation requires that a society obtain approval of its SSA before establishing a new subsidiary.

7.100 Similar to the requirements for banks, the FI Scheme prudential standards state that subsidiaries should not be overly large compared with the holding society; loans and investments in subsidiaries are subject to large exposure limits and require consolidation of the group for the purposes of calculating capital adequacy. Further, managed funds are required to be conducted through a special purpose vehicle, usually a subsidiary or trust. Both the capital supporting these operations and assets under management may be deducted for the purpose of calculating a society's capital adequacy (if the society guarantees funds under management, the operation is treated as if on-balance sheet and capitalised accordingly).

7.101 The legislation imposes a general limitation on individual shareholdings of building societies to a maximum 10 per cent (exemptions were granted to those societies which already had other ownership levels at the commencement of the FI Scheme). Exemption from the 10 per cent limit is subject to conditions that specify limits on, and full disclosure of, intragroup exposures; require a majority of independent board members; impose requirements for the financial strength of the holding entity; and impose spread of ownership and control rules on the ultimate holding entity.

Other Groups

7.102 A range of other significant financial conglomerates exist in Australia with a variety of parent entities including friendly societies, general insurance companies and merchant banks. Many of these entities have prudentially-regulated operations, conducted through subsidiaries.

Other Arrangements

7.103 To date, co-ordination of regulation and regulation of conglomerates has been ad hoc. While some limited Memoranda of Understanding have been established bilaterally between some regulatory agencies within the COFS, legislative constraints on information sharing limit the effectiveness of co-operation among all agencies to varying degrees. The Government has agreed in principle to amend relevant legislation to overcome these problems.

Views Presented in Submissions

7.104 Where submissions commented on conglomerates, it was often noted that conglomerates are already a feature of the Australian financial system, holding more than 80 per cent of the system's assets.[5] The 2 matters most discussed were appropriate corporate structure for conglomerates and the approach to regulation.

7.105 On corporate structure, there was wide recognition of the problems of contagion and support for separation of activities. Among those that commented on the issue — banks, insurance companies, regulators, governments and industry advisers — there was virtually universal support

5 Reserve Bank of Australia, Submission No. 111 to the Financial System Inquiry, p.109. Other submissions variously stated between 70 per cent and 80 per cent of the assets of the financial system are in conglomerates.

for allowing the establishment of a non-operating holding company structure with operating subsidiaries, such as a bank and insurance company.

7.106 In support of the holding company structure, Westpac drew upon COFS comment that prudential concerns about contagion, conflicts of interest and transparency might be alleviated to some extent under a financial holding company, as opposed to a licensed bank parent/subsidiary structure. This could arise from the perception of greater 'separateness' of the different activities undertaken by the conglomerate.

7.107 A number of submissions identified the emergence and influence of conglomerates as a driver for an array of reforms to regulatory arrangements.

7.108 At the conservative end, reform proposals were restricted to some modification of the existing framework, with an emphasis on improved arrangements for harmonisation of standards and co-ordination of regulation, including:

- that the COFS be strengthened with its own secretariat to oversee the regulation of financial conglomerates and in this regard become a de facto mega-regulator;
- that lead regulator arrangements be adopted, which is supported by the RBA and Australian Bankers' Association (ABA) (there are variations on this recommendation, including one that the lead regulator be appointed on the basis of the dominant activity of the group or, where a bank entity is part of the conglomerate, regardless of its relative size, the bank regulator be the lead regulator);
- that the solo plus approach to regulation be adopted whereby the regulator of a particular aspect of the business, say insurance, focuses on that entity but takes a qualitative assessment of the group as a whole and possibly also makes a group-wide assessment of capital (this approach is supported by the ISC and ASC).

7.109 At the more radical end, some submissions favoured a total rethink on the approach to regulation of conglomerates and suggested rationalisation of the current raft of prudential regulators and harmonisation of arrangements is required. For example, NAB cited overseas experience and considered that the lead regulator / solo plus models are inadequate.[6]

7.110 The emergence of conglomerates is not universally supported, although most recognised it as irreversible. Comments about conglomerates included:

- conglomerates with a bank brand have an unfair advantage, given the alleged public perception that the RBA and Government guarantee all activities of the group; and
- conglomerates should not be allowed and the Government instead should allow banks to conduct only a narrow range of activities, thus providing a truly safe haven for Australian depositors.

7.111 The ownership basis of conglomerates also attracted comment. Most submissions commented that requirements similar to those of the *Banks (Shareholdings) Act 1972* should generally be applied to the holding company. Others considered that the rule should be flexible, because presence of substantial shareholdings can improve the chances of securing emergency injections of capital in the event of difficulties.

7.112 There were mixed views as to whether financial conglomerates should incorporate significant non-financial operations.

The Approach of the Inquiry

7.113 The Inquiry will consider the future approach to prudential regulation of financial conglomerates in Australia.

7.114 A balance will be struck between prudential, consumer protection and competition considerations. These considerations are outlined below.

6 National Australia Bank, Submission No. 131 to the Financial System Inquiry. Appendix 2 cites the CSFI Study on the United Kingdom experience that the system perpetuated the proliferation of regulatory agencies (one bank had to answer to 6 separate bodies), competitive inequality between banks and other financial institutions, differing regulatory styles and purposes between the various agencies and an unduly complex structure.

7.115 The main prudential issues include:

- the assessment of capital adequacy — how to prevent double counting of capital and how to minimise regulatory capital requirements, recognising their significant cost;
- whether, and if so how, to minimise brand contagion and intragroup exposures through the establishment of so-called firewalls (that is, regulations which aim to prevent financial problems in one member of a corporate group spreading to the others);
- how to ensure access to, and exchange of, information by regulators responsible for regulated activities and entities within the group;
- how to ensure that regulators are able to manage any financial difficulties which may emerge within a regulated group, including, if necessary, through general powers over non-regulated entities and activities within the group, including holding companies; and
- whether, and if so how, regulation should restrict the inclusion of industrial or other non-financial activities within a financial conglomerate.

7.116 The main issue for consumer protection is the need to ensure that customers dealing with members of a corporate group are aware of the nature of the regulatory protection afforded them. One of the principal difficulties with conglomerates is that customers often believe that the fact that one part of the group is regulated means that there is added protection for other products or activities offered elsewhere in the group. This is not only misleading for the consumer, but also confers an unfair competitive advantage on the group and risks a moral hazard for government in the event that failure occurs.

7.117 The main concern for competition is that regulations aimed at prudential and consumer issues may:

- restrict entry into the financial services sector; or
- increase the costs of operation of groups subject to the regulation, thereby reducing their competitiveness.

Options

7.118 There are a number of policy options for changes to the present rules in relation to conglomerates. These are set out as follows, together with a discussion of their implications.

Provide for the Establishment of Non-Operating Holding Companies

7.119 Under this approach, prudential regulations would be modified to provide that banks and other regulated entities may be established as subsidiaries of non-operating holding companies. Ideally, prudential requirements would be met through the imposition of laws directly on holding companies. For example, if laws relating to the ownership of banks are retained, these should apply to the holding company.

7.120 Other regulatory requirements which may be necessary for holding companies include:

- unless prudential regulation is unified, the establishment of lead regulator arrangements;
- information disclosure and information sharing rules; and
- any necessary controls over the management of the holding company and the businesses which it might establish or acquire.

7.121 The implications and effectiveness of this option would depend on its detailed design. Assuming that the design meets a high standard, the main advantages of this option may be that it:

- provides a superior structure for financial disclosure, for the quarantining of some types of assets and liabilities within subsidiary entities in order to protect other entities within the group from their risks, and for the application of more transparent capital allocation rules;
- through this greater transparency, promotes increased market knowledge and hence discipline on management, as well as ensuring through greater market confidence that financial conglomerates can effectively compete for capital;

- assists, in the event of the failure of an institution, the management of its reconstruction, for example by more readily allowing impaired subsidiaries to be sold off; and
- provides greater flexibility for the entity to structure and control its businesses (in some cases this may assist new entrants into regulated activities).

7.122 Fundamentally, however, it would assist entities to structure their operations so as to minimise the impact and costs of regulation, including capital requirements. Activities would tend to be conducted in entities which provided the most conducive regulatory arrangements. This would create some competition among regulators, and so create incentives for regulation of like products to be harmonised. It may also encourage greater competition in financial markets, as well as reduce any international competitive disadvantage faced by Australian financial enterprises in markets where foreign competitors may otherwise enjoy regulatory advantages.

7.123 The main disadvantages are likely to be:

- the risk of brand contagion, where failure in one part of the organisation leads to failure of others, notwithstanding that they are prudentially regulated (even where regulation ensures that there are substantial firewalls between businesses within a group, it is possible that the use of a common brand will lead to customer perceptions that the failure of one entity implies danger to another, leading to withdrawals of funds);
- customer confusion where other entities within the group trade on the status of the regulated operation; and
- conflicts of interest for the common management of the group.

7.124 The disadvantages arguably are similar to those which already apply to financial groups where the parent company is required to be a bank or life company. As noted earlier, the Government has already approved a non-operating holding company structure for the CML/State Bank group. This suggests that the authorities may have already formed a view that this structure has advantages without appreciable new disadvantages, when compared with alternative arrangements already permitted.

7.125 Another more specific issue related to holding company structures is whether each conglomerate should be restricted to only one entity holding a particular licence (for example, a banking licence). It might be argued that, if there is sufficient confidence in prudential firewalls and consumer protection to allow a holding company structure at all, it would follow that there should be similar confidence that a holding company may operate more than one bank within its group. This has implications for the equivalence of treatment of depositors in the different banks, but is also an issue which the Inquiry will consider in its Final Report.

Allow Financial Conglomerates to Include Non-Financial Entities

7.126 The authorisation of non-operating holding companies for financial conglomerates may go some way to increasing competition in markets for regulated financial services. A much more substantial increase in entry or threat of entry to these markets, and hence competition, could be achieved by removing or relaxing the present restrictions on the inclusion of industrial or other non-financial companies within financial conglomerates.

7.127 The potential for new entry into regulated financial activities has increased appreciably in recent years due to the increased globalisation of the market and the introduction of new technologies. Increased globalisation brings to Australia a considerable number of financial companies which already have non-financial subsidiaries. New technologies may increase the range of companies whose expertise confers an advantage in the provision of at least some types of financial services. These may include information technology and communication companies themselves, as well as other enterprises utilising new technologies in new distribution systems. Other companies operating in more traditional fields may also have developed advantages, such as in risk assessment and management, which might be applied in a range of financial services.

7.128 Participation by non-financial entities in financial conglomerates raises similar issues to those arising in the determination of rules for the ownership of regulated financial institutions. However, this issue is separately addressed in the next section of this chapter.

7.129 A number of options could be considered for relaxing restrictions on non-financial entities within financial conglomerates. These include:

- complete removal of the restriction, leaving decisions on whether to license entities within conglomerates as banks to an assessment of the suitability of the management of the group, the effectiveness of the regulatory arrangements for the holding company and the associated firewalls;
- modification of the restriction to allow non-financial entities only in more restricted circumstances, for example, where the financial activities of the group are substantial and represent a major part of the group's assets; and
- maintenance of the restriction in relation to full retail bank operations, but providing for the granting of licences for more restricted purposes (through conditions imposed on the licence) where it would be reasonable to do so (for example, to authorise greater participation in areas of the payments system).

The Ownership of Regulated Entities

7.130 A number of restrictions are imposed on the ownership of regulated financial institutions, particularly banks. These restrictions generally have prudential purposes, with regulators concerned both with the probity of those controlling regulated entities and with the implications of ownership for the capital strength of the institution. Other purposes of the regulations are:

- to minimise the likelihood that the stability of a financial institution would be prejudiced by the varying fortunes of a predominant shareholder;
- to facilitate more timely access to capital at a time of stress than might otherwise be the case; and
- to ensure that the ownership and control of financial institutions are contestable in the market and open to market scrutiny.

7.131 Ownership restrictions constitute a barrier to entry to financial markets and it is appropriate that they be reviewed to ensure that their anti-competitive effects are justified by their prudential benefits. These issues are reviewed in this section. The separate question of whether restrictions should apply to foreign ownership of financial institutions is addressed in Chapter 6.

Existing Arrangements

7.132 In Australia, the restrictions on ownership may take one or more of the following forms:

- a prohibition on mutual ownership structures;
- a prohibition on ownership or controlling shareholdings by industrial or other non-financial companies;
- a requirement for a wide spread of ownership of the institution or its ultimate holding entity, including restrictions on large shareholdings, and a requirement for transparency of the ownership structure; and
- minimum capital requirements or other tests imposed as licence conditions.

7.133 The application of each of these in Australia is now described in turn.

Mutuality

7.134 Mutual institutions arose from the co-operative self-help movement of the mid-19th century. The traditional focus of the boards and management of mutuals is the maximisation of benefits to members. The capital of such institutions is usually in the form of reserves only, accumulated and held perpetually for the benefit of current and future members. Members usually access reserves only on winding-up or change of corporate structure. A key principle of mutuality is ‘one member, one vote’, irrespective of the size of individual shareholdings, deposits or loans. This compares with joint stock companies where boards and management focus on the interests of shareholders, whose ordinary voting rights are ‘one share, one vote’.

7.135 In Australia and the United Kingdom, there is a trend toward demutualisation to provide access to capital, to unlock reserves and deliver value and direct ownership to members or to meet regulatory requirements.

Only credit unions in Australia remain a uniquely mutual industry in the financial system. A number of building societies in Australia have raised capital through the issue of mutual permanent shares. These are similar to ordinary shares in terms of dividends and issues, but carry a voting right of 'one shareholder, one vote'. The ASX amended its listing rules to allow listing of mutual shares largely to accommodate building societies raising capital to meet capital adequacy requirements under the FI Scheme. Ironically, spread of ownership, epitomised by mutual organisations, has the potential to contribute to inefficiency by delivering security of tenure to incumbent boards and management.

7.136 In Australia, there is a general policy opposed to mutual ownership of banks. Pursuant to this policy, conversion of building societies to banks has been accompanied by full demutualisation. Where a mutual life office has acquired a bank, it has been required to demutualise within an agreed period.

Corporate Identity of Parent Entities

7.137 Current policy on banking authorities requires the parent entity to be a bank licensed in Australia or an approved foreign bank regulated on a consolidated basis in its home jurisdiction in accordance with the Basle Concordat.[7] In the former case, the bank must have a wide spread of ownership. Exceptions to this rule have been made on rare occasions — the most recent being the decision to allow a holding company structure in the case of CML / State Bank (see previous section on conglomerates).

7.138 The effect of this policy is to prohibit the ownership of substantial shareholdings in banks by industrial companies or other non-bank corporations.

7 Colonial Mutual Life's purchase of State Bank of NSW is an exception. Policy, including legislative change, is yet to reflect this recent decision. Interim informal arrangements are in place.

Spread of Ownership

7.139 The *Banks (Shareholdings) Act 1972* provides for a spread of ownership of locally incorporated and owned banks. Generally, it limits shareholdings to 10 per cent of voting shares. An exemption from this limit may be obtained by application to the Treasurer, who will approve a shareholding of up to 15 per cent unless he is satisfied that the holding is not in the national interest. Beyond this level, exemption may be granted by the Governor-General if this is in the national interest. To date, this has mostly been applied to allow bank takeovers by other banks, or to allow foreign banks to establish wholly-owned subsidiaries in Australia.

7.140 For building societies, the FI Code imposes a general maximum shareholder limit of 10 per cent of any class of share but provides for exemptions in accordance with standards. The basic tenet of the standards is that exemptions will be granted only for 100 per cent ownership under conglomerate arrangements (see previous section).

7.141 The *Insurance Acquisitions and Takeovers Act 1991* provides that, where share acquisitions or issues result in a controlling interest of more than 15 per cent, the Minister must be notified. The Minister then has 30 days to provide a conditional or unconditional go-ahead or issue a restraining order.

Minimum Capital and Other New Licence Tests

7.142 The Banking Act, RBA Prudential Statements and general government policy identify the requirements for issue of a banking authority for both locally incorporated and foreign banks (either operating locally incorporated subsidiaries or branches).[8] A starting point is the expectation that the proposed license holder will make a worthwhile contribution to banking services in Australia. In the case of local incorporation, conditions include minimum tier 1 capital of $50 million.

7.143 Foreign bank branches authorised to operate as banks in Australia are prevented by a special condition from accepting retail deposits in Australia (defined as an opening deposit balance of $250,000 or less). It is

8 The issue of foreign ownership of financial institutions is discussed in Chapter 6.

claimed that this policy is necessary as the RBA is unable to apply depositor preference or otherwise provide the same level of protection as that provided to depositors with Australian banks (or foreign bank subsidiaries incorporated in Australia and fully capitalised).

7.144 The registration of a life office by the Insurance and Superannuation Commissioner requires a base capital of $10 million in addition to the probity test by the ISC to determine whether the applicant is fit and proper.

7.145 Formation requirements for credit unions reflect their co-operative status. There is no minimum base capital requirement but capital adequacy must be met continuously. Sponsors of any proposed credit union must satisfy the SSA that the proposals are viable in the longer term and that the proposed credit union will attract at least $200,000 in deposits in a reasonable period and will be able to meet all prudential standards.

7.146 New building societies also need to satisfy the SSA that the new institution is viable, that standards will be met and that $10 million in capital will be available within a reasonable period.

Views Presented in Submissions

7.147 The main focus of submissions that addressed ownership issues was on the current shareholding restrictions. While most submissions commenting on this issue recommended retention of the current shareholding restrictions, others believe that the rationale for retaining the restrictions is no longer valid. For example:

- Treasury observed that dispersion of shareholdings may give unwarranted security of tenure to bank management, which could inhibit efficiency and innovation;
- MLC questioned 'the logic of assuming en masse, rational investors are likely to commit new capital under [financial distress]', arguing therefore that 'the logic of a broad-based shareholding as insurance is misguided'[9]; and

9 MLC Ltd, Submission No. 87 to the Financial System Inquiry.

- the Australian Competition and Consumer Commission (ACCC) observed that ‘it would appear that Australia's banks are being shielded from the effects of global competition. The *Banks (Shareholdings) Act 1972* and the *Foreign Acquisitions and Takeovers Act 1975* could be significant impediments to international competition. Both these Acts can be used to block acquisitions of Australian banks by foreign financial institutions and claims about international competition ring rather hollow while such protection for banks exists’.

7.148 A number of submissions suggested an advantage of higher individual ownership levels is that they could serve to facilitate access to capital. National Mutual suggested a gradual removal of the current restrictions for both banks and insurance companies in line with the effective implementation of a new regulatory framework. Such removal should also allow for non-financial corporate ownership of substantial shareholdings.

7.149 Some submissions called for allowing ownership of banks by groups other than bank or joint stock entities. This is seen as particularly important for some significant foreign institutions to contest the Australian market. All recommended that any operating authority be issued on the basis of the standing of the applicant and its potential contribution to the Australian market rather than the corporate personality of the applicant.

7.150 Submissions also addressed the current role of the Treasurer in allowing exemptions to the shareholding restrictions. It is broadly recommended in submissions that ownership restrictions should be subject to ACCC scrutiny only in the area of competition and to the prudential regulator only in the area of fitness and propriety.

7.151 A number of submissions from the credit union movement advocated that credit unions remain strictly mutual, although some submissions sought the ability to issue mutual capital.

Approach of the Inquiry

7.152 The Inquiry will evaluate the balance of competition and prudential considerations relating to the ownership restrictions applying to financial institutions, particularly those applying to banks and life offices under Commonwealth jurisdiction. This review will encompass both the rules applying in the respective areas and the processes by which they are applied.

7.153 In doing so, the Inquiry will take account of the increasing globalisation of the financial system and the advantage to Australian consumers from greater competition brought by globally competitive suppliers. If the rules on ownership restrict entry to the Australian market by strong foreign competitors, Australian consumers are likely to be the main losers.

7.154 Similarly, it is important that Australia's own institutions be subject to strong competition if they are to adapt effectively to meet the challenge, and reap the benefits, of globalisation. It is also possible that strong new Australian participants in financial markets could emerge if entry restrictions are eased.

Options

7.155 The main options to be considered are as follows.

The Issue of Bank Authorities to Mutual Entities

7.156 Under this approach, the Banking Act and RBA Prudential Statements would be modified to provide for banking authorities to be issued to mutual organisations. This would allow for mutual entities such as certain life offices (or their subsidiaries), building societies, credit unions or SSPs to apply for a banking authority, provided all other requirements were met, without relinquishing their mutual status. Further, it would allow banking authorities to be issued to foreign mutual banks to operate locally incorporated subsidiaries or branches.

7.157 This would be in line with much international practice, given that some 20 per cent of banking in Europe and Canada is conducted by mutual institutions and the largest bank in Europe is a mutual.

7.158 This option would require particular consideration if the prudential regulation of building societies and credit unions were joined with that of banks.

Relaxation of Restrictions on Non-Bank Ownership of Banks.

7.159 The existing policy restricting the ownership of banks may unduly restrict entry to Australian banking markets or limit Australia's attractiveness as a regional financial centre. The benefits of this policy for prudential purposes need to be weighed carefully against these concerns.

7.160 A range of other options may be available. For example, consideration might be given to retaining some restrictions but with greater flexibility. Authorisations might be given to entities which have a well-established, strong presence in the financial services sector, notwithstanding that they also have industrial or other non-financial operations. Consideration would need to be given to the effectiveness of firewalls separating financial and other activities of the group. Restrictions may be considered on the scale or range of these other activities.

7.161 An approach that relied on a probity test including transparency of ownership structures could serve to reduce barriers to entry, increase competition and align Australia with similar policy in Europe and the United States.

7.162 Most of the issues involved are similar to those arising in the analogous discussion of conglomerates (see previous section).

Reduce or Eliminate Shareholding Limits

7.163 It has been argued that the existing maximum shareholding restrictions reduce market discipline by providing more secure tenure to boards and management. Current shareholder restrictions and notification requirements serve to protect takeover targets. Increasing or removing the maximum shareholder limits could serve to expose boards and management to greater market discipline.

7.164 Any change would need to be balanced carefully against the prudential risks created by concentration of ownership.

7.165 In particular, it must be recognised that removal of these restrictions would effectively also remove the means of administering other requirements, particularly probity tests on potential purchasers, imposed on financial institutions.

Reduce or Remove Other Entry Restrictions

7.166 Other restrictions include probity, capacity and minimum capital tests. Few such restrictions appear unduly onerous, although some may operate harshly and may need to be reviewed.

7.167 The restriction on entry to retail deposit-taking by foreign bank branches is a potentially more severe barrier to effective competition and will be reviewed in the light of broader recommendations on the framework for prudential regulation.

Participation in Payments and Settlement Systems

7.168 Chapter 2 provides details on the size and components of the payments system and the relative importance of various payment instruments. The focus of this section is the legislative and industry framework governing participation in the payments and settlement systems.

7.169 The payments system has always been a focus of government regulation, and some of these regulations have operated to restrict who is entitled to offer payment services. Such restrictions are anti-competitive, but may be justified by the need to ensure that the payments system has the highest integrity. The task for the Inquiry is to consider whether the present rules appropriately balance competition and integrity.

Background

7.170 A ‘payment’ is the transfer of monetary value between 2 parties.

7.171 When value is exchanged using cash, the person buying the good or service pays for it with currency, and generally this is where the transaction ends or reaches finality (ie ‘settles’). However, many payments are not achieved in this direct and immediate way but are achieved by using a payment instrument. Such instruments give a payment instruction to be executed by a third party — usually a bank.

7.172 In this case, the value in the payment instrument must subsequently be exchanged between financial institutions and the transaction does not reach finality until that value has been settled between those institutions through accounts held at the RBA. This may take some days, so that there is a risk that the institution on which the instrument is drawn may not be able to honour the obligation at settlement.

7.173 For many years in Australia, the main non-cash payment instrument was a cheque, which is a paper instruction to the effect that money be transferred from the drawer’s bank account to another party’s account (or to the bearer of the cheque). Another paper-based instrument is a post office money order. In recent years, many other forms of payment instruction have emerged — plastic cards and electronic messages being the most prevalent. New instruments are continuing to develop.

7.174 When goods or services are purchased for money, parties to the transaction must be confident that the instruments they use will result in certain and final payment. History has shown that, where there is uncertainty about the integrity of the payments system, the effects on the economy are very damaging. The integrity and stability of the institutions managing the risks in the payments system are therefore central to the confidence of users.

7.175 In addition, the efficiency of the system influences the cost structures of all agents in the economy.

7.176 In the following discussion, the term ‘payments system’ means both the processes of delivery and exchange of payments instruments (payments ‘clearing’) and the exchange of financial assets between financial institutions through Exchange Settlement Accounts (ESAs) at the RBA (payments ‘settlement’). Participation in the payments system is determined by law, by the regulatory authorities and by industry self-regulation.

Existing Arrangements

Legal Framework

7.177 As in most countries, the Government in Australia maintains a statutory monopoly over the issue of currency. The *Australian Notes Act 1910, Reserve Bank Act 1959* and *Currency Act 1965* provide the legislative framework for the issue of currency as legal tender. The Royal Australian Mint is responsible for the manufacture of coins while the RBA has responsibility for the printing of notes and the issue to the public of both notes and coins.

7.178 Other laws restrict which institutions may participate in the payments and settlement system and impose requirements to comply with certain capital and other prudential standards. The Banking Act requires banks to settle for payments exchanged between them by means of transactions across ESAs which the banks are required to maintain with the RBA.

7.179 Until the early 1980s, banks had an exclusive franchise on the payments system. Since then, the development of extensive credit and debit card networks has meant that building societies and credit unions have become participants in the payments clearing business and have limited participation in payments settlement through SSPs. Since 1994, 2 SSPs have held settlement accounts at the RBA. Building societies and credit unions are exempted from the need to hold a banking authority under the Banking Act.

7.180 The *Cheques and Payment Orders Act 1986* is the principal legislation dealing with paper payment instruments in Australia. It establishes the framework under which cheques and payment orders are drawn, accepted and paid. The Act states that a cheque may be drawn only on a bank. Building societies, credit unions and other non-bank financial institutions prescribed by the Treasurer can offer payment orders to their customers. Reflecting the public perception of the superiority of cheques, only one building society and one credit union have chosen to issue payment orders.[10] However, most building societies and credit unions have agency

10 Bank for International Settlements 1994, p.9.

arrangements with banks. These arrangements have allowed the clients of non-bank financial institutions to draw cheques on their institution's account at a bank.

7.181 In July 1995, the Commonwealth Government announced that it would amend the Cheques and Payment Orders Act to allow building societies, credit unions and their industry SSPs to issue cheques in their own right.

7.182 Like other sectors of the economy, the financial system is subject to the market conduct provisions of the *Trade Practices Act 1974*. Under s. 45 of the Act, anti-competitive agreements are prohibited. Under s. 88 of the Act, the ACCC has power to grant immunity from legal prosecution for some arrangements or conduct that might otherwise breach the restrictive trade practices provisions of the Act. Application for authorisation must be made by a party to the arrangement or a party engaging in the conduct in question.

Key Participants in the System

Reserve Bank of Australia

7.183 The primary rationale for RBA involvement in the payments system is management of payment system risk. This reflects the centrality of interbank settlement to systemic stability. The RBA is banker to the banks, conducts the ESAs of banks and makes settlement account facilities available to SSPs for the building society and credit union industries.

7.184 In addition to this prudential role, the RBA has a number of commercial functions. It is the main banker to the Commonwealth Government, some State governments and a number of government instrumentalities; it operates the RBA Information and Transfer System (refer Chapter 2); and it conducts accounts for other central banks and some international financial organisations.[11] As noted above, the RBA is also responsible for the issue of currency.

11 Bank for International Settlements 1994, p.5.

Australian Payments Clearing Association

7.185 The Australian Payments Clearing Association (APCA) is a company established in 1992 to oversee new entry to the payments system and to manage and co-ordinate the operation of effective payments clearing and settlement systems. APCA members consist of all the banks (including the RBA) and 2 industry SSPs. Reflecting the pre-eminent position of the 4 major banks — ANZ, NAB, Commonwealth Bank of Australia and Westpac — in Australia's payments system, the voting rights attached to APCA's shares mean that the 4 majors each have one vote while the state, regional and foreign banks and SSPs collectively have 4 votes. The RBA has one vote.

7.186 APCA is organising Australia's payments system into 4 separate clearing systems:

- Australian Paper Clearing System (mainly cheques);
- Bulk Electronic Clearing System (for direct entry payment instructions — eg social security payments, salaries, mortgage payments);
- Consumer Electronic Clearing System (for ATM, EFTPOS and card payment instructions); and
- High Value Clearing System.

7.187 Separate rules and membership apply for each of these clearing systems.

7.188 APCA sought, and received, authorisations from the Trade Practices Commission (TPC) (the forerunner to the ACCC) for:

- its Memorandum and Articles of Association;
- the Regulations and Procedures for the Australian Paper Clearing System; and
- the Regulations and Procedures for the Bulk Electronic Clearing System.

7.189 These authorisations relate to industry arrangements which are deemed necessary for the efficient conduct of business but which could be construed as contrary to s.45 of the Trade Practices Act. The authorisations are due for review in 1998.

7.190 In granting the authorisations, the TPC stated:

> *There is substantial public benefit in the operation of a secure and efficient payments system. It accepts that the payments system is the core of the financial system and is vital to the functioning of the overall economy.*[12]

7.191 The Commission concluded:

> *In all the circumstances, APCA's Memorandum and Articles of Association and its proposed Regulations and Procedures for the Australian Paper Clearing System:*
>
> - *are likely to result in benefits to the public which outweigh the potential detriment from any lessening of competition resulting from them; and*
> - *in respect of any exclusionary provisions contained in these documents, are likely to result in such a benefit to the public that the arrangements should be allowed to be given effect to, or the proposed arrangements should be allowed to be made.*[13]

7.192 The Commission reached similar conclusions in granting its authorisation to the proposed Regulations and Procedures for the Bulk Electronic Clearing System.

7.193 APCA has recently sought authorisation for the proposed Regulations and Procedures for the Consumer Electronic Clearing System. Application for Authorisation for the Regulations and Procedures for the High Value Clearing System will be deferred until the Real Time Gross Settlement (RTGS) system is introduced.

7.194 Fourteen banks are direct clearers for the Australian Paper Clearing System. Other members of this clearing stream settle on an agency basis. The Bulk Electronic Clearing System has 21 direct clearers and allows approved organisations, currently numbering over 59,000, to make arrangements with

12 Trade Practices Commission Determination 1993, p.29.
13 Trade Practices Commission Determination, 1993, p.32.

their financial institution to debit and/or credit large numbers of customer accounts regularly. Organisations can be credit users in the system making payments (direct credits) such as the Commonwealth Government does with social security payments or as large employers do if they directly credit employees' accounts with wage and salary payments. Organisations can also be debit users receiving payments (direct debits) such as payments for insurance premiums, payments for utility bills and mortgage repayments.

7.195 APCA's application to the ACCC for the Consumer Electronic Clearing System envisages a single category of membership in which those financial institutions which issue credit and debit cards and those financial institutions which 'acquire' the merchant transaction act as principals.[14] The rules will cover ATM interchanges and EFTPOS only. Providers of credit cards (Visa, MasterCard and Bankcard) have set their own rules for participation in their respective schemes and for clearing, where it arises. Charge card arrangements also fall outside the APCA umbrella. Chapter 2 provided details on the various transaction cards in use and being trialed in Australia.

7.196 The rules for APCA's High Value Clearing System have yet to be developed. Currently there are only 5 banks participating in settlement for high-value electronic transactions — the 4 majors and the Colonial State Bank. Settlement for all other banks and financial institutions is undertaken by these banks on an agency basis.[15] However, APCA has advised that membership will be limited to those institutions with ESAs at the RBA.[16]

Australian Payments System Council

7.197 The Australian Payments System Council was established in 1984 to advise the Treasurer on the development of Australia's payments system. In May 1993, the Council was given a new charter to give greater recognition to consumer interests. The Secretariat and Chair of the Council are provided by the RBA.

14 Australian Payments Clearing Association 1996, p.2.1.

15 Westpac Banking Corporation, Submission No. 90 to the Financial System Inquiry, p.130.

16 Australian Payments Clearing Association, Submission No. 33 to the Financial System Inquiry, p.18.

Views Presented in Submissions

7.198 Issues raised in submissions fell broadly into 4 groups:

- implications of new technology;
- stored value cards (SVCs);
- access to the payments, clearing and settlement systems; and
- rules for the conduct of the payments system.

Implications of New Technology

7.199 The first group of issues related to the impact of technology on payments instruments and delivery mechanisms. Banks and insurance companies were concerned that new technology was changing the economics of their industries, meaning that new service providers would be able to provide consumers with access to the payments system through online services. The RBA noted that the emergence of new payment instruments principally raised issues relating to consumer protection, money laundering, tax base erosion and privacy.[17]

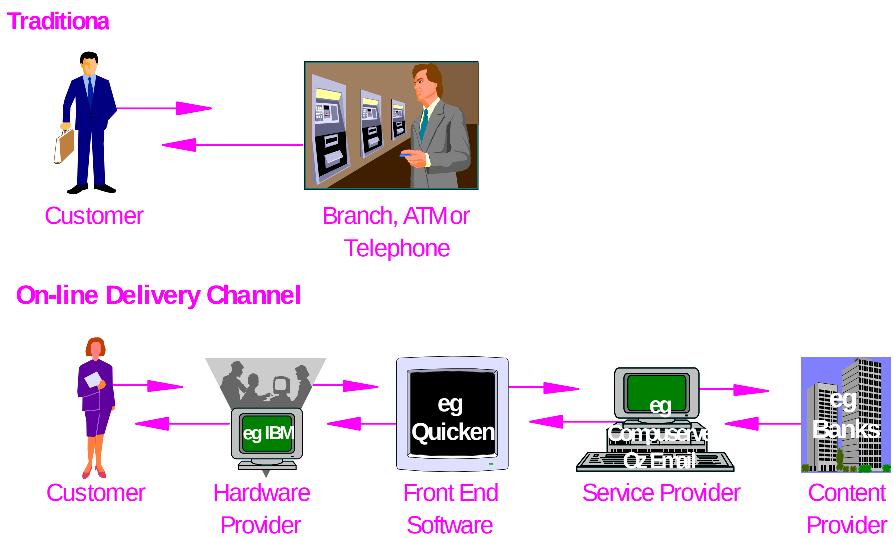
7.200 A significant issue for banks was the growth of new forms of money, such as CyberCash and Digicash, which would allow niche competitors to provide secure and reliable exchange of value over the Internet. Such schemes generally involve the purchase of tokens from the issuing company using conventional payment instruments such as credit card or debit entries to a bank account and then using the tokens to make payments to third parties. Under some scheme designs, the tokens have to be returned directly to the bank or the issuer to be redeemed; in others, the tokens function in the same anonymous way as currency and can be passed from one holder to another. The RBA noted that it liaises with other central banks on the issues posed by these new international monetary systems but is inclined to the view that only supervised financial institutions, with a track record in

17 Reserve Bank of Australia, Submission No. 111 to the Financial System Inquiry, p.71

payments (such as banks), would have the standing and credibility to become large players.[18]

7.201 Another issue was the potential for telecommunications companies and software providers to come between the financial institution and the customer. The change in industry dynamics implied by electronic commerce is illustrated in Figure 7.2. While noting that the potential for software and network suppliers to become the gateways to banks posed difficult commercial issues for banks, the RBA considered that these were not issues of public policy.[19]

Figure 7.2 Traditional Versus Online Delivery Systems



Source: Westpac Banking Corporation, Submission No. 90 to the Financial System Inquiry, based on McKinsey presentation to Virtual Banking Conference, September 1995, p.52.

Stored Value Cards

7.202 Another issue was whether entry requirements and prudential standards should be imposed on issuers of SVCs. Currently, legislation

18 Reserve Bank of Australia, Submission No. 111 to the Financial System Inquiry, pp.70-72
19 Reserve Bank of Australia, Submission No. 111 to the Financial System Inquiry, p.71.

governs rules for cash and paper instruments, but otherwise members of existing clearing systems determine rules for payments instruments.

7.203 One view was that issuers of SVCs should be licensed banks or DTIs.[20] The basis of this argument was that if growth in electronic payment systems were strong then the failure of any payments provider would have a detrimental effect on the overall stability of Australia's payment infrastructure and public confidence in the system.

7.204 The regulatory framework to be applied to SVC products internationally is still undecided.[21] In the United States, the approach to regulation of new payment instruments such as SVCs has been not to impede innovation by premature regulation.[22] However, in the European Union it has been recommended that only authorised DTIs be able to issue SVCs.[23]

7.205 American Express suggested that a SVC is not functionally different from the travellers cheque first issued by American Express in 1891.[24] Noting that a variety of stored value products are already in use all over the world and that their non-bank issuers are subject to regulatory oversight which differs from that of the banks, American Express advised that more than 20 State regulatory authorities in the United States had told the company that a stored value 'electronic travellers cheque' would be regulated under the same State money transmission laws that currently govern paper-based travellers cheques and money orders.

7.206 During the Inquiry's consultations with the SVC issuer, Mondex International, it was noted that at present all shareholders of the Mondex system are banks — except for one subsidiary of AT&T in the United States which holds a limited banking licence. In Australia, the Mondex franchise is owned by the 4 major banks. Banks, as franchise owners, could choose to sub-franchise other institutions.

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20 See for example, Submissions from Westpac Banking Corporation, Submission No. 90; National Australia Bank, Submission No. 131; International Banks Securities Association, Submission No. 146; and Australian Bankers' Association, Submission No. 126 to the Financial System Inquiry.

21 Reserve Bank of Australia, Submission No. 111 to the Financial System Inquiry, p.73.

22 See for example, Kelley, Edward Jr, June 1996.

23 Group on European Union Payments Systems 1994, p.7.

24 American Express International, Submission No. 86 to the Financial System Inquiry, p.6.

7.207 The Australian SVC issuer, Quicklink, cautioned against proscriptive, pre-emptive attempts to regulate SVCs. It suggested that the Australian market could support perhaps 2 or 3 commercially viable national schemes.[25] Pointing to the importance of competition for delivering consumer and economic benefits, Quicklink argued:

> *Given an enlightened approach to regulation, including the introduction of certain regulatory and consumer safeguards and appropriate monitoring structures, there appears little valid argument in favour of limiting participation in the SVC segment of the payment system to the current RBA-regulated institutions.*

7.208 The RBA advised the Inquiry that it had not sought to stifle innovation and that arrangements might be made for unregulated institutions issuing SVCs to provide some assurance to card holders about redeeming value in cards.[26] However, it went on to advise:

> *The RBA is inclined to the view that SVCs which are likely to be widely issued and accepted, and whose use generates significant liabilities which must be cleared and settled, should be issued only by supervised financial institutions.*

Access to the Payments Clearing and Settlement Systems

7.209 A third group of issues related to whether access to the payments settlements system should be liberalised. In this context, Bankers Trust noted that advances in technology will reduce the float period (ie the period between receipt of a cheque and clearance of funds) to zero, allow prior verification of the adequacy of balances and allow instantaneous settlement and transfer of assets. These developments, in Bankers Trust's view, would remove many of the systemic risk concerns about the payments system and focus attention on system's integrity and criteria for membership of the clearing system.

7.210 A number of submissions considered that, because of the critical importance of the payments system to the overall economy and the need to

25 Quicklink Card Systems, Submission No. 102 to the Financial System Inquiry, p.16.
26 Reserve Bank of Australia, Submission No. 111 to the Financial System Inquiry, p.72.

ensure consistency with international standards, only banks and SSPs should be able to provide payment settlements. This view was expressed by the RBA, Commonwealth Bank, Westpac, ANZ, St George Bank and CML. Another view was that access to payments settlements could be extended to non deposit-taking institutions provided such institutions met minimum capital requirements and are subject to oversight by the RBA or the appropriate prudential authority. Proponents of this view included the NAB, CUSCAL, National Mutual, Aussie Home Loans and the Treasury.

7.211 All submissions agreed that the chief considerations in reform of the payments system must be to:

- preserve public confidence in the system;
- maximise the efficiency of the system; and
- ensure that the system is flexible enough to respond to innovations.

7.212 Another issue raised in this context was the appropriate regulatory response for alternative payment systems which could emerge independently of APCA.

7.213 The ACCC, in its submission, declined to make recommendations on clearing systems because of the forthcoming applications from APCA.

7.214 Generally, the major banks were of the view that standards, rules and protocols for the payments system were best determined and administered by APCA and its members. APCA noted that its rules are not institutionally based, and that participation in APCA’s clearing systems is dependent on meeting a set of criteria relating to payments clearing and settlement requirements.

Rules for the Conduct of the Payments System

7.215 A fourth group of issues was clustered around market conduct rules and the need to ensure that third-party users have fair access to electronic networks and infrastructure.

7.216 Of concern to Diners Club were electronic network transaction costs and the merchant commission rate policy of the banks. The major banks were concerned that they received an adequate return on their investment in ATM and EFTPOS infrastructure; but there was a perception in some quarters of inefficient pricing policies. For example, the AAPBS noted that economies of scale were evident in national networks for payments and electronic service delivery, but a cause for concern was the lack of equitable and efficient access to privately owned networks such as the EFTPOS network. The AAPBS therefore recommended that such networks should be regarded as essential facilities in terms of the National Competition Principles Agreement.

7.217 While of the view that no serious abuses of market power had occurred in Australia, American Express was concerned to ensure that appropriate safeguards be built into the system to discourage abuse of market power by dominant market participants.

7.218 Reliance on agency arrangements with banks was raised as a concern in a number of submissions. American Express noted:

> *The regulatory differentiation between banks and non-banks, and between deposit-taking institutions . . . and non deposit-taking institutions . . . has . . . resulted in a highly exclusionary and anti-competitive level of access to the payments clearing system . . . No non deposit-taking institutions can access the payments clearing system except via associate membership in APCA . . . In other words, access to the electronic networks must be via an institution which, as the line between products and issuers blurs, is increasingly likely to be a competitor.*[27]

7.219 The potential for certain service providers to exert monopoly power was raised in a number of submissions. Westpac noted that only Telstra and Optus were investing in the broadband and fibre optic cable technology which has the potential to become part of future new core delivery systems. It therefore recommended that strategic alliances between suppliers of infrastructure and payments systems participants be prohibited.

27 American Express International, Submission No. 86 to the Financial System Inquiry, p.7.

Approach of the Inquiry

7.220 Both the Campbell Committee and 1991 Martin Committee stressed the competitive advantage to institutions in having access to the payments system. While the Campbell Committee recommended that only banks should be granted the authority to have cheques drawn on them, the Committee's clear preference was that indirect participation by non-banks in the payments system be facilitated.[28]

7.221 The foreshadowed amendments to the Cheques and Payment Orders Act would address one source of competitive disadvantage faced by non-bank financial institutions.

7.222 Beyond this, particularly given technological innovations and the range of views canvassed in submissions, the Inquiry considers it appropriate to review the access arrangements to Australia's payments system by considering:

- the efficiency of the system;
- whether the current regulatory regime and industry arrangements encourage innovation and competition among payments participants;
- the scope for further competition in the payments system consistent with the requirement for financial system stability and consumer protection; and
- whether existing arrangements act as a constraint on market innovations in other sectors.

7.223 The Inquiry's particular focus in this area will be as follows.

- It will report on the costs, efficiency and performance of the existing system, including existing electronic and paper clearing arrangements, the role of banks as agents in payments settlements and legislative constraints to innovation.

28 Australian Financial System Inquiry 1981, pp.418-419.

- It will report on the opportunities for a wider range of entities to offer payment instruments such as credit, debit and stored value cards and other payment instruments and present its findings on changes in the financial services sector which may bear on whether access to the various clearing systems is unnecessarily restrictive. In making these observations, the Inquiry will not extend to making recommendations which relate to the responsibility of the ACCC for authorisations. Issues which will be further considered by the Inquiry include:
  - the terms and conditions relating to access to proprietary electronic networks;
  - industry standards and the scope to use standards for anti-competitive purposes;
  - the need to balance the commercial interests of existing network owners against the benefits of wider access in terms of consumer choice and convenience and the need to ensure that putative new entrants are both reputable and financially secure;
  - the scope for anti-competitive arrangements between various financial service providers and telecommunications and software providers; and
  - whether the current regulatory framework, including the scope of industry arrangements, best meets the needs of all groups of consumers and encourages innovation.
- It will make recommendations on the appropriate regulation of SVCs and other new payment instruments, having regard to systemic risk, prudential regulation, consumer protection and competition concerns. The Inquiry will consider:
  - an assessment of the need for legislation for new transaction cards and other payments instruments analogous to the Cheques and Payment Orders Act;
  - how consumer protection objectives can best be met in an environment of increasing online electronic commerce, including via the Internet; and

  — the implications of new international private money issuers such as CyberCash and Digicash for the integrity of existing payments systems.

- It will make recommendations on the role of the RBA in the payments system. This will include assessment of the RBA's activities against national competition policy principles.
- It will present its findings on the implications of liberalising access to ESAs at the RBA, particularly in respect of the efficiency of capital market operations and Australia's standing in international banking markets. Consideration of this issue will depend critically on conclusions the Inquiry reaches with respect to prudential regulation of the financial system as a whole. It will also take into account the implications for international competitiveness and the scope for innovation in those parts of the financial system which most heavily rely on high-quality payments settlement services. Other considerations will include the impacts of RTGS and technological innovation on settlement risk.

Meeting the Cost of Regulation

7.224 Finally, this section addresses how the direct costs of prudential regulation should be met. Since existing arrangements for prudential regulation deal with the issue quite differently in different sectors, the Inquiry will need to address this question in making any recommendations for changes to the regulatory framework.

7.225 Even if no change is recommended or occurs, there may be competitive neutrality grounds for reviewing existing arrangements.

Existing Arrangements

Banks

7.226 There is no formal recovery of the costs of supervising banks. However, banks are paid a below-market rate of interest (5 percentage points below the Treasury Bill rate) on the amounts they hold in non-callable deposits (NCDs) at the RBA. NCDs with the RBA are set at 1 per cent of banks' on-balance sheet liabilities (less capital) and consequently provide an incentive to locate business outside the core bank or otherwise off balance sheet. The charge is a revenue-raising impost by the Government and does not relate to the direct cost of regulation, which is well below the revenue raised from banks. Some view it as a bank licensing fee or implicit deposit insurance. Revenue from the charge amounted to $185 million in 1995-96, or around 4 basis points on the $487 billion in assets of the Australian banking system at June 1996. This compared to the cost of bank regulation of approximately $10 million over the same period.

Building Societies and Credit Unions

7.227 Each credit union and building society pays a supervision levy comprising 2 elements — the direct cost of regulation by its SSA and an element for AFIC. Levies are generally asset based, although AFIC and some SSAs apply caps. Some SSAs distribute costs of operation based on time spent on each industry. In some States, levies are subsidised through government grant, income from contingency funds (for credit unions) or, in the case of Queensland building societies, income from the Queensland Building Societies Fund.

7.228 Over 1995-96, levies varied between 3 and 5 basis points for credit unions and between 1 and 4 basis points for building societies.

Life and General Insurance Companies and Superannuation Funds

7.229 In 1995-96 total expenses of the ISC were around $36 million, with total levies (including those from life and general insurance companies, and superannuation funds) to cover regulation around $38 million. Proceeds accrue to general revenue and the Government funds the ISC through a

Budget allocation based on public service formulae. While the bulk of expenses relates to superannuation funds, a breakdown of expenses for prudential regulation purposes alone is not available.

7.230 Life companies are levied under the *Life Insurance Levy Act 1989* to cover the cost of their regulation. The levy is a fixed amount for each institution ($70,000 in 1995-96) and yielded $3.2 million in 1995-96.

7.231 General insurers are levied under the *General Insurance Supervisory Act 1989*. The levy is on a fixed basis, currently $16,300 per year for each institution, with total levies collected in 1995-96 being $2.5 million.

7.232 Superannuation funds pay a supervisory levy under the *Superannuation Supervisory Levy Act 1991*. In this case, however, the levy is on a sliding scale based on assets ($200 minimum plus an additional $200 for each $500,000 of fund size, to a maximum of $14,000). These levies fund not only prudential regulation but also activities in support of fund compliance with rules associated with retirement income policies, which are the basis of tax advantages for the industry. In 1995-96 total levies due for superannuation funds were around $31 million.

Australian Securities Commission

7.233 The Corporations Scheme is fully funded by cost recovery from revenues collected by the ASC. In 1995-96, total revenue of $275 million was collected by the ASC (mainly in fees for lodgement of company annual returns), of which $126 million was paid to the States under revenue-sharing agreements. Outlays by the ASC were around $128 million.

Other Direct Costs of Regulation

7.234 A variety of other amounts are recovered in the administration and co-ordination of regulatory arrangements. These include the costs of self-regulatory bodies such as the ASX, SFE and APCA, which are funded by participating members using various arrangements, including shares of business.

Views Presented in Submissions

7.235 Most submissions highlighted the impact on competitive neutrality of different approaches to recovering the cost of regulation, including the effects of general revenue-raising imposts such as the NCD arrangements for banks and distortions from different levels and means of raising tax, including State taxes.

7.236 Some agencies highlighted the difficulties with the current budgetary processes, under which funding may be varied without changes in regulatory functions or policies. They suggest substituting approaches to insulate agencies from such variations, subject to appropriate assessment of compliance costs and agency performance.

Approach of the Inquiry

7.237 In its review of arrangements for recovery of the direct costs of regulation, the Inquiry sees the following principles as important:

- user pays;
- competitive neutrality;
- cost effectiveness and accountability, but with adequate funding;
- avoidance of regulatory capture; and
- transparency.

7.238 The user pays criterion generally conflicts with Budget funding of regulation.