

Chapter 8 Summary . . .

Financial Safety

Overview

- Financial safety is fundamental to the smooth operation of the economic system. Government intervention in the form of prudential regulation provides an added level of financial safety beyond that provided by conduct and disclosure regulation. This chapter presents the Inquiry's recommendations on the framework for, and approach to, prudential regulation in Australia.

Key Findings

- The intensity of prudential regulation should be proportional to the degree of market failure which it addresses, but it should not involve a government guarantee of any part of the financial system.
- The framework for the provision of prudential regulation should be designed to ensure that its objectives are clear, that it deals efficiently with the development of financial conglomerates and the blurring of product and institutional boundaries and that it promotes competition by minimising unnecessary or artificial regulatory distinctions between different entities.
- Prudential regulation can have adverse effects on efficiency, competition and innovation and there is scope to adjust existing regulation to reduce these effects, particularly through more flexible rules for the ownership and corporate structure of licensed entities.

Key Recommendations

- The objectives flowing from these findings would best be achieved by combining existing institutionally based prudential regulation in a single agency at the Commonwealth level. This agency, the Australian Prudential Regulation Commission (APRC), should be responsible for the prudential regulation of all deposit taking institutions (DTIs) as well as for life companies, friendly societies, general insurers and superannuation funds.
- The APRC should be separate from the Reserve Bank of Australia, but the two agencies should closely coordinate their respective activities to ensure their regulatory objectives are achieved.
- The APRC should be responsible for licensing prudentially regulated financial entities and for regulating, on prudential grounds, proposals for the merger of existing licensed entities.
- In general, requirements for a wide spread of ownership of DTIs should be retained. Ownership restrictions for DTIs and insurance companies should be rationalised with a 15 per cent maximum shareholding restriction and the more flexible granting of exemptions. Mutual ownership of banks should be allowed.
- Restrictions on corporate structure should be eased to allow the establishment of non-operating holding companies for licensed entities and to allow holding companies to own more than one licensed entity, subject to necessary prudential safeguards. There should be greater flexibility for non-regulated activities to be part of conglomerates which include regulated entities.
- The current arrangements for depositor protection through depositor preference should be retained but clarified and extended to all regulated DTIs. On balance, the benefits of a scheme of deposit insurance are not considered strong enough to warrant its introduction.

Financial Safety

8.1 Introduction

Financial safety is fundamental to the smooth operation of the economic system. Financial services are intermediate inputs to other areas of the economy, linking markets through contemporaneous exchange and through time. Many services that the financial system provides to the economy at large are built on confidence that transactions will clear and that promises will be honoured. Without that confidence, overall economic efficiency can be seriously impaired.

Despite its importance, safety does not require that all financial promises be kept. Risk is an essential component of any financial system and, in an efficient system, is priced to reward those who bear it.

As noted in Chapter 5, however, some financial risks cannot be adequately priced or managed by the market. Some financial promises have the combined characteristics of being onerous to honour, difficult to assess, and of major adverse consequence if breached — not only for the promisee, but for third parties as well. In addition to information asymmetry, of particular concern are threats to system stability. In these areas, the financial system should be subject to a higher intensity of regulation.

This chapter considers government regulations are aimed at financial safety. This form of regulation is usually referred to as prudential regulation.

The chapter begins with a brief review of assurances provided by regulation. It then turns to the two major issues facing the Inquiry in this area:

- the framework for providing prudential regulation; and
- the approach to prudential regulation.

8.2 The Extent of Regulatory Assurances

The general philosophy underlying prudential regulation is outlined in Chapter 5. Prudential regulation is preventative in nature in that it is directed largely at preventing promissory breach through financial failure. Recognising that no system of preventative regulation is perfect in all circumstances, prudential regulation must also deal with the resolution of failure when it does occur. A philosophical issue constraining the design of a system of prudential regulation is appropriately limiting the extent of any regulatory assurance that attaches to regulated financial institutions and products regulated.

It is the Inquiry's view that any regulatory assurance should be tightly circumscribed. The reasons underlying this view are detailed in Chapter 5. Ultimately, it is the responsibility of the management and board of a financial institution to ensure that its businesses deliver on the promises made, and it is not appropriate for government to underwrite them. Prudential regulation adds an extra layer of oversight beyond regulation of disclosure and conduct, but this should not constitute a guarantee.

The Inquiry accepts that the extent of any regulatory assurance is necessarily imprecise. Regulatory action will not always follow the same predetermined path, since circumstances vary. In particular, it is a reality of the regulatory system that financial distress will be handled on a case-by-case basis where potential systemic risk is involved.

Further, systemic risk is related to perceptions. A prudential regulator is required to strike a difficult balance between increasing the likelihood that financial promises are kept and being perceived as the underwriter of those promises. Even if regulatory responsibility is clearly limited by law, the investing public may perceive the regulator as implicitly guaranteeing the

creditworthiness of regulated institutions. Ironically, the regulator is perversely exposed in this respect to its own performance — the better its track record in preventing failure, the more likely the public is to regard the regulator as guaranteeing the underlying promises. Whatever the reality, perceptions can be a source of instability if they are found to be incorrect.

This issue is important in the Australian context. In some areas of prudential regulation, the extent of the regulatory assurance is unclear, even in law. Beyond this lack of clarity, the perceived extent of the regulatory assurance almost certainly exceeds the legal extent in almost all areas of prudential regulation.

An objective of the framework and approach to prudential regulation outlined below is to provide a structure that defines the limits of any regulatory assurance as clearly as possible and offers enough flexibility to adjust it, upwards or downwards, as the nature of the financial system evolves.

8.3 Framework for Prudential Regulation

One of the major issues for this Inquiry is the framework, or institutional structure, for regulation. This section reviews the existing regulatory structure and then considers a series of key issues before recommending a preferred reorganisation of responsibilities. These issues include:

- the coverage of prudential regulation;
- the case for combining regulation of all deposit taking institutions;
- the case for combining regulation of DTIs, insurance and superannuation; and
- the case for separating bank regulation from the Reserve Bank of Australia.

8.3.1 Current Arrangements

The existing framework for prudential regulation is institutionally based, with separate agencies regulating the activities of each class of institution. There are three key agencies and regimes for prudential regulation:

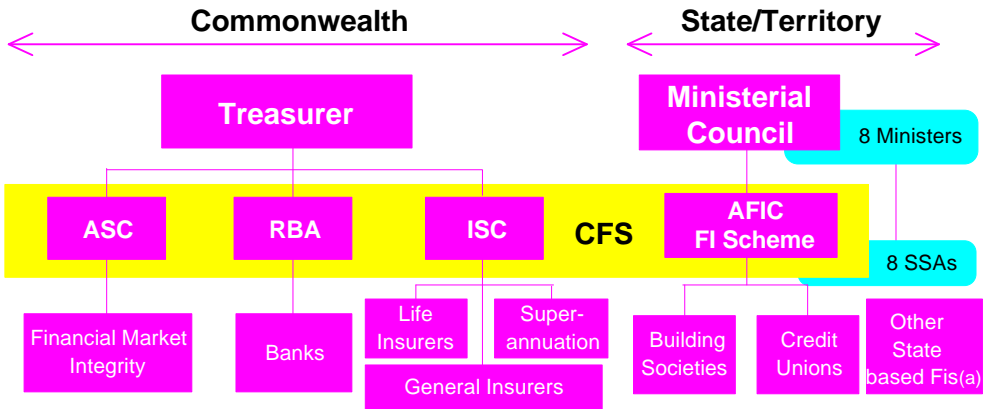
- the Reserve Bank of Australia (RBA) for banks and payments settlement;
- the Insurance and Superannuation Commission (ISC) for life and general insurance and superannuation; and
- the State based Financial Institutions (FI) Scheme that incorporates the Australian Financial Institutions Commission (AFIC) and associated State Supervisory Authorities (SSAs) for the credit union and building society industries (it is expected that prudential regulation of friendly societies will come under the FI Scheme from 1 July 1997).

Figure 8.1 provides an overview of the main regulatory arrangements for Australia's financial institutions. Coordination of prudential regulation is through the Council of Financial Supervisors (CFS), which also includes the Australian Securities Commission (ASC) (which provides lower intensity conduct regulation in a number of areas, as discussed in Chapter 7).

The strengths and weaknesses of this structure, as well as options for rearranging responsibilities, were canvassed in the Discussion Paper. The more important of these are repeated in the discussion below.

Current Prudential Framework . .

Figure 8.1: Overview of Prudential Regulatory Arrangements



(a) Other State based financial institutions include friendly societies, trustee companies and State government owned financial institutions.

8.3.2 The Scope of Prudential Regulation

The existing prudential framework is institutionally based. That is, institutions fall within the ambit of a particular regulator if they carry the relevant label ('insurance company', 'credit union' and so on).

The regulatory philosophy outlined in Chapter 5 argues for the application of intense regulation to financial products according to the characteristics of the promises which they contain. However, in practice, it is often impractical to regulate products directly. Since the objective of regulation is to increase the probability of a promise being honoured, and since this relates to the creditworthiness of the promisor, it follows that the focus of regulation must remain on the promising entity as a whole. The scope of prudential regulation should encompass all institutions offering financial services that carry promises of similar intensity, regardless of their institutional labels. It also follows that each institution should be regulated to a level consistent

with the most intense promise made, unless its various financial services can be quarantined effectively.

In terms of intensity, institutions offering payments services or conducting the general business of deposit taking — including retail banks, building societies and credit unions — are clear candidates for prudential regulation.¹ The nature of deposit taking, particularly transformation of illiquid assets into liquid liabilities, the information asymmetry for depositors and the fact that institutional failure has the potential to cause systemic instability, warrants intense prudential regulation.

Beyond deposit taking, systemic risk declines because failure by any one institution is less likely to generate a run on similar institutions through contagion effects.

There are nonetheless other financial services that rank highly on the scale of promissory intensity. In particular, there is a strong case for prudentially regulating:

- capital backed investment products offered by life insurers and friendly societies;² and
- risk products, including term life and general insurance products.

In the case of the capital backed products, the institution implicitly absorbs the credit risk of the investments involved. The fact that these assets are typically long-term increases the exposure of retail investors and reduces their capacity to make valid judgments about the creditworthiness of the promisor. In the case of term life and general insurance, the institution underwrites event risk for policy holders.

1 Deposits are also taken by a number of other classes of financial entity on a much more restricted basis. The customers of these institutions are made aware of the risks of these investments, usually through a prospectus. These institutions perform a very narrow set of functions with respect to a narrow client base and are well removed from the core of DTIs. Consequently, intense prudential regulation has not been required in these cases and is not proposed by this Inquiry.

2 Capital backed investment products may be offered through statutory funds of life companies or benefit funds of friendly societies. Where offered, additional reserves must be held in the fund to offset a diminution in the value of assets under a range of conditions, including for example, an interest rate increase.

The Inquiry supports the view that deposits, certain capital backed investments and insurance products warrant prudential regulation. However, the intensity and approach to regulation should vary across the spectrum of products. Less intense and intrusive regulation may reflect that the regulatory assurance is lower, that the inherent risks of the product are lower, that the promise associated with the product is less onerous or that the information imbalance for prospective purchasers is less acute. Beyond these products and services, however, the case for prudential regulation becomes much less compelling.

Unit trusts and other managed funds offer returns based on the earnings of a pool of assets managed on a 'best endeavours' basis. While substantial falls in the market value of investments, if sustained, will reduce wealth and may inflict hardship, these are clearly a consequence of the risk accepted by the investor. Market linked investments may still be subject to fraud or managerial incompetence. In general, the appropriate form of regulation for these products is one based mainly on disclosure of the characteristics of the product rather than on the solvency of the entity offering it. Regulation of the conduct of such an entity would normally be considerably less intense than prudential regulation.

The arguable exception to this general rule is superannuation. The compulsory nature of some superannuation savings, the lack of choice for a large proportion of members, the mandatory long-term nature of superannuation and the contribution to superannuation of tax revenue forgone provide a case for prudential regulation of all superannuation funds, even where investors have knowingly accepted market risk. This rationale is complemented by the need for government to regulate the compliance of superannuation funds with retirement income policies such as compulsory preservation. However, the regulatory approach will be different, with its focus more on compliance issues and ensuring appropriate risk management practices, than securing creditworthiness. This aspect is addressed further in Section 8.4.

Therefore, the scope of prudential regulation can be expected to combine institutional and functional coverage. While certain activities may be closely regulated, certain classes of institution such as money market corporations and finance companies should, generally, remain outside the prudential

regulatory scope. Regulation of these institutions is discussed in Section 8.4.2.

Recommendation 30: Prudential regulation should be imposed on deposit taking, insurance and superannuation.

Prudential regulation should be imposed on institutions licensed to conduct the general business of deposit taking from the public, or offering capital backed life products, general insurance products or superannuation investments.

8.3.3 The Case for Amalgamating Regulation of Deposit Taking

The existing regulatory structure includes separate arrangements for banks, building societies and credit unions — institutions that offer essentially the same intensity of financial promises. The building society and credit union industries both made submissions strongly supportive of being brought under a single Commonwealth regulatory scheme, preferably within the same scheme of prudential regulation as applies to banks.

The case for amalgamating prudential regulation of DTIs into a single Commonwealth scheme is driven by regulatory neutrality, competition, efficiency and effectiveness. Where institutions provide similar financial services and products, there is a strong presumption that they are subject to the same regulatory requirements. As discussed in Section 8.4, this does not require that each institution face exactly the same regulatory imposts. In some cases the need for regulatory intervention may be slight; in others quite intrusive. The point is that all institutions providing similar financial services of equivalent promissory intensity should be regulated within the same framework and with the same objectives. The clearest way to achieve this is by having a single regulator.

The FI Scheme was introduced in 1992 and provided, for the first time, a national framework for prudential regulation of non-bank DTIs and their

industry service organisations, SSPs. The prudential standards imposed by AFIC are, in some respects, higher than those imposed by the RBA on banks, and supervision and inspection by SSAs is more intrusive. However, like other cooperative State schemes of the past, the FI Scheme suffers from problems relating to its structure. Industry recognised the potential shortcomings when a State based scheme was first mooted and sought instead the establishment of a Commonwealth scheme.

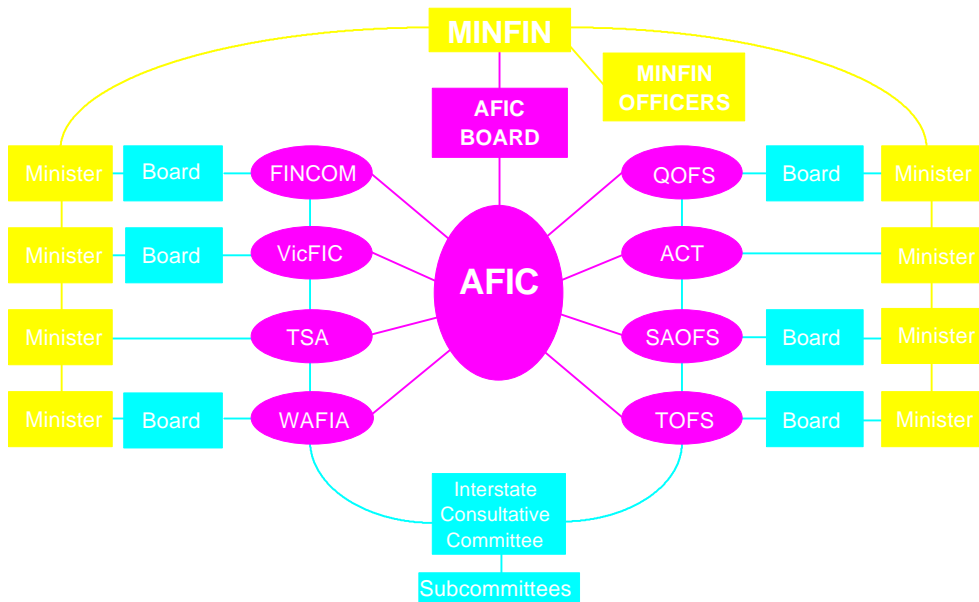
The FI Scheme structure is outlined diagrammatically in Figure 8.2. That the structure is cumbersome, duplicative and costly was reinforced by a number of submissions to the Inquiry. While the FI Scheme has raised the prudential standing of institutions supervised, it has failed to deliver uniformity, cost efficiency or regulatory neutrality either across industries supervised or with competitors in the wider financial system. The excessive layering in the structure has resulted in duplication of supervisory, policy and administrative arrangements; slow decision making in important areas, including legislative review; and conflicts between those making policy and those implementing it.³ Historically, building societies and credit unions have been innovative in the provision of financial services and are capable of increasing market contestability and providing greater choice. The current FI Scheme does not lend itself to this role in the future.

Outside the regulators, submissions overwhelmingly supported amalgamation. Views received on the FI Scheme from State and Territory governments and the FI Scheme regulators were divided. A number recognised the positive contribution of the scheme but considered a move to a Commonwealth framework to be timely, while others argued for retention of a separate scheme. The strongest argument for retention is that parts of the industry have a strong local focus and could suffer from being regulated along with multinational banks and without the benefit of a supervisor with local knowledge. A second argument is that the industry would risk losing its essential character if bundled in with banks.

3 For example, each SSA and AFIC maintain registry functions similar to the ASC's role for companies under the Corporations Law. Societies are not issued Australian Company Numbers, which creates administrative problems in the day to day interface that societies have with the rest of Australia's business community. Interpretation and application of

Financial Institutions Scheme is Cumbersome . . .

Figure 8.2: Financial Institutions Scheme — Statutory Structure



Note: Adapted from AFIC publication *Introducing the Australian Financial Institutions Commission and the Financial Institutions Scheme*.

While these comments reflect genuine concerns, they presuppose an inability on the part of a combined regulator to deal with them. The non-bank DTI industry is already a mixture of building societies and credit unions, of big and small institutions, and of local and national operators. Some SSAs already deal with DTIs, funds managers and insurance providers. Dealing with disparity is a reality for any regulator. It would be incumbent on any combined regulator to establish an approach to regulation that supported the objectives of the industries and institutions involved, allowing those that wished to operate nationally as well as those that wished to remain local to do so. In the same way, the character of each industry is a matter for that industry itself. The regulator should neither force a change in

the law and standards varies between SSAs (and AFIC) affecting the commercial decisions of societies and SSPs.

character nor block one, provided the basic requirements of prudence are met.

On balance, the Inquiry finds the case for amalgamating regulation of all DTIs under one regulatory authority to be compelling. If non-bank DTIs are to be an effective source of competition for the banks in the retail market, it is fundamental that they be able to operate on a national basis and to compete on the same regulatory terms as banks. The FI Scheme has played an important role in establishing the non-bank DTIs on a firm prudential footing, but is not well suited to carrying the industry forward into the next century.

8.3.4 Combining Deposit Taking, Insurance and Superannuation

Whereas the case for amalgamating all DTI prudential regulation is based on the regulatory objective of competitive neutrality, the case for amalgamating prudential regulation of deposit taking with that of insurance and superannuation is based on a broader set of regulatory objectives, including neutrality, cost effectiveness and flexibility. The case has two elements; one based on the existing financial system, and the second based on the Inquiry's view of the future.

The financial system of today is a far cry from the system that existed when current banking and insurance arrangements were put into place. While non-bank DTI and superannuation regulatory arrangements are more recent, each of these was implemented in response to a need that had become urgent in view of industry developments. In neither case was the regulatory structure designed to cope with more than the immediate problems facing the respective industries.

The financial world continues to evolve into a global system of interrelated markets and institutions. While access to these markets has been limited to wholesale market participants, technology is bringing them within reach of retail participants. Product boundaries have come under pressure and institutions now cross-sell products that are well removed from their core businesses of two decades ago. Diversification of activities, creation of conglomerates and the growth of derivatives have introduced new profit

opportunities for old industries and new risks for regulators. Some 80 per cent of Australia's financial system assets are held by financial conglomerates.⁴ While these conglomerates have, in the past, been dominated by a particular activity — banking, insurance or funds management — this is changing rapidly through merger and diversification.

The challenge for the regulatory framework is to foster competition and efficiency, while maintaining acceptable levels of safety for investors. In such a world, there is a strong case for regulatory amalgamation.

- Given that the greater part of the retail financial system is likely, in the foreseeable future, to be dominated by financial conglomerates covering the deposit taking, long-term and retirement income savings and insurance fields, strong regulatory coordination of these entities will be essential. Amalgamation would provide a regulatory structure that more closely reflected the industry's preferred corporate structure and would avoid the need to pursue potentially inconsistent artifices such as lead regulator arrangements.
- Closely substitutable products have already emerged across the spectrum of banking and life insurance businesses. Examples are savings products offered by life companies that have cheque book and card access and, under foreshadowed arrangements, retirement savings accounts offered by both banks and life companies. Inconsistent regulation of these products damages both competitive neutrality and consumer confidence and understanding.
- Amalgamation of existing agencies into a single prudential regulator would offer some economies in regulatory implementation and greater flexibility in marshalling resources to problem areas as they emerge.
- Amalgamation would assist in the development of public understanding of the nature of the 'regulatory assurances' afforded by such regulation, in particular the fact that it does not involve any public guarantees.

4 Reserve Bank of Australia, Submission No. 111, p. 109. Other submissions variously stated that between 70 per cent and 80 per cent of the assets of the financial system were held by conglomerates.

The second case for amalgamating prudential regulation under one institution is driven by a view of where the forces of change may be taking these industries.

The main conclusion of Chapter 4 is that the financial world appears to be entering a period of intense pressure for change. The pressures emanating from technological advances and globalisation of markets appear likely to change the face of financial service provision into the next century. It is not possible, with any certainty, to identify the exact form or direction that these changes will take, or the time frame within which the changes will occur. Several trends are nevertheless relevant:

- as a result of declining information costs, institutions appear likely to dichotomise into large scale finance generalists and boutique finance specialists;
- the finance generalists will continue to seek ways to expand their product range, through either conglomeration or strategic alliances; and
- institutions will continue to seek new methods of service delivery, in some cases cross-selling financial products from elsewhere in the group, in others using third-party delivery mechanisms.

The main message from these trends is that regulators are likely to come under great pressure in coming years to identify where ultimate responsibility for delivery of many financial services lies, to identify risks accurately, and to devise regulations that are effective in achieving their objectives, without obstructing the industry's capacity to innovate and keep up with developments occurring in overseas markets.

This will place great weight on regulatory flexibility. It is critical that the regulatory structure not be limited by lack of vision with respect to the entire financial system. Perhaps, most importantly, flexibility allows reinforcement or retraction of the regulatory scope, in response to changing markets; or the emergence of new, or decline of existing, financial products, services or institutions, as appropriate. It is equally important that regulatory responses, when they are warranted, are not inhibited by lack of jurisdiction or concerns over territory. These demands point clearly to the advantages of a single prudential regulatory authority.

The main arguments against amalgamation are that the products, and hence the approaches to their regulation, display appreciable differences and that there are costs in any change from existing arrangements. The first element of this argument rests largely on the case that certain institutions are special and warrant special treatment perpetuated through regulatory segmentation. Regulatory amalgamation of deposit taking and insurance activities is already under way within the FI Scheme with the pending introduction of prudential regulation for friendly societies under the same scheme as regulation of non-bank DTIs. The second element of the argument simply requires a balance of the costs of change against the benefits of amalgamation.

8.3.5 Proposed Regulatory Framework

While the existing framework of segmented prudential regulators is, arguably, performing adequately, it is, in the Committee's opinion, neither ideal for the financial system as it exists today nor well suited to coping with the pressures that are likely to emerge in the future. The Committee judges the benefits of amalgamating prudential regulation under a single regulator to substantially outweigh the costs associated with disrupting the existing regulatory structure.

A single regulator:

- offers regulatory neutrality and greater efficiency and responsiveness;
- provides a sounder basis for regulating conglomerates;
- offers the prospect of greater resource flexibility and economies of scale in regulation that should enhance the cost effectiveness of regulation; and
- provides the flexibility and breadth of vision to cope with changes that seem likely to occur in the financial system in coming years.

In making its judgment in favour of regulatory amalgamation, the Committee is fully aware that change may emerge differently, or more slowly than suggested in Chapter 4, or possibly not at all. Regulatory amalgamation in this context still represents the best option: if change does

occur, the regulatory structure will be better placed to cope; if change does not occur, the regulatory structure will still be better suited to supporting the efficiency and competitiveness of the financial system as it currently exists. In any event, a measured adjustment to a broader regulatory framework avoids the costs associated with possibly having to make the adjustments under the pressure of a financial crisis at a later date.

8.3.6 Where Should Regulatory Responsibility Reside?

The remaining issue to be resolved with respect to the regulatory framework is where the responsibility for combined prudential regulation should reside. The main options appear to be either to vest responsibility in the RBA, or to establish a new stand-alone regulator to absorb the prudential regulatory functions of the existing agencies including the RBA.

The Case for Separation

In a large number of countries, the prudential regulator is separate from the central bank. In Europe, monetary union will impose a substantial degree of separation on some of the oldest central banks in the world. There are four main arguments that favour the adoption of this approach in Australia, particularly in the event of regulatory amalgamation.

First, the main argument against assigning prudential regulatory responsibility to the RBA is that there are non-bank areas of prudential regulation involved. Inevitably, the RBA's approach to regulation is influenced by the fact that it is itself a bank. Assigning the amalgamated regulatory role to the RBA would run the risk that it would approach regulation from a limited banking perspective, thereby failing to provide the broader perspective that is central to the proposed amalgamation. Few central banks in the world have either sought, or been required to take on, prudential responsibilities that extend beyond the narrow confines of deposit taking.

Secondly, separation assists the task of clarifying the nature of the assurance provided by prudential regulation. While the central bank may provide

support to financial institutions to maintain financial stability, separation makes clear that the balance sheet of the RBA does not provide an implied or automatic guarantee of deposits or other investments, in the event of insolvency of a regulated institution. Again, this is particularly important in the context of the inclusion of non-bank activities within one regulatory agency but the argument applies even without such amalgamation.

Thirdly, separation enables each organisation to focus clearly on its primary objectives and clarifies the lines of accountability for their regulatory tasks. The Combined regulator will have a challenging task and must be able to maintain a broad vision of the role of prudential regulation as the financial system evolves. This is less likely to be the case if the institution has multiple objectives beyond regulation. The regulator will need to attract and retain top-quality staff and expertise if it is to provide a flexible and responsive approach to regulation. This is less likely to be the case if functions other than regulation compete for resources within the institution. A parallel argument applies to the RBA. The rationale for the RBA's existence is central banking. Requiring the RBA to develop new skills beyond its core competence would risk distracting it from its main functions of monetary policy and systemic oversight.

Finally, separating the roles of prudential regulator and provider of emergency liquidity to distressed institutions (which is a role that the Inquiry envisages will remain with the RBA) removes a potential conflict of interest. The key question facing the provider of emergency liquidity is whether or not the recipient institution is illiquid or insolvent. To the extent that the reputation of the regulator may be adversely affected by institutional failure, there is an incentive for liquidity to be provided more readily than may be the case where there is a separation of functions.

The Case Against Separation

The RBA argues against regulatory amalgamation and considers that bank regulation and systemic oversight (including monetary policy) should not be separated. The case for keeping bank regulation with the RBA rests primarily on concern that without bank regulation:

- monetary policy will be less effective;

- the RBA will be restricted in its role as the supplier of emergency liquidity to the system; and
- coordination problems may arise in a systemic crisis.

Bank Regulation and Monetary Policy

The argument that monetary policy is less effective without a close link to bank regulation would certainly have been the case in the pre-Campbell world, where monetary policy and banking policy were synonymous. It has little foundation in the 1990s where monetary policy is market oriented. Monetary policy in the 1990s requires that the RBA have a good understanding of the economy, including the financial system, but the implementation of monetary policy is no longer dependent on the banking system.

It is true that the RBA may, from time to time, need to have regard to the health of the financial sector in determining monetary policy. However, that regard does not require that it be the regulator, only that it have access to the relevant information.

Bank Regulation and Liquidity Support

The second argument concerns the provision of emergency liquidity support.

In Australia, the RBA is the only public sector agency able to provide emergency liquidity and the Inquiry envisages that the RBA will continue in this role. Arguably, as the bank regulator, the RBA's decision to lend to a bank is made easier. Without direct regulatory contact, there would be an incentive for the RBA to duplicate the oversight role (effectively creating a 'shadow' bank regulator) to protect its commercial interests in the event of being called on for liquidity support. A degree of duplication is evident overseas where central banks do not conduct bank regulation. The Inquiry accepts that some duplication is likely, but considers that it can be minimised by creating strong links between the RBA and the independent prudential regulator.

Bank Regulation and Systemic Crises

In a systemic crisis, the response of the central bank will depend on the nature of the problem. Responses to systemic risk are discussed in more detail in Chapter 9. Briefly, a systemic threat originates either from within the financial system, such as a run on a bank, or as a result of an external shock, such as a share market crash. Where there is a threat to liquidity, the central bank works to restore liquidity to maintain confidence and help quarantine the distressed institution(s). Most liquidity is provided to banks through the purchase of securities on market and under repurchase agreements. The banks, in turn, provide liquidity more generally to their customers.

An argument against separation is that the RBA is better placed to provide liquidity through institutions in which it has confidence and which it can trust with a financial exposure.

While there is some merit in this argument, the ability to channel liquidity through the banking system in times of crisis is not fundamentally dependent on having a regulatory function. The RBA would need to have confidence in the institutions through which it would channel liquidity in exceptional circumstances. However, that confidence could be provided in other ways, including close involvement between the bank regulator and the RBA. The Inquiry also recommends a continuing role for the RBA in regulating the payments system, which would also maintain strong RBA relationships with banks and other institutions.

Conclusion

There is undoubtedly some merit in the case to retain banking regulation with the RBA, in view of its other responsibilities. The strength of this case, however, rests largely on retaining bank regulation separate from prudential regulation of other financial institutions, a position which the Inquiry does not support. On balance, the Inquiry considers that the benefits of regulatory amalgamation, and of separation from the RBA, substantially outweigh the other considerations involved.

Accordingly, the Inquiry favours establishment of a new stand-alone prudential regulator of the financial sector, the Australian Prudential

Regulation Commission (APRC). The APRC would take over the prudential regulatory responsibilities from the RBA in the case of banks, the ISC in the case of insurers and certain superannuation products, and AFIC and SSAs in the case of building societies, credit unions, SSPs and friendly societies.

Recommendation 31: A single Commonwealth prudential regulator should be established.

A single Commonwealth agency, the Australian Prudential Regulation Commission (APRC), should be established to carry out prudential regulation in the financial system.

In favouring a more holistic approach to prudential regulation, separate from the RBA, the Inquiry acknowledges that there are both transition costs and the need to ensure regulatory cooperation to address effectively those rare threats to systemic stability. This can best be achieved by establishing close coordination arrangements between the regulator and the RBA. These should include strong linkages at the board level, continuation of the RBA's obligations under the *Financial Corporations Act 1974* to collect information, exchanges of information, joint inspection activities and establishment of bilateral coordination arrangements.

Recommendation 32: The APRC should be separate from, but cooperate closely with, the Reserve Bank of Australia.

The APRC and the Reserve Bank of Australia (RBA) should be separate organisations. However, strong mechanisms should be established to ensure appropriate coordination and cooperation between the two agencies.

- The RBA should have three ex officio members on the APRC Board.
- Provision should be made for full information exchange between the RBA and APRC.
- The RBA should retain responsibility for reporting under the *Financial Corporations Act 1974*.

- Provision should be made for RBA participation in APRC inspection teams.
- A bilateral operational coordination committee, chaired by an RBA deputy governor, should be established to coordinate information exchange, reporting arrangements on financial system developments, and other ongoing operational cooperation between the RBA and APRC, including cooperation in establishing clear procedures for the management of regulated entities which experience financial difficulties.
- The financial system regulators — the RBA, CFSC and APRC — should continue to pursue operational cooperation through a joint council chaired by the RBA.

8.3.7 General Powers of the APRC

One motivation for recommending a single prudential regulator is to provide greater flexibility, responsiveness and efficiency in the face of potentially major changes in the financial landscape. In pursuing these outcomes, it is important that the APRC have wide powers to establish and enforce prudential regulations. It is also important that the APRC be independent of executive government.

Enforcement of prudential regulations is closely linked to licensing powers. The regulator will have many more entities to deal with than any of the existing regulatory agencies. Under these circumstances, it would be impractical, inefficient and unnecessary for the Treasurer to retain a direct role in licensing and other decision making with respect to these institutions. Moreover, minimising the role of executive government in prudential regulation matters would assist in the process of clarifying the limits to the ‘regulatory assurance’ and ensuring the independence of the APRC.

This does not mean that there should be any diminution in the standard of prudential regulation. The recommendations of the Inquiry are predicated on the expectation that the APRC would maintain a high standard of

prudential regulation consistent, in the case of DTIs, with international standards established by the Basle Committee on Banking Supervision.

The best way to ensure these outcomes is to establish a strong regulatory agency which has a high level of responsibility independent of executive government. In particular, the powers of the APRC should include those relating to licensing and the imposition of licence conditions. The APRC must have strong authority analogous to that now conferred on the Treasurer and Governor-General. Thus, where the APRC makes a decision on prudential grounds, such decisions should not be subject to administrative or other review.

Recommendation 33: The APRC should have comprehensive powers to meet its regulatory objectives.

The APRC should be empowered under legislation to:

- establish and enforce prudential regulations on any licensed or approved financial entity — unlicensed entities would be prohibited from offering financial products of specified classes, including deposits (subject to exceptions noted in Recommendation 37), insurance, retirement savings accounts, and superannuation or retirement income products; and
- consistent with prudential requirements, issue, revoke or place conditions on authorities for deposit taking institutions (DTIs), life and general insurance companies or other classes of licence, and approve public offer superannuation fund trustees.

Decisions made by the APRC on prudential grounds should not be subject to administrative or other review.

8.4 Approach to Prudential Regulation

A comprehensive review of existing prudential standards in each of the regulated areas and how they are applied was beyond the scope of this

Inquiry. This section concentrates on the broad approach to regulation and selected issues that arise from the specific changes proposed for the regulatory framework.

The following discussion focuses on three main elements of the regulatory approach:

- the intensity of regulation;
- managing industry entry, ownership and corporate structure; and
- managing failures.

8.4.1 Regulatory Intensity

Prudential regulation is high on the scale of regulatory intensity. As mandatory arrangements prescribed by regulation substitute for the judgment of market participants, subtle changes take place in the incentives they face. Prudential regulation introduces an element of moral hazard;⁵ with less incentive to be vigilant, regulated parties tend to alter their behaviour in ways that often increase risk.

The more prescriptive regulation becomes, the more inherently costly it is. A good regulatory system requires the regulator to strike a balance between the efficiency costs of increasingly intrusive regulation and the benefits such intrusion offers to the effectiveness of regulation. The balance should err, if at all, on the side of efficiency. The Inquiry believes it is critical that regulation remove neither the incentive for parties to investigate before entering financial commitments nor the gains that normally accrue to those who are more adept at gathering and managing information.

Recommendation 34: The intensity of prudential regulation needs to balance financial safety and efficiency.

5 Moral hazard is defined in Chapter 5. For example, in the US, the effect of deposit insurance exacerbated the savings and loan crisis by providing high risk Savings and Loans managers with the opportunity to speculate with the investment of insured deposits, while the government bore the risk arising from depositor losses.

The APRC's charter should emphasise the need to approach prudential regulation in a way that balances the objective of promoting financial safety with the need to minimise the adverse effects on efficiency, competition, innovation and competitive neutrality. This balance should preserve a spectrum of market risk and return choices for retail investors, meeting their differing needs and preferences.

Section 8.3.2, on the scope of prudential coverage, emphasises that prudential regulation covers a range of financial promises that vary widely, not only in the basic nature of the promise but also in the way they combine the three characteristics of onerousness, ease of assessment and consequences of breach. Following are some general comments about the approach to regulation of institutions offering different types of financial products.

Deposit Taking Institutions

Intensity

As noted in Chapter 5 and Section 8.3, deposit taking involves the most intense combination of promissory characteristics. Consequently, DTIs require the most intensive level of prudential regulation. Accordingly, the objective of prudential regulation of DTIs should be to ensure that the risk of loss of depositors' funds is remote.

While recognising that all DTIs fulfil similar economic functions, especially in the provision of retail financial services, there are significant differences among them arising from size, sophistication and markets served. Maintaining this diversity provides for choice, efficiency and competition. Therefore, prudential regulation needs to be sufficiently flexible to accommodate differences in operations, while pursuing the fundamental objectives of stability, efficiency and depositor protection.

Given the diverse size and sophistication of DTIs, the keys to successful prudential regulation are a clear understanding on the part of the regulator of the markets in which institutions operate and a focus on how institutions manage risk.

While quantitative prudential requirements such as capital adequacy, liquidity requirements and large exposure limits should continue, regular on-site reviews of risk management systems should form an integral part of the approach to prudential regulation. Importantly, in view of the growing linkages between financial markets internationally, the standard of prudential regulation for all DTIs should be consistent with that approved by the Basle Committee on Banking Supervision.

Recommendation 35: Prudential regulation of DTIs needs to be consistent with international requirements.

Prudential regulation of all licensed DTIs should be consistent with standards approved by the Basle Committee on Banking Supervision and should aim to ensure that the risk of loss of depositors' funds is remote. Quantitative prudential requirements such as capital adequacy, liquidity requirements and large exposure limits should apply. Regular on-site reviews of risk management systems should form an integral part of the approach to prudential regulation.

Prudential regulation should be sufficiently flexible to accommodate differences in the operation of DTIs, while pursuing the fundamental objectives of stability, efficiency and depositor protection.

Licensing

Currently, a bank licence entitles an institution (usually a company incorporated under the Corporations Law) to hold an exchange settlement account (ESA) with the RBA, to issue cheques in its own name, to accept deposits from the public without issuing a prospectus, and to use the word 'bank' in its name and operations.

Building societies, credit unions and certain industry support organisations are incorporated under the FI Scheme legislation. Such entities are entitled to accept deposits without a prospectus and to use the titles 'building society' or 'credit union'.

Licensing and registration bring institutions under prudential regulation, with the threat of licence withdrawal or deregistration providing the ultimate sanction for the prudential regulator. Enforceable conditions may also be applied to licences for prudential purposes. Strict control of licensing, and registration and use of associated names, contribute to system stability and protection of the public from misrepresentation.

The APRC should oversee a generic DTI licensing regime that accommodates preservation of the existing corporate personalities of 'bank', 'building society' and 'credit union'. The generic licence should provide equal rights to conduct business (other than payments business which is to be separately regulated as set out in Chapter 9) to all classes of deposit taker.

The maintenance of different corporate personalities, as reflected in the use of particular titles, retains commercial flexibility. The Committee favours retention of existing titles, with some restrictions.

To maintain clarity of consumer perceptions, only mutual organisations should be entitled to use the terms 'credit union', 'credit society' or 'mutual' in their titles. There appears, however, to be no similar basis for restricting the use of the term 'building society'. It would be desirable that the incorporation of these entities be transferred from the States/Territories to the CFSC under the Corporations Law.

A continuing distinction between banks and other DTIs remains relevant both in an international setting and in distinguishing those entities large enough to maintain an exchange settlement account with the RBA from other, smaller DTIs. The authority for an entity to use the word 'bank' in its brand should be reserved for licensed DTIs which meet two additional conditions:

- satisfy a minimum capital requirement as prescribed by the APRC from time to time (the Committee suggests retention of the current \$50 million); and
- have an exchange settlement account with the RBA.

The Committee recognises the role played by industry service organisations incorporated as SSPs under the FI Scheme. This role, which is mirrored in a number of countries overseas, provides collective services to small

institutions that do not have the scale economies necessary to justify providing those services in-house. These services may include payments services, treasury management and liquidity support. They are an important historical element of the character of the industry, particularly credit unions, and the Inquiry sees no reason to discourage their continuation, if the industries involved wish to support them. At the same time, there is no need to establish a separate category of entity. SSPs should become companies under Corporations Law and pursue a DTI licence with the APRC.⁶ Such a licence should be able to encompass any activities relevant to the roles they wish to play under the new structure of DTIs.

Recommendation 36: A single DTI licensing regime should be introduced.

The APRC should be responsible for the licensing of all DTIs subject to prudential regulation. DTI licences should be issued such that:

- only those entities which meet minimum capital standards as prescribed by the APRC from time to time, and hold an exchange settlement account (ESA) with the RBA, should be entitled to use the name ‘bank’;
- only those entities which are mutually owned should be entitled to use the name ‘credit union’, ‘credit society’ or ‘mutual’;
- any licensed DTI should be entitled to use the name ‘building society’; and
- licensed DTIs should be entitled to use any other business names provided they are not, in the view of the APRC, misleading to depositors.

Industry support organisations such as special services providers (SSPs) under the Financial Institutions Scheme should become companies under

6 Any required change in corporate personality should provide for preservation of all current relationships and contracts and protection against unintended consequences such as triggering additional stamp duty or crystallising capital gains.

the *Corporations Law* and apply to the APRC for a licence appropriate to the role they wish to pursue.

The incorporation and general corporate regulation of building societies and credit unions should be transferred to the *Corporations Law* and the CFSC.

Unlicensed Deposit Taking

There are a number of savings and investment products that are near substitutes for deposits and there are entities other than banks, building societies and credit unions that accept funds through deposits in limited circumstances. The limited scope of their operations, the transparency of their promises and the absence of contagion risk make their promises less intense than those of DTIs. Consequently, it is not proposed to bring these other classes of institution within the licensed DTI regime.

Fundraising by these other entities is subject to disclosure obligations under the *Corporations Law*. Some classes of institution — for example, pastoral finance companies — have been granted an exemption from prospectus requirements by the ASC on condition that deposit taking is conducted on a strictly limited basis. The rationale for exemption rests in the historic origins of pastoral finance companies and the close, cooperative style relationship with farmers.

Normally, an exemption is granted only in exceptional circumstances, is subject to regular review and is revoked if conditions are not met. In the interests of competitive neutrality and prudential regulation, the APRC should be given an opportunity to comment on any exemption likely to create deposit substitutes or unlicensed DTIs. Any extension of the deposit type role of these entities which increases the intensity of their promises should require licensing as a DTI and hence prudential regulation by the APRC.

Generally, conditions for an exemption should include the requirement for the institution to provide a profile statement clearly indicating that the institution is neither licensed nor prudentially regulated.

Recommendation 37: Deposit taking by unlicensed entities should be restricted and regulated by the CFSC.

The offer of deposits by unlicensed entities should remain subject to the fundraising provisions of the *Corporations Law*. The CFSC should be responsible for the issue of exemptions under the *Corporations Law* from the fundraising requirements for deposit products. Exemption should be granted only in exceptional circumstances, be for five years or less and be subject to revocation if conditions are not met. Conditions should include limiting the scope of any offer, as applies currently for pastoral finance companies. Any extension of the deposit taking role of these entities beyond the scope of the exemption should require licensing and regulation as a DTI by the APRC.

In the interests of competitive neutrality, the APRC should be consulted by the CFSC where exemptions from fundraising provisions of the *Corporations Law* may result in the general offer of deposit products.

Deposit products which are not regulated by the APRC should be disclosed as such in profile statements.

Life Companies and Friendly Societies

Life Companies

Life companies, through statutory funds, offer a range of risk, savings and retirement income products to the public. On the basis of funds managed, more than half of these investments are capital backed. Given the complexity and long-term nature of this business, life companies warrant prudential regulation. While the need for regulatory intervention is less than that for deposits, because the likelihood of either a run or contagion is very low, the regulatory imperative remains relatively high.

Historically, taxation considerations have played a large role in the establishment and growth of these investments in life companies. Around 74 per cent of life company assets are superannuation assets enjoying the associated taxation concessions. Investments in ordinary life company funds are accorded unique taxation treatment, not available to unit trust

investments. This involves a flat tax rate applied to the earnings of life company funds and an exemption from tax (under certain conditions) when the income is received by policy holders.

A particular challenge for the prudential regulation of life companies is to establish a regime which provides competitive neutrality with comparable products, including comparable savings products offered by DTIs, for example, retirement savings accounts (RSAs). The potential gains in terms of competition, however, are unlikely to be substantial unless more neutral taxation arrangements are also introduced.

Recommendation 38: The APCR should regulate life companies.

The APCR should be responsible for the prudential regulation of life companies on a similar basis to that currently applied by the ISC.

However, the prudential regulation of life companies should be designed to provide, as far as is practicable, neutral treatment of life products compared with similar deposit and other investment and risk products. This should minimise the opportunities for regulatory arbitrage between life company investment and deposit taking business.

Friendly Societies

Friendly societies commenced operations in Australia in the mid-nineteenth century as part of the cooperative self-help movement. Providing unemployment, health, pharmacy, endowment and fraternal benefits, friendly societies reached their peak in the 1920s, when 44 per cent of Australians were members of a friendly society.⁷ With the advent of social welfare during the Depression, the government assumed much of the traditional coverage, originally available only through membership of a friendly society.

7 Green & Cromwell 1984.

Friendly societies enjoyed a resurgence in the 1980s when a number of them offered tax advantaged savings products in the form of insurance bonds. The investment earnings of the friendly society were not taxed and earnings were tax free in the hands of the member. At that time, some societies, including new societies established specifically to exploit the tax concession, grew rapidly.⁸ Many of the tax advantages were subsequently removed and today the investment savings products, particularly single premium bonds and annuities, which are similar to those offered by life companies, are subject to broadly similar taxation treatment, including the taxation deeming provisions. Approximately \$8 billion of assets are currently under friendly society management in Australia, down from their 1992 peak of nearly \$10 billion.

With respect to these investment savings products, regulation is a combination of State legislation for incorporation and oversight, and exemptions under the *Life Insurance Act 1995* that allow friendly societies to offer annuities and conduct certain types of life insurance business. Friendly societies provide these financial products through benefit funds which, like the statutory funds of a life company, are not legal entities but exist in the accounts of the society. In many respects, the benefit fund structure offers greater transparency than the equivalent statutory fund structure of a life company. Only one type of benefit is provided per fund, whereas life companies generally offer a number of different types of policies from a single statutory fund.

A State based cooperative scheme for the prudential regulation of friendly societies has been developed over the past six years and is expected to commence on 1 July 1997 as a constituent of the FI Scheme. Like the FI Code for building societies and credit unions, the friendly society legislation provides both for incorporation of societies and prudential regulation of activities, as well as product disclosure.

For reasons of competitive neutrality and to improve consumer understanding, the disclosure and prudential regulation of friendly society

8 This was especially true in Victoria where the maximum benefit limit for any one member was \$150,000 compared with limits of less than \$20,000 in other States. As a result, some 80 per cent of industry assets are held by Victorian societies.

life insurance investment products should be on the same basis as similar products offered by life companies.

While there are some 200 friendly societies, fewer than 70 offer long-term savings investments, typically single premium insurance bonds through a benefit fund structure. The largest 10 societies account for more than 80 per cent of industry assets. A number of friendly societies are effectively conglomerates and offer a range of financial and non-financial services. Most of these other activities either do not warrant prudential regulation or are adequately regulated by other agencies such as health funds regulated by the Private Health Insurance Administrative Council,⁹ pharmacy/dispensary societies regulated by State laws governing pharmacies, provision and management of retirement housing regulated by various State retirement villages laws, superannuation products offered outside benefit funds under the *Superannuation Industry (Supervision) Act 1993* (SIS), and deposit taking through ownership of building societies under the FI Scheme.

The character and activity of the industry is further confused by the number of non-financial entities incorporated as friendly societies. In some States this has occurred where registration as a friendly society was a substitute for incorporation as a club under State associations laws (eg Queensland). In recent years, a number of these societies have elected to transfer incorporation to alternative statutes.

In the interests of competitive neutrality, efficiency and investor protection, the Inquiry believes that friendly society products offered under exemption from the Life Insurance Act should be subject to the same prudential regulation as that applying to life companies. One approach would be to remove the friendly society exemption under the Life Insurance Act. This would force friendly societies either to transfer the affected business to life companies, or to apply for licensing as a life company. An alternative would be to adopt a similar approach to recommendations made for building societies and credit unions, namely:

⁹ The Private Health Insurance Administrative Council is a Commonwealth agency that sets standards, such as reserving requirements, for all entities offering health insurance.

- transfer registration and corporate governance responsibilities to the CFSC;
- subject the offer of financial products and services to disclosure under the Corporations Law and CFSC surveillance; and
- subject the provision of life insurance products to prudential regulation by the APRC. Regulation by the APRC would not preclude continuation of the current approach that eases some prudential requirements applying to low-risk/low-value benefits, such as funeral funds.

Regulation of friendly societies is fragmented and legislation is generally outdated. While a number of States have raised the level of regulation, a strong national prudential framework is long overdue. However, the approach proposed under the new friendly society legislation will create a new disclosure regime for friendly society products, including retail investments regulated currently under the Corporations Law and subject to ASC surveillance.¹⁰

The Inquiry has reservations regarding the fragmentation of investment product disclosure, duplication of infrastructure at the State level and the ability of AFIC and SSAs to maintain consistency with the Corporations Law and ASC enforcement. Against this, the issue of retail investments by friendly societies, other than those offered under exemptions from the Life Insurance Act, is likely to be small and there is an urgent need to establish a modern uniform regulatory scheme. Therefore, the recommended transfer of friendly societies to a Commonwealth regulatory framework should not delay the prior introduction of the new State based arrangements under the FI Scheme.

Disclosure of all friendly society products should be transferred to the Corporations Law and CFSC at the same time as transfer of disclosure of life company products.

¹⁰ The new Friendly Societies Code will duplicate relevant sections of the Corporations Law, be administered by each SSA and be subject to standards issued by AFIC.

Recommendation 39: Regulation of friendly societies should be transferred to the Commonwealth.

The future regulation of friendly societies should provide for:

- transfer of responsibility for registration and corporate governance to the CFSC;
- disclosure regulation under the *Corporations Law* and surveillance by the CFSC; and
- prudential regulation by the APRC of those societies that provide products under exemption from the *Life Insurance Act 1995*.

The recommendation to move to Commonwealth arrangements for the prudential regulation of friendly societies should not delay introduction of the new friendly societies scheme on 1 July 1997.

General Insurance

Whereas claims on life contracts tend to occur according to predictable patterns, general insurance liabilities tend to be unpredictable, arising from accidents and natural disasters. Typically, general insurance contracts tend to be short term, based on year-to-year renewal. In both cases, insurance provides protection by transferring risk of economic loss arising from critical life events from policy holders to insurance companies.

In Australia, the protection provided by general insurance amounts to approximately \$1,600 billion, with around half covering the household sector, and half commercial and industrial assets.

More than other retail financial service providers, general insurers operate on a global basis. Many providers are branches or subsidiaries of foreign insurers and all rely heavily on reinsurance arrangements which operate internationally.

As with life insurance, the rationale for prudential regulation of general insurance is one of consumer protection in the context of substantial

information asymmetry and the adverse consequences for policy holders if insurance claims cannot be met.

Accordingly, there is a continuing role for prudential regulation of general insurance. This is a specialist function, and the licensing and other regulatory arrangements now in place for general insurance should be retained with minimal change under the proposed APRC scheme.

Recommendation 40: The APRC should regulate general insurers.

The APRC should be responsible for the prudential regulation of general insurers on a similar basis to that applied currently by the ISC.

Superannuation

General approach

The general rationale for the prudential regulation of superannuation was discussed in Section 8.3.2.

Most superannuation is offered under a trust structure and all superannuation is subject to rules under the SIS regime. In broad terms, these rules cover:

- management of the trust structure, with trustees charged with prudent management on behalf of fund members;
- vesting, preservation and portability;
- requirements that member benefits be fully secure and not restricted by lien; and
- obligations to inform members through annual reports detailing benefits, fees and charges, investment strategy and the fund's financial position.

Prudential regulation of superannuation is necessarily at the lower end of the intensity scale. With the exception of capital backed investments and defined benefit funds, the risk in superannuation investments is largely

retained by the investor. As Australians of all ages increasingly participate in superannuation investments, it is important both for investment choice and allocative efficiency of the broader economy, that prudential regulation not diminish the risk spectrum of available superannuation investments.

There is no single ‘superannuation’ product or class of provider. Where superannuation takes the form of a deposit or other capital backed product, it should be prudentially regulated on the same basis as similar products. However, where it is a risk product (as in most cases) the focus of regulation is on ensuring that superannuation funds have risk management strategies and conduct, and administrative systems, which are appropriate to their purpose and accord with both government requirements and with the governing investment policies contained in the trust deed.

It is efficient to link prudential regulation of superannuation, where it is required, with regulation to ensure compliance with government retirement income policies, ensuring that superannuation providers face a single regulator and that inspections can be undertaken on a comprehensive basis.

Recommendation 41: The APCR should regulate superannuation in accordance with retirement objectives.

Regulation to ensure the compliance of superannuation funds, other than excluded funds, with retirement income requirements should be undertaken by the APCR in conjunction with prudential regulation. Disclosure regulation should be undertaken by the CFSC.

Excluded Funds

Excluded funds are superannuation funds with fewer than five beneficiaries. These were established to allow the self-employed and small businesses to maintain their own cost-effective superannuation vehicles. Excluded funds are largely self-managed and presently number some 140,000. While they are subject to SIS, some requirements are relaxed in recognition of the close relationship between trustees and members.

The Inquiry considers that self-managed funds provide a worthwhile and competitive option for superannuation investors. However, as self-managed funds, they should not be subject to prudential regulation. To apply prudential regulation in such circumstances is impracticable. Moreover, it should be made clear that such schemes are conducted entirely at the risk of the beneficiaries — in relation to financial safety, there should be no regulatory assurance attaching to such schemes.

A better approach to self-managed funds would be for the Australian Taxation Office (ATO) to regain responsibility for ensuring that the limited SIS requirements are met. The ATO has responsibility for ensuring that the taxation rules which are of central importance for superannuation are met, and has the resources and powers appropriate for regulation of this kind.

At present, some excluded funds have beneficiaries who are at arm's length from the trustees. This is unsatisfactory to the extent that there is little protection of the interests of these third-party beneficiaries and because there is little practical scope for effective prudential regulation of such funds. The Inquiry considers that funds which have third-party beneficiaries should not be regarded as excluded funds. On balance, the Committee would prefer to discourage this particular configuration of superannuation structure.

The Committee believes that there is opportunity to improve the prudence and compliance of excluded funds by requiring all beneficiaries of such funds to be trustees.

Recommendation 42: Compliance by excluded funds should be monitored by the Australian Taxation Office.

Excluded funds should not be subject to prudential regulation by the APRC. Regulation of compliance with the other requirements of the *Superannuation Industry (Supervision) Act 1993* should be transferred to the Australian Taxation Office. Measures to improve prudent behaviour should include:

- increasing responsibilities on trustees and auditors to ensure compliance by excluded funds with retirement income laws; and
- requiring all members of excluded funds to be trustees.

Retirement Savings Accounts

RSAs are expected to be offered from 1 July 1997 with the commencement of the *Retirement Savings Account Act 1997*.¹¹ RSAs are a superannuation product without a trust structure, offered by a limited range of institutions that are subject to a high level of prudential regulation. To a degree, prudential regulation substitutes for the protection offered by the trust structure required of other superannuation products under the SIS regime.

RSAs will carry the same tax preferred status as other superannuation products. SIS rules governing superannuation savings will also apply to RSAs, the main exception being the requirement for a trust structure. Where offered by a bank, building society or credit union, an RSA will be an account on the balance sheet of the DTI, similar to a deposit account. Where offered by a life company, the RSA will be a contracted policy, similar to a life policy, provided through a statutory fund.¹²

Under the existing regulatory framework, the RBA is responsible for prudential regulation of banks; AFIC and SSAs for the regulation of building societies and credit unions; and the ISC life company division for the regulation of life insurers. The ISC augments this institutional approach with functional regulation of RSAs to ensure compliance with retirement income and other superannuation standards such as preservation and vesting requirements.

Under the regulatory arrangements proposed by the Inquiry, this regulation would be greatly rationalised. The APRC would be the sole regulator for prudential and superannuation compliance purposes. The CFSC would be responsible for disclosure obligations. While only licensed DTIs and life companies will be able to offer RSAs initially, it may be appropriate to extend the entitlement to offer RSAs to any other institution offering deposit or investment products that can satisfy capital requirements and is subject to prudential regulation by the APRC.

11 Legislation is expected to be passed during the 1997 Budget sittings of Parliament.

12 Friendly societies are expected to come under the FI Scheme from 1 July 1997. Once the industry has achieved full compliance, there is a possibility that friendly societies may be approved to offer RSAs.

Recommendation 43: Other APRC regulated institutions should have the right to offer retirement savings accounts.

The right to offer retirement savings accounts (RSAs) should be extended to any institution able to offer capital backed deposit and investment products subject to prudential regulation by the APRC.

Disclosure regulation of RSAs should be transferred to the CFSC.

The Role of Market Forces

As noted in Section 8.2, the primary responsibility for prudent behaviour rests with the board and management of a financial institution. Effective disclosure can increase this accountability and help clarify the role (and ‘regulatory assurance’) of prudential regulators. Such disclosure should be seen as supportive of prudential regulation, not as an alternative to it.

To maximise the extent to which market disciplines can contribute to encouraging prudent behaviour, it is desirable that prudentially regulated entities be subject to the same disciplines of disclosure as those applied to unregulated entities. It is also desirable that the operations of the APRC be publicly disclosed to the maximum extent practicable.

Recommendation 44: The APRC should promote more transparent disclosure.

To promote further transparency for markets in assessing the risks posed by financial institutions’ activities, prudentially regulated institutions should meet CFSC standards of public disclosure. The APRC should promote further disclosure of indicators of the risk assumed by the entities which it regulates.

8.4.2 Regulation of Entry, Ownership and Corporate Structure

Restrictions on entry, ownership and corporate structure play an important role in prudential regulation. These prudential considerations should be distinguished from the competition and foreign investment issues that are considered in the regulation of mergers. These additional issues are examined in Chapter 10.

To minimise adverse effects on competition, restrictions should be kept to the minimum essential for meeting prudential objectives. Entry, ownership and corporate structure are regulated to ensure that:

- owners (or potential owners) are ‘fit and proper’ to conduct licensed activities and will comply with prudential regulation;
- the safety and stability of a financial institution are not prejudiced by its ownership structure;
- regulated financial entities have the capacity to undertake the financial activities for which they are licensed; and
- corporate structures are adopted which best facilitate regulatory arrangements for depositor or investor protection are used.

Restrictions on Entry and Ownership

In Australia, the main objectives of entry and ownership restrictions have been to achieve the following:

- a wide spread of ownership, particularly of DTIs;
- transparency of the ownership structure;
- separation of the ownership of the financial sector from that of other sectors — in general, groups containing regulated financial entities are not allowed to include substantial non-financial operations;
- prevention of mutual ownership of banks; and
- imposition of adequate capital requirements.

These tests have been administered through licence conditions or through specific laws restricting shareholdings.

- The *Banks (Shareholdings) Act 1972* places a general limit on shareholdings in banks of 10 per cent of voting shares. The Treasurer may provide exemptions up to 15 per cent and the Governor-General may provide an exemption up to any higher level if this is considered to be in the national interest. To date, the higher exemptions have mostly been applied to allow bank (or life company) acquisitions of banks, or to allow foreign banks to establish wholly owned subsidiaries in Australia.
- The *Insurance Acquisitions and Takeovers Act 1991* provides that, where share acquisitions or issues would result in a controlling interest of more than 15 per cent, the Treasurer must be notified. The Treasurer then has 30 days to provide a conditional or unconditional approval or to issue a restraining order.¹³
- The FI Code imposes on building societies and potentially other institutions under the FI Scheme, a general maximum shareholding limit of 10 per cent of any class of shares but provides for exemptions in accordance with standards issued by AFIC. The basic tenet of the standards is that exemptions will be granted only for 100 per cent ownership by a conglomerate which can satisfy a test as to spread of ownership of the ultimate holding entity.

Spread of Ownership and Shareholder Restrictions

Spread of ownership protects institutions against undue influence by a major shareholder and creates a broad interest group in the shareholder base. A dispersed ownership base also protects against a form of contagion risk that may otherwise occur if a financial institution is associated with adverse changes in the fortunes of a major shareholder.

The Inquiry considers that the concept has sufficient weight to justify the continued application of the spread of ownership objective as a general principle for DTIs. The case is much weaker for insurance companies, which are less susceptible to contagion effects. Exceptions to the principle should be relatively rare, but could be considered on their merits.

¹³ In practice, many acquisitions are authorised by the ISC under a delegation from the Treasurer.

With the growing importance of financial conglomerates and the bringing together of the prudential regulation of all DTIs, life companies and general insurers, it would be desirable to streamline the regulation of ownership and apply rules consistently to all such entities (and their holding companies).

The Inquiry considers that the arrangements would be simplified by a single threshold test. It favours a single rule of 15 per cent which is the level that applies under the regulation of foreign investment. Replacing the various acts and rules with a single Acquisitions Act covering all DTIs and insurance companies would streamline administration and remove some of the inappropriate perceptions of the ‘specialness’ of financial entities. Exemption for existing licence holders should be determined by the APRC (even where the licence is held by an entity in the same group). Approval for foreign ownership or ownership by non-financial entities above this limit should be determined by the Treasurer (rather than the Governor-General), giving consideration to the prudential regulator’s advice on prudential matters, such as ‘fit and proper’ person tests and ability to meet prudential standards on a continuing basis.

Giving power of approval to the APRC would facilitate more efficient processing of applications for ownership exemptions. All acquisitions would remain subject to competition regulation, and takeovers of a public company would remain subject to regulation under the Corporations Law.

Other requests for exemption would be relatively infrequent and should be determined by the Treasurer (or APRC under delegation from the Treasurer), applying a national interest test.

Recommendation 45: The principle of spread of ownership should be retained and regulation rationalised.

The general principle of a wide spread of ownership of regulated financial entities (or holding companies where part of a conglomerate) should be retained. Existing legislation and rules should be streamlined through the introduction of a single Acquisitions Act with a common 15 per cent shareholding limit. Exemptions may be granted as follows.

- The APRC should have power to approve, subject to prudential requirements, an exemption allowing a licence holder to acquire more than 15 per cent of a licensed institution.
- Any other person may acquire more than 15 per cent of a licensed institution only if the Treasurer approves the acquisition in the national interest.

Separation of Financial and Other Sectors

Current policy generally requires the separation of the ownership of DTIs and life companies from other sectors of the economy. Again, this is justified principally on the basis of the need to ensure that the safety of the financial sector is not compromised by the influence or fortunes of other entities.

While these policies are similar to those applied in the US and UK, separation is not required in many other countries.

The effect of these policies is to prohibit the ownership of substantial shareholdings in regulated financial corporations by non-regulated entities and to prevent regulated financial corporations from developing or acquiring industrial companies. This restricts potential competition (both in financial and industrial markets) and potentially damages innovation in the Australian market.

The developments in the financial sector noted in Part One include the development of strong links between some financial entities and telecommunications, information technology and the retailing sectors. Other institutions are finding it commercially attractive to develop capacities which support their financial businesses but which have a non-financial character and may develop as broader business opportunities. Such developments could be hindered by an unduly restrictive approach to the separation principle.

On balance, the Inquiry considers that the case is sufficiently strong for separation to be retained as a broad guiding principle. However, the desirability of fostering innovation and greater competition justifies greater flexibility in the application of this principle. The APRC should be able to

consider on their merits applications for licences, or the approval of acquisitions by licensed entities, that would result in groups which include some non-financial activities.

In such cases, consideration would need to be given to corporate and ownership structure and the effectiveness of firewalls separating financial and other activities of the group. The APRC should be empowered to apply conditions on the issue of licences, to satisfy prudential concerns. The RBA should have a correspondingly more flexible approach in considering those entities to which it will issue an ESA.

Recommendation 46: The approach to sectoral separation needs to be more flexible.

The general principle of separation of regulated financial activities from other activities should be retained, but applied with greater flexibility than at present, having regard for:

- the congruity of non-regulated activities with provision of financial services;
- relevant experience in the intended regulated financial activity; and
- whether prudential regulations will be met on a continuing basis, including any additional requirements deemed necessary.

Mutuality

Mutual enterprises in Australia, such as credit unions, building societies and some mutual life companies, trace their origins to the cooperative self-help movement of the mid-nineteenth century.¹⁴ The traditional focus of the board and management of a mutual is the maximisation of benefits to members. The capital of such institutions is usually in the form of reserves only, accumulated and held in perpetuity for the benefit of current and

¹⁴ A number of building societies and life companies have demutualised in recent years, issuing new share capital and allocating reserves to members.

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 contrasts with most corporations where boards and management focus on the interests of shareholders, whose ordinary voting rights are ‘one share, one vote’.

In Australia, there is a general prudential policy opposed to mutual ownership of banks. The main concern is the ability of a mutual to access capital. Pursuant to this policy, conversion of building societies to banks has been accompanied by full demutualisation. Where a mutual life company has acquired a bank, it has been required to demutualise within an agreed period.

Only credit unions remain a purely mutual industry in the Australian financial system.¹⁵ In contrast, in Europe and Canada some 20 per cent of banking is conducted by mutual institutions and the largest bank in Europe is a mutual.

The Inquiry does not consider that the continued prohibition on mutual ownership of banks on the grounds of access to capital is justified. Therefore, provided that any prospective mutual bank can satisfy prudential requirements, including access to capital, the APRC should be willing to consider applications from mutual entities for banking authorities.

Recommendation 47: Mutual entities should be permitted to hold all classes of licences.

Mutual ownership of all types of licence and authority holders should be accommodated, provided they can satisfy essential tests of probity and financial standing and ongoing compliance with capital requirements.

15 The friendly society industry is also mutual. However, unlike legislation regulating credit unions, the new friendly society legislation provides for demutualisation and equity raisings by friendly societies. While building societies are classed as cooperatives, the industry is a mix of mutual, demutualised and wholly owned institutions.

Minimum Capital and Other New Licence Tests

In addition to probity tests, initial licensing requirements include minimum capital requirements directed at ensuring the substance of potential licensees.

In the case of local incorporation of entities applying for bank licences, conditions include a minimum capital of \$50 million. Where foreign banks are authorised to operate bank branches in Australia, there is no explicit capital requirement. However, foreign bank branches are prevented by regulation from accepting retail deposits in Australia (defined as deposits with an opening balance of \$250,000 or less). The restriction on retail deposit taking relates to the RBA's powers of resolution in the event of distress, particularly in relation to depositor protection.

In the case of other DTIs, incorporation and registration as a new building society carries a requirement for \$10 million in capital, with credit unions subject to formation requirements that reflect their cooperative status.¹⁶

In the case of other licensed financial entities, life insurers require base capital of \$10 million and general insurers \$2 million.

To an extent, minimum capital requirements are a screening device, deterring inadequate applications for licences. In general, they should be retained. However, in the case of DTIs which come within the umbrella of an industry support organisation (SSPs or their successors under the new licensing arrangements), requirements should be flexible to ensure that they do not unnecessarily restrict the entry of new and often innovative participants.

Recommendation 48: New entrants should be subject to minimum capital and other requirements.

16 There is no minimum base capital requirement for credit unions but capital adequacy must be met continuously. Sponsors of a proposed credit union must satisfy the SSA that the proposals are viable in the longer term, that the proposed credit union will attract at least \$200,000 in deposits in a reasonable period and that it is be able to meet all prudential standards.

In general, the existing entry capital requirements should be retained. However, the APRC should take a flexible and facilitative approach to allowing new DTI licences where the entities meet other prudential requirements and are assisted by industry support organisations.

Financial Conglomerates

Conglomerates are groups of companies under common control whose predominant activities consist of providing at least two different classes of financial services.¹⁷

Under current policy, the issue of a banking authority requires the parent entity to be a bank—either an Australian licensed bank or an approved foreign bank regulated on a consolidated basis in its home jurisdiction in accordance with the Basle Concordat.¹⁸ 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 Colonial Mutual Life Assurance Society (CML)/State Bank.

Having some 80 per cent of assets, conglomerates are already a dominant feature of Australia's financial system.¹⁹ However, until the CML/State Bank merger, where that group's banking and insurance assets were of similar size, conglomerate operations have been dominated by a particular financial activity—banking, insurance or funds management.

Financial conglomerates are expected to continue to evolve as 'one-stop financial shopping' services. While some may pursue this strategy by

17 For the purposes of this Report, the definition of conglomerates proposed by the Tripartite Group of Securities, Insurance and Bank Regulators (1995 report) has been adopted.

18 The Bank for International Settlements created a standing committee on bank supervision in 1975. This Basle Committee established guidelines for the division of responsibilities among national supervisory agencies. This Concordat has been revised and upgraded several times, with the 1991 addendum setting minimum standards for the supervision of international banks.

19 See section 8.3.4, and Reserve Bank of Australia, Submission No. 111, p. 109.

forming alliances with specialised service providers, others may develop this model by diversifying their operations.

Diversification across traditional sectors of banking, life insurance, funds management and securities can provide economies of scale and scope. Efficiencies or cost savings are likely to be achieved through infrastructure and administrative rationalisation, information technology savings and marketing synergies. At the same time, such structures may facilitate more efficient exploitation of customer databases (within the requirements of privacy laws).

Financial conglomerates also represent a commercial response to regulatory imperfections. Regulatory arbitrage is facilitated by a conglomerate structure, so that products can be offered through the entities within a group which have the lowest regulatory cost. Provided the corporate structure and regulation are appropriate, this form of arbitrage is constructive rather than destructive, as it maximises benefits for consumers, increases competition and competitiveness of institutions and provides a regulatory incentive to ensure regulatory arrangements are responsive and effective.

In banking groups, the RBA has required the parent entity to be a bank and has taken a conservative approach to diversification activity, recognising the difficulty of effective quarantining of activities. The two main concerns are retention of contagion risk among the component entities through brand association and the conflicts of interest within the group.

These considerations must be addressed, but do not of themselves constitute sufficient grounds for restricting the corporate form of conglomerates.

The appropriate corporate structure depends on the ability to establish effective separation through firewalls to minimise or at least control contagion risk and encourage prudent behaviour. The relationship between corporate structure and prudential regulation must confront three separation issues.

The first requirement is legal separation that quarantines the assets and liabilities of the various entities in the conglomerate. In Australia, there is evidence that the provisions for statutory and benefit funds provide one effective form of separation. For example, in the cases of the Regal and

Occidental life insurance companies and the OST Friendly Society, the courts found that the assets allocated by the firm to particular funds — statutory funds in the case of Regal and Occidental and benefit funds in the case of OST — were available only to meet the liabilities of the particular fund and could not be used to meet other creditors or otherwise pooled and shared equitably by all policy holders. This has the effect, in practice, of elevating the ranking of policy holders compared with other creditors and is, in some ways, comparable to the preferred status of deposits under the Banking Act. For banks, these accounting structures are considered to be insufficient and the RBA requires certain activities to be quarantined into special purpose vehicles or subsidiaries with some (if not total) separation of operations, boards and capital.

Beyond this, legal separation is best structured around a non-operating holding company which acts as parent to a group of licensed and other financial entities. Each operating entity must be separately capitalised, subject to effective reporting obligations and be subject to ongoing effective inspection by the prudential regulator. The regulator must also have the power and capacity to monitor the group as a whole, including intra-group activity. There was almost unqualified support in submissions to the Inquiry for the holding company structure as the preferred corporate form for financial conglomerates.

Secondly, while legal firewalls may protect against creditors of one unit seeking to pursue other group entities and relieve the other entities of any formal obligation to support a distressed affiliate, they cannot guarantee economic separation. Any serious threat to the reputation of the brand arising from the failure of any one entity within the group may be met with financial support from other entities to protect the goodwill of the brand. Provided the group can ‘afford’ the support, this is a reasonable response. However, danger arises where a bail out is pursued at the risk of threatening the solvency of other entities in the group, including DTIs.

The third, and perhaps most difficult, task is to engender market perceptions that the activities are in fact separated. Even if both legal and economic separation is achieved, it can be difficult to convince the market that there is a distinction between entities of the same conglomerate and to modify the market's behaviour and pricing of risk accordingly.

Overall, the Inquiry considers that these concerns are not sufficient to stand against the general acceptance of conglomerate structures, given their considerable benefits. In any event, conglomerates are already a well-established feature of financial systems both in Australia and overseas and there is no practical way of preventing their further growth. The regulatory framework must adapt to them, and the establishment of a single prudential regulator as proposed by this Inquiry would represent a considerable step in that direction.

For the operation of conglomerates, the APRC should establish standards covering holding company structures, firewalls, internal controls, intra-group reporting and requirements for independent boards of directors. These, in turn, provide a basis for disclosure, quarantining of some types of assets and liabilities, depositor/investor protection and transparent capital allocation. The transparency offered by a clearly defined corporate structure and associated firewalls promotes market discipline and should assist with management of failure in one or more parts of the conglomerate.

Where the conglomerate can satisfy these requirements, there should be few restrictions on diversification into different financial activities (and some non-financial ones, as noted in the previous section).

The RBA and AFIC currently enforce a policy of prohibiting dual licensing. Thus, a merger of two banks requires one licence to be relinquished following a reasonable transition period. Until recently, the merged bank was also required to quit one of the bank brands.²⁰ The main justification for the single licensing regime is to ensure that depositors are treated equally in the event of a wind-up. However, the Inquiry believes that merged entities should not be forced to relinquish licences and that legitimate commercial strategies may involve establishing and positioning more than one brand under separate licences. While a proliferation of licences is unlikely to meet requirements for transparency and prudence, the issue of additional separate licences to other entities of a group should be considered on merit, provided that probity and capital tests are met.

²⁰ In 1991, the Commonwealth Bank was required to abandon the State Bank Victoria brand. In 1995, Westpac was allowed to retain the Challenge Bank brand under changes to the 'one authority' policy announced by the Hon R. Willis in the Treasurer's Press Release 95/028 on 15 March 1995.

Recommendation 49: Non-operating holding companies should be permitted subject to certain requirements.

Subject to a financial conglomerate meeting prudential requirements, the APRC should permit adoption of a non-operating holding company structure. The structure must satisfy the APRC in the areas of capital, management, adequacy of firewalls, reporting of intra-group activities and independent board representation on subsidiary entities.

Recommendation 50: Multiple licences and other financial activities may be permitted.

A conglomerate should not be prohibited from obtaining a number of classes of licences or conducting non-regulated financial activities. More than one licence of each class should be permitted, provided the APRC is satisfied that arrangements do not compromise prudential standards and that deposit holders and other investors are treated equitably.

Recommendation 51: The APRC should be empowered to access operations of other non-regulated entities in the group.

The APRC should have clear powers to verify intra-group exposures and otherwise be satisfied as to the adequacy of separation of the regulated financial entity from other financial operations within the group, including any holding companies and affiliates such as merchant banks and finance companies.

Prudential Regulation of Other Financial Institutions

Money Market Corporations

Money market corporations, also known as merchant banks, are registered under the *Financial Corporations Act 1974* (FCA). As a class, they have

exemptions under s. 11 of the Banking Act to conduct banking business in Australia and to use the words 'bank', 'banking', etc to describe their activities (although they may not use 'bank' in their name). At December 1996, there were 73 merchant bank groups (comprising 134 individual registered institutions) operating in Australia with around \$60 billion in total assets. Around 95 per cent of assets are held by foreign owned merchant bank groups, 36 of which are subsidiaries of foreign owned banks.²¹

Historically, merchant banks were formed to circumvent restrictions on the issue of banking authorities to foreign banks in Australia and on banking activities more generally. The industry grew fivefold over the 1980s reaching \$55 billion in 1989 (9 per cent of financial system assets) before a substantial retraction in the early 1990s. Though at an historic high, the industry currently represents less than 6 per cent of the financial system. Twelve merchant bank groups have established special purpose vehicles to raise tax-effective funds under s. 128F of the *Income Tax Assessment Act 1936*.

Banking business conducted by merchant banks includes: lending to corporates; dealing in securities; derivative and foreign exchange trading; funds management; investment banking; stock broking; and corporate advisory work. Merchant banks deal mainly with the professional market, cannot take deposits from the public and are otherwise subject to the public fundraising requirements of the Corporations Law. Merchant banks have been a source of financial innovation and competition and have contributed to the sophistication of Australia's financial sector.

The RBA has suggested that Australia is unique in allowing banks to conduct financial intermediation in subsidiaries which are not authorised as banks or other DTIs, credit providers or the like, and which operate outside the ambit of supervised financial institutions. To the extent such activities are conducted by foreign owned banks, they are contrary to one of the principles of the Basle Concordat: that no bank's international operations should be unsupervised.

21 Data provided to the Inquiry by the RBA.

In its submission, the RBA argued that it needed more formal powers to supervise non-bank financial institution (NBFI) subsidiaries of authorised banks and non-bank operations of foreign banks to fulfil obligations under the Bank for International Settlements (BIS) arrangements.

The Inquiry does not believe that prudential regulation should be extended to merchant banks as a class of institution. However, where a merchant bank is part of a group that includes regulated financial entities, the APRC would need to be empowered to access information and inspect the operations of the merchant bank where activities or potential problems may affect the standing of regulated financial entities (see Recommendation 51).

The Inquiry also remains firmly of the view that merchant banks should not be allowed to accept retail deposits because depositor protection does not extend to merchant banks.

Merchant banks have a considerable presence in the securities, foreign exchange and derivatives markets. Generally, merchant banks should not be disqualified from either holding ESAs or participating directly in high-value settlement arrangements, provided they conduct significant settlements on behalf of third parties and meet appropriate prudential (eg liquidity, collateral, capital) and operational requirements.

The International Banks and Securities Association of Australia (IBSA) has suggested current bank regulations are an impediment to foreign institutions, especially foreign banks, applying for authority to operate either as a foreign bank branch or an Australian bank. This may have consequences for competition and efficiency. The main impediments include ownership of the parent entity, the requirement to hold non-callable deposits, prime asset requirements and the effects of interest withholding tax.

The Inquiry considers that these restrictions reduce both the contestability and efficiency of the financial system and has made recommendations which should mitigate many of the ownership restrictions, while maintaining competitive neutrality, financial safety and depositor protection. The other issues are discussed in Chapter 11.

Recommendation 52: Fundraising by money market corporations should be subject to CFSC surveillance.

The fundraising and market conduct activities of money market corporations (merchant banks) should be subject to the *Corporations Law* and CFSC surveillance. Money market corporations should not be permitted to accept retail deposits.

The RBA should continue to register money market corporations under the *Financial Corporations Act 1974* for the purpose of collecting statistics for money and credit aggregates. Current exemptions from the *Banking Act 1959* under s. 11 in respect of banking business and s. 66 in respect of the use of the term ‘bank’ should be applied by the APRC.

Money market corporations, like other entities, should be able to hold ESAs and participate directly in high-value settlement arrangements, provided they conduct significant settlements on behalf of third parties, and meet appropriate prudential (eg liquidity, collateral, capital) and operational requirements.

Finance Companies

Finance companies were established in the period following World War II, often by banks, in response to demand for consumer credit, particularly to purchase cars and whitegoods.²² Along with other NBFIs, finance companies enjoyed strong growth prior to the early 1980s but subsequently declined in importance when many of the trading restrictions imposed on banks were removed as a consequence of deregulation.

Finance companies provide business and consumer lending, including hire-purchase and second mortgage finance, commercial leasing and equipment financing, with some specialists supporting the sales activities of associated industrial concerns, of products such as motor vehicles and computers. There are 107 finance company groups in Australia with total assets of \$50.6 billion. Australian banks own 16 finance company groups

²² Through this period, banks were restricted with respect to interest rates and asset allocation and could not undertake this type of lending on balance sheet.

with assets of \$24.6 billion; there are a further 16 groups of specialist financiers with \$13.6 billion in assets.

Like money market corporations, finance companies are registered under the FCA and provide statistics to the RBA for the purposes of calculating money and credit aggregates. Finance companies do not take deposits but finance operations, mainly in the wholesale market, through the issue of debentures that are subject to public fundraising provisions of the Corporations Law and surveillance by the ASC. In lending to consumers, finance companies are subject to the *Uniform Consumer Credit Code* and, in other instances, to general fair trading laws. There is no prudential regulation of finance companies.

The Inquiry considers that the current regulation of finance companies is appropriate and does not see the need for additional prudential regulation on any of the usual grounds of investor protection, information asymmetry or system stability. Since finance companies' liabilities are longer term with less than 5 per cent of liabilities at call, and since maturity mismatch is minor, the threat of a run or contagion is remote. Several have failed over the past two decades without threatening system stability.

As with merchant banks, the main concern for safety and soundness arises where a finance company is a subsidiary of, or part of a group that includes, regulated financial entities. The APRC needs adequate powers and resources to verify intra-group and related entity exposures and to be satisfied that the finance company affiliate does not introduce imprudent risks to any regulated entity within the group (see Recommendation 51).

Recommendation 53: Fundraising by finance companies should be subject to CFSC surveillance.

The fundraising and market conduct activities of finance companies should be subject to the *Corporations Law* and CFSC surveillance.

The RBA should continue to register finance companies under the *Financial Corporations Act 1974* for the purpose of collecting statistics on money and credit aggregates.

8.4.3 Resolution of Financial Failures

As noted earlier, prudential regulation involves responsibility not only for constraining the risk of institutional failure but also for resolving failure where it does occur. Indeed, resolution of failure is one of the main functions of prudential regulation, particularly where financial promises are most intense.

An unregulated institution fails when it is unable to meet its financial commitments. Following the usually lengthy process of liquidating assets, creditors are paid out according to their ranking. Since failure usually involves insolvency, unsecured creditors are left to absorb any deficiency in capital.

Such a process, if applied to DTIs, could create considerable financial disruption, not least because of the roles DTIs play in the payments system and as repositories for the nation's liquidity. Unlike unregulated institutions, regulated financial institutions are considered to have failed, in prudential terms, long before reaching balance sheet insolvency.

The cornerstone of prudential regulation of DTIs and other regulated financial institutions is capital to provide a buffer against unexpected loss. In the absence of major, unexpected economic upheaval or regulatory failure, the prudential regulator should have adequate notice of financial distress before a capital deficiency emerges. In these circumstances, the regulator should be in a position to arrange the exit of the distressed institution, by merger or sale, before depositors' funds are put at risk. This risk, however, cannot be eliminated, especially in a world where technology is continually opening up new instruments, markets and risks.

Similar issues arise in other areas of prudential regulation, although the urgency of exit management is less obvious. In all cases, it is no longer appropriate for the public to regard any investment, other than currency and government securities, as government guaranteed.

Deposit Taking Institutions

Breaches of prudential standards provide early warning to regulators of distress in regulated institutions. Where an institution is in breach of explicit

prudential standards, some forbearance may be shown by the regulator, problems are unlikely to recur. For example, the institution may be able to

Notwithstanding the obvious importance of forbearance in particular is the most effective way of avoiding depositor losses. In some countries, legislated, to avoid regulatory conflict in such situations.

facilitating a takeover, merger or other reconstruction of the business. In the orderly wind exits, a legislated mechanism for orderly resolution in such circumstances is

Provisions for the resolution of a bank failure are set out in ‘Protection of Depositors’ under Division 2 of the Banking Act. These provisions have often been described as ‘ ’ because, while they are clear how they would operate in practice. To date, they have not been tested

The Banking Act requires the RBA to act to ‘protect’ depositors and empowers it to carry out investigations and, if deemed necessary, assume control of the business of any bank which is unable to meet its obligations or is about to suspend payment. It also provides that the assets of a bank shall be available to meet deposit liabilities prior to all other liabilities of the bank. No such priority exists for depositors with building societies or credit unions under the FI Code.

The question is whether these arrangements — or some modification of them — provide an appropriate basis for managing liquidations of DTIs, if they occur.

The options are relatively limited. A number of countries rely on deposit insurance as an integral component of dealing with liquidation. The variants

on deposit insurance are numerous. Some schemes are government funded, others are industry funded; some are funded in advance, others rely on levies after a problem has arisen; some levy risk adjusted premiums, others levy flat premiums; some cap or co-insure amounts, others do not; and some involve additional layers of regulation while others do not.

The case for deposit insurance is that it provides clearly identified depositor protection in the event of liquidation. This protection can be a two-edged sword. It clearly identifies the limit of the regulatory assurance. Yet, it does little to prevent a run on the distressed institution; indeed, limited insurance may exacerbate a run if professional funds are uninsured. Further, there are particular concerns with adverse effects on market discipline. Overseas experience suggests that in the long run deposit insurance may raise the probability and cost of instability by weakening the incentive structure.²³ Another area of concern is the difficulty inherent in designing an adequate deposit insurance scheme, given the concentration of the Australian banking industry and the expectation that the government would underwrite any such scheme.

The debate over the merits of deposit insurance has a long history. International experience emphasises that some forms of insurance work better than others, and that poorly designed deposit insurance schemes are worse than none at all. While deposit insurance is accepted in most OECD countries in one form or another, the spectacular failure of the savings and loan insurance scheme in the US has created public resistance to the concept in Australia.

The issue for the Inquiry was to decide whether a carefully crafted deposit insurance scheme could improve on existing arrangements. Apart from the ability to establish credible limits on the regulatory assurance, the Inquiry was not convinced that such a scheme would provide a substantially better approach or additional benefits compared with the existing depositor preference mechanism. On balance, the Inquiry was of the opinion that depositor preference on liquidation would provide a greater level of depositor protection than an explicit deposit insurance scheme, without unnecessarily hampering the APRC's capacity to manage exits.

See for example, Garcia 1996.

Existing arrangements nevertheless require some clarification and adjustment. Under the regulatory arrangements proposed by this Inquiry, it would be desirable for competitive neutrality reasons and to ensure clarity for consumers to extend to all licensed DTIs broadly the same arrangements for resolutions. Thus, the functions of the Reserve Bank under Division 2 of the Banking Act should be transferred to the APRC and depositor preference extended to all DTIs.

At the same time, it should be made clear that the resolution arrangements are not intended to confer any form of guarantee over deposits. The legislation should be clarified to ensure that depositors have no recourse to the APRC and that the APRC has no obligation to make good any losses incurred by regulated institutions.

In principle, it would be desirable also to establish a clear definition of the deposits subject to depositor preference. For example, the consumer orientation of depositor preference could be established by excluding commercial deposits or by capping the preference. In practice, both of these courses raise problems that are potentially counterproductive.

Exclusions are only sustainable if identified in the legislation. The commercial interests of the DTI sector, however, would inevitably generate creative ways of circumventing these exclusions. Since products can be renamed more quickly than legislative amendments can be enacted, this route is unlikely to prove fruitful.

Capping depositor preference is an approach adopted in most deposit insurance schemes. Under such an arrangement, depositor preference would operate in two tiers: first preference would apply up to the cap and second preference would apply to all other deposits. However, smaller DTIs which have a much heavier reliance on deposits for their funding than larger institutions could have difficulty attracting larger deposits under such a restriction and would be relatively disadvantaged in the marketplace by an arrangement designed to deal only with circumstances that are likely to arise rarely, if at all. On balance, the Committee concluded that there should be no cap placed on the value of deposits subject to preference.

The preference for deposits under the Act provides a great deal of protection to depositors, provided there is a buffer of equity and other liabilities of the

DTI. In practice, this is so in the case of most banks in Australia as they have substantial non-deposit liabilities. However, most credit unions and building societies and some smaller banks have relatively few non-deposit liabilities. With these smaller institutions, which rely heavily on deposits for funding (and which may have limited access to additional equity capital) there is a case for the continuation (or establishment) of voluntary joint funds which may be called upon to assist with industry exits. Participation in such schemes may enhance their safety and perceptions of safety, improve the cost of funds or possibly facilitate a lower intensity of prudential regulation. Equally, for reasons of competitive neutrality, there should be no compulsion to participate, based on the particular name or class of DTI. Such fidelity funds, which are already established for credit unions, should be used only to support resolution of problems of any distressed institution, and should not be accessible by depositors or promoted as providing explicit deposit insurance.

These funds could be operated as a combined national scheme by the APRC and membership opened to any licensed entities that wished to join. Alternatively, consideration could also be given to delegating the schemes to industry run organisations, under APRC oversight. Membership of such funds could be taken into account by the prudential regulator in determining the nature and intensity of regulation. For example, entities which do not participate in such schemes may be required to diversify their funding base, hold additional capital, or meet stricter rules on liquidity or asset allocation. Such schemes work successfully in Europe in relation to smaller mutual DTIs.

The effectiveness of these arrangements for mutual entities could be further assisted by allowing them to issue non-voting or participating share capital. Since the extent of depositor protection provided by depositor priority is enhanced by increasing non-deposit funding, DTIs should be encouraged to issue a wide range of debt and equity instruments.

If the potential liquidation of a DTI posed a systemic threat, the RBA would be expected to make decisions regarding liquidity support to the system or other institutions. The close operational relationship between the APRC and the RBA proposed in Recommendation 32 would be in place to assist with this contingency. The RBA should retain a general power to do anything necessary to meet its responsibility for system stability. Where the RBA

provides liquidity support it should, as now, have a clear statutory preference ranking behind depositors but ahead of other creditors for any loan made to a DTI that is subsequently wound up.

Recommendation 54: There should be appropriate mechanisms for resolving failure of DTIs.

The depositor preference mechanism that applies to banks should, subject to appropriate transitional arrangements, be extended to all regulated DTIs, and associated resolution arrangements transferred to the APRC and clarified by legislative amendment.

The DTI sector should consider continuing the contingency funds now operated for credit unions either by amalgamation to form a nationally based fund or by establishment of industry based funds to assist the APRC in merger or rehabilitation of member DTIs. Membership should be voluntary and extended to other entities wishing to join. Participation in the scheme should be taken into account by the APRC in determining the nature and intensity of prudential regulation applying to these institutions.

To facilitate depositor protection, restrictions on the classes of debt and equity that may be issued by DTIs, particularly by mutual institutions, should, as far as possible, be removed.

Insurance and Superannuation

As for DTIs, in the event of financial failure of a life company, general insurance company, friendly society or superannuation fund, the APRC should be empowered to replace the fund manager, trustees, auditor and actuary or to appoint an administrator. The APRC or its appointee should then manage the resolution of the entity in the best interests of policy holders or members.

Existing rules which broadly provide that assets of a particular fund can only be applied against the policy and member liabilities of the fund and for recourse by investors against directors, trustees and professional advisers should be retained. For reasons of competitive neutrality, similar arrangements should extend to friendly societies.

Similarly, the additional protection afforded superannuation should be retained. Currently, the Treasurer, on advice from the prudential regulator,

is empowered to levy industry up to 0.05 per cent of assets to make restitution where there has been a significant fraud and restitution is considered to be in the national interest. This cover does not extend to poor investment decisions. To minimise the moral hazard risk of such a scheme, it would be advisable to limit restitution to that necessary to restore the investor's funds to, say, 80 per cent of their value. The scheme should not apply to excluded funds and should apply only to losses incurred by individual scheme beneficiaries (not employer companies).

There is a strong case for extending protection of this type to retirement annuity products, given the onerousness of the implications for retirees of a failure of such products and their importance in supporting the Government's retirement income objectives.

Recommendation 55: There should be appropriate mechanisms for resolving failure of insurance and superannuation.

The APRC should be empowered to replace management control (or, for superannuation funds, trustees) of regulated financial entities in the event of their failure, or in the event that the regulator reasonably forms a view that failure is likely to occur in the absence of such intervention.

Existing policy holder preferences applied to statutory funds of life companies should be retained and extended to benefit funds of friendly societies.

Where losses as a result of serious fraud are incurred by beneficiaries of superannuation funds (other than excluded funds), the Treasurer should have powers, on the advice of the APRC, to levy superannuation funds and other superannuation providers at a rate not exceeding 0.05 per cent of assets where such restitution is considered to be in the national interest. Restitution should be limited to 80 per cent of the original entitlement of beneficiaries as determined by the APRC. Consideration should be given to establishing a similar scheme for other retirement income products such as annuities.