FINANCIAL SECTOR ADVISORY COUNCIL

REVIEW OF THE OUTCOMES OF THE FINANCIAL SYSTEM INQUIRY 1997

AUGUST 2003

ISBN 0 642 74238 3

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FINANCIAL SECTOR ADVISORY COUNCIL — REVIEW OF THE OUTCOMES OF THE FINANCIAL SYSTEM INQUIRY 1997

OVERVIEW

The Australian economy, and its financial system, has proven resilient in the face of considerable world economic and political turmoil over the past 5-10 years and despite continuing uncertainty about the international outlook. Australia has enjoyed continued economic growth and generally positive sentiment despite considerable external and internal shocks including:

- the Asian financial crisis;
- a world economic downturn;
- difficulties in the insurance market, including the ramifications of the events of September 11, and a number of large corporate failures;
- emerging information on lax corporate governance standards, particularly in the United States; and
- extraordinary falls in world stock markets resulting in world wealth destruction.

Globalisation, convergence and technological change are three important forces that will continue to drive the evolution of the financial system. There is a need for policy development and regulatory structures to keep pace with the inevitable interplay of these forces. It is the Council's view that the Australian regulatory system is fundamentally well placed to meet these challenges.

The post-Wallis regulatory reforms took place upon a strong foundation of Australian corporate and financial infrastructure. Successive governments have demonstrated commitment to the timely overhaul of corporate and financial regulatory architectures — involving a comprehensive program of financial deregulation, cemented by a robust system of corporate regulation. Appropriate cooperation between the Commonwealth, States and Territories and the component industries has also contributed immeasurably to Australia's strengths. International cooperation is both necessary and embraced by Australia.

Overall, the past 20 years of public policy development have provided the twin legacies of a coherent regulatory system and sound macroeconomic environment. The critical importance of a stable and efficient financial system in underpinning the real economy has received increased recognition since the Asian financial crisis.

A solid record of economic performance — sustained growth, controlled inflation and ongoing productivity improvement — has insulated the Australian financial system from stress in recent times. However, this strong performance, together with a range of confounding external factors, makes it more difficult to assess the contribution that specific reforms may have made. There is a risk that the favourable economic climate may skew impressions of the impact of recent reforms or the general health of the system. Despite these measurement difficulties, the Council is confident that Australia's financial system is on a firm footing and compares favourably to the rest of the world.

Australia has a highly competitive and contestable financial system. Globalisation and financial convergence have opened up new opportunities for market participants. Considerable rationalisation has occurred across most lines of financial business, resulting in a critical mass more able to contest increasingly international markets. Increasing provision of financial services across borders — particularly the entry of foreign insurers into the domestic market and increased offshore investment of Australian banks — has arguably met with mixed success. The emergence of conglomerate financial institutions is one trend yet to firmly entrench itself in the financial landscape, although there are no barriers to such developments. Adherence to a principles-based, rather than a rules-based framework is seen as one means of limiting the potential for regulation to impact adversely on investment decisions and market entry.

The RBA recently released reforms to wholesale fee setting and the access regime for credit cards aim to change the relative prices of different payments instruments and increase the level of competition to incumbents from both local and international credit card providers. The RBA's reform of this and other areas of the payments system should provide consumers and merchants with efficient pricing signals while ensuring systemic stability of the payments system.

Superannuation remains a key policy challenge because it has brought into stark relief that the interests of the vast majority of the population are aligned with market outcomes. Reducing the opaqueness of the industry through enhanced disclosure and education are seen as important policy prescriptions.

The Council has considered a range of measures to gauge efficiency trends and the international competitiveness of the financial system. The Council has placed emphasis on the use of qualitative evidence in forming its views with some quantitative measures where available. In general, there are indications of early success and significant further potential.

- Financial corporations are now better placed to achieve appropriate scale, to adjust product offerings, and to invest in new technology and risk management systems.

- Australia has succeeded in attracting considerable financial services investment to its shores, with Axiss Australia performing an important facilitative role in this process.

- Consumers have benefited from cost savings, the emergence of alternative providers and through access to new technologies.

- Some industry sectors, especially superannuation, remain relatively high-cost. Removing a number of remaining structural impediments, such as portability rules and lack of fund choice, can be expected to encourage further rationalisation and efficiency.

It is necessary to continue to monitor performance and emerging trends in order to develop and maintain system efficiency and international competitiveness.

The failure of the HIH Insurance Group of companies (HIH) has raised important questions about the appropriateness of the regulatory architecture and the skills available within the regulatory agencies. The Council notes that the general insurance industry was not a major focus of the Financial System Inquiry. The recent amendments to the regulatory framework were necessary to modernise the regime and should go a long way toward preventing repeat episodes. While the origin of problems with HIH certainly pre-dated the formation of the Australian Prudential Regulation Authority (APRA), the Council is concerned that it remains appropriately resourced to meet the growing challenges of regulation and has an appropriate governance structure. The occasional failure of institutions is an expected part of any financial system, however, it should not occur so unexpectedly nor give rise to losses of such magnitude.

In assessing the impact of recent reforms, a strategic and forward-looking perspective needs to be taken. A broad range of qualitative and quantitative indicators must be adopted. Judgement, experience and, inevitably, a degree of subjectivity must also be brought to bear. In addition, it may only be possible for the success or failure of particular reforms to be measured over a longer-term horizon.

The Council is uniquely placed to comment on the state of play and various trends in the financial system. Since its inception in 1998, it has structured its discussions among members and with other representatives of the financial system to address a range of topical concerns and trends in the financial system. The chapter dealing with the **Changing Financial Landscape** documents the issues emerging from these discussions.

It is also timely to provide a qualitative assessment of **Progress Against Key Financial System Inquiry Outcomes** and measure achievement of the Government's objectives in light of the changing environment and emerging trends in the system. The discussion has been arranged around the outcomes articulated by Wallis and seeks to address a number of specific recommendations. Further information indicating the scope of the paper is provided at **Attachment A**.

To supplement its qualitative observations, the Council has developed a range of **Statistical Measures of the Financial System** against which to gauge regulatory trends, efficiency and consumer outcomes, and international competitiveness of the financial system. These are contained in the **Statistical Appendix** at Attachment B.

The measures are designed to assist Government in measuring progress towards financial sector goals of stability and efficiency. They have been compiled with reference to particular outcomes as articulated by Wallis. The measures must be interpreted with caution. They represent only a partial quantitative means of assessing change over time. Their interpretation is likely to lead to some contention.

THE CHANGING FINANCIAL LANDSCAPE

Drivers of change over recent years

The Council considers that until recently bi-partisan political commitment and cooperation among jurisdictions has been a key ingredient in the successful implementation of the Wallis reforms. Australia is a more coherent federation than many other examples around the world, which has worked to its considerable advantage. This has underpinned progress towards a more sensible regulatory architecture.

Over the past 20 or so years, successive governments have demonstrated commitment to the timely overhaul of corporate and financial regulatory architectures — involving a comprehensive program of financial deregulation, cemented by a robust system of corporate regulation. Appropriate cooperation between the Commonwealth, States and Territories and the component industries has also contributed immeasurably to Australia's strengths. International cooperation is both necessary and embraced by Australia.

Australia's economic strength and resilience has underpinned the relatively smooth transition. A lack of concern with inflation and the general health of our financial system relative to South-east Asia and the United States have aided the Wallis reforms. This macroeconomic stability has been accompanied by wide-ranging structural and labour market reforms together with a general focus on business efficiency and competition.

A number of interesting inter-related structural forces have been at play throughout the implementation period.

- ***Globalisation*** is being facilitated by technology, greater comparability in accounting standards, and greater mobility of capital and people. Traditional roles are breaking down as non-financial services competitors (such as retailers, airlines and telecommunications companies) are entering the industry and offering financial services. However, consumers' acceptance and trust of financial promises offered by new (and often unknown) entrants can limit the speed and success of globalisation in some retail markets (for example, banking and insurance).

- ***Financial convergence*** and market widening, where the combination of deregulation and technology is enabling new participants (for example, technology providers) to overtake traditional players and become new owners and controllers in exchange traded markets, and often in the most lucrative markets. There is a danger of risk increasingly being concentrated in entities not subject to prudential regulation (for example, hedge funds) and transferred to relatively uninformed consumers through the use of more sophisticated instruments.

- ***E-Commerce*** and technological developments are advancing the frontier of financial system possibilities. For example, these forces are giving rise to virtual companies dealing in several countries. In an increasingly global financial market, Australia cannot expect to drive the regulatory agenda.

In global terms, the financial system is less consolidated than other industries. Domestic banks continue to maintain the confidence of and hence dominate their home markets. The funds management industry is also widely held. This indicates a possible future trend will be wide-scale merger and acquisition activity as the major players embrace strategies for pursuing ongoing growth.

Other developments

The post-Wallis reforms have taken place in the context of a rather volatile external environment. The Australian economy, and its financial system, has proven resilient in the face of considerable world economic and political turmoil over the past 5-10 years and despite continuing uncertainty about the international outlook. Australia has enjoyed continued economic growth and generally positive sentiment despite considerable external and internal shocks including:

- the Asian financial crisis;
- a world economic downturn;
- difficulties in the insurance market, including the ramifications of the events of September 11, and a number of large corporate failures;
- emerging information on lax corporate governance standards, particularly in the United States; and
- extraordinary falls in world stock markets resulting in world wealth destruction, potentially reflecting a shift back to more realistic growth expectations.

International integration of the financial system has consequences of an international nature for regulatory frameworks. The Wallis vision of principles-based, rather than rules-based regulation, if adhered to, should result in a relatively simpler and less costly regulatory framework. It might also provide Australia with a comparative advantage in terms of lower regulatory costs. It is important that regulators embrace a facilitative role in terms of promoting entry to new markets.

- The concept of 'competing regulation' is seen as relevant, with firms that operate on a global scale concerned with the costs of dealing with multiple regulators.
- Among international institutions, 'convergent regulation' is being promoted in pursuit of financial stability and in order to remove artificial constraints on cross-border activity.

A range of sectoral trends have also emerged demonstrating the continual evolution of the Australian financial sector, including:

- a move into wealth management as envisaged by Wallis, backed by rapid growth in superannuation assets;
- major takeovers and rationalisation within certain sectors;
- a mixed experience with foreign competition across sectors (including by Australian institutions operating abroad), with certain notable exits;
- significant increases in share ownership following demutualisations and privatisations;
- growth in community banking;
- the emergence of third party distributors, notably mortgage brokers and independent financial advisers;
- a significant uptake in technology by consumers of on-line banking and on-line broking;
- new emerging markets and alternative trading platforms;

- a greater proportion of household wealth being held in the form of market claims, with a lesser proportion being held as deposits;
- rapid growth in securitisation and the origination of loans by non-bank financial institutions; and
- margins on conventional lending entering a period of consolidation.

Likely developments over coming years

The Council's deliberations over recent years have been far reaching. The following list represents a sample of the matters which it sees as shaping and contributing to Australia's future success:

- maintaining a bi-partisan political commitment to developing a national vision of long-term financial system policies by closely engaging industry in the policy and reform debate and by participating internationally;
- appreciating the increased risk of financial contagion associated with the globalisation of markets and embracing policies to ensure financial stability;
- Australia's tax competitiveness must be addressed to secure our international position and so as not to distort capital flows;
- further financial sector consolidation appears necessary to achieve sufficient scale to underwrite more vigorous competition and international competitiveness;
- particular sectors, particularly superannuation and insurance require further reform;
- superannuation, particularly, requires attention to reduce the opaqueness of the industry through enhanced disclosure and education;
- with specific exceptions, there generally needs to be a period of regulatory stability from here, to consolidate the gains made; and
- an enduring concern is the mutual dependency between the adequacy of Australia's savings performance and future retirement incomes which will, in turn, help determine the pace of development of Australia's financial system and the depth and breadth of markets.

Benchmarking the Wallis Reforms

Regulatory framework issues

Wallis Outcome 1: Create a flexible regulatory structure which will be more responsive to the forces for change operating on the financial system

Wallis Outcome 2: Clarify regulatory goals

Assessment of Present Position

The regulatory framework has been implemented largely as envisaged by Wallis, with the creation of multiple independent regulatory bodies with clearly defined roles. Some exceptions have emerged on particular issues, notably interchange fees, where there are multiple regulators involved with possibly insufficient clarity as to their roles.

The coverage of prudential regulation is largely as envisaged, although trends in the intensity of prudential regulation, and the balance between institutional and product regulation are still emerging. This balance needs to be struck appropriately, resisting pressure to sacrifice efficiency for stability in the wake of inevitable failures.

Some early criticism was levelled by industry over regulators failing to appropriately consult with industry and each other to ensure a streamlined regulatory approach with reduced compliance costs to business. The Council considers that this has been largely a transitional matter and that regulatory performance over the majority of the post-reform period has been 'leading-edge'.

The Council's major findings in terms of the regulatory framework are that:

- Australia should resist any tendency towards unnecessary re-regulation of the financial sector, particularly prescriptive regulation, as it may come at the cost of hampering business investment opportunities in Australia and abroad, and limit the economic benefits for the national economy; and

- regulators should be encouraged to take a global view in their deliberations, particularly considering the dimensions of international competitiveness and consumer protection measures.

The collapse of the HIH has raised questions over the appropriateness of the prudential framework. The Council notes that the regulatory framework must effectively manage failure in order to achieve greater efficiency, but that the extent of insolvency of HIH should not have occurred. The Council's preliminary view on this matter is that:

- prima facie, there is no evidence of a flaw in the Wallis financial sector reform model, although general insurance was not a major focus of the Inquiry;

- the recent amendments to the regulatory framework were necessary to modernise the regime and should go a long way toward preventing repeat episodes;

- it would be undesirable if further amendments to the regulatory framework, from any level of government, were an over-reaction to the HIH failure rather than justified policy change;

- the origin of the problems with HIH certainly pre-dated APRA but the Government should ensure it is appropriately resourced to meet the growing challenges of regulation into the future;

- the occasional failure of institutions is an expected part of any financial system, however, it should not occur so unexpectedly nor give rise to losses of such magnitude; and

- there is a need to widely and continuously emphasise that price should be a reflection of risk.

Emerging Issues

The reputation of the RBA needs to be preserved to ensure its credibility and to maintain its distance from industry. Its involvement at the margin in consumer issues (for example, in setting interchange fees) is considered potentially too operational and could appropriately be vested in the Australian Competition and Consumer Commission (ACCC). The RBA should focus on its systemic stability functions.

In terms of the role of APRA, there is a need to ensure an appropriate balance between safety and efficiency is struck. The regulatory framework must effectively manage failure, and allow failure to occur, in order to achieve greater efficiency. This may require further guidance to be provided by Government to APRA and other regulators. Financial Sector Advisory Council (FSAC) will continue to monitor and review this situation and will advise government if it considers that the balance requires adjustment.

The overlapping consumer protection roles between Australian Securities and Investments Commission (ASIC) and APRA and between ASIC and the ACCC have been a source of confusion to industry. Recent regulatory changes, while underlining the primary role of ASIC for consumer protection in the financial system, may have led to the roles of the other agencies becoming superseded to some extent. This issue requires further clarification.

The specific role of the ACCC in the financial sector was perhaps not sufficiently examined by Wallis. This issue could also be considered in greater detail in continuing to define the role of the other regulators.

Overall, the Council considers it is necessary to largely 'hold the line' on regulatory intensity and to ensure that there is an appropriate period of stabilisation and bedding down to consolidate the gains.

Regulatory resources, accountability and coordination

Wallis Outcome 3: Increase accountability of the agencies charged with meeting those goals

Assessment of Present Position

The regulatory bodies have been vested with appropriate operational autonomy and generally appropriate governance arrangements. As advocated by Wallis, accountability and reporting by the regulators can be improved.

There is scope for the regulatory agencies to improve their exchange of information, particularly it seems, in co-ordinating views on administrative policy issues prior to commencing public consultation processes. The Council has noted recent improvements in this regard. Implementation of the major reform initiatives has been smooth.

As would be expected, questions of regulatory resourcing and quality have drawn significant comment from industry over time. The Council's view is that, while there is room for improvement, Australia's regulators are generally performing well. Industry criticism has generally concerned the approachability of regulators as well as their promptness and transparency in operations.

There is an ongoing need to ensure that regulators remain appropriately equipped for their task, and are operating as intended. Improved accountability and reporting should assist Government in this regard, and help justify its position to industry. There is possibly a false saving in any attempt to minimise regulatory costs, were it to lead to regulatory failure.

In terms of funding arrangements, the review of Financial Sector Levies will appropriately compile the range of opinions. The Council has heard of instances of cross-subsidisation between and within industry sectors that may warrant attention in any redesign of the levy framework.

FSAC itself has proven to be a useful conduit for eliciting and distilling the views of industry and regulators alike. The Council continues to be recognised by regulators and industry representatives as an important part of the framework and provides independent advice to Government.

Emerging Issues

The Council identified a need to compile quantitative data in order to assess the benefits of the Wallis reforms (though there are likely to be significant measurement difficulties in some cases) and suggested that this data could be categorised into three groups;

- cost of the regulators;
- cost to industry of complying with the regulations; and
- impact of the improvements in the regulatory regime on the overall efficiency of the industry (it was acknowledged that this would be the most difficult to measure).

The Council proposes that a range of partial measures could be adopted by Government to assist it in understanding progress towards key Wallis outcomes and industry trends. These measures are noted below.

The related issues of staff quality, experience and remuneration are drawing increasing attention, including in light of the recommendations of the HIH Royal Commission.

The Council has called upon the Government to re-consider its position on co-funding the financial system regulators given the significant public good aspects of well-functioning markets (in addition to the benefits to firms in the regulated markets).

The Council also notes the recent initiative of the Government, flowing from the HIH Royal Commission, to replace APRA's board with a full-time executive group (or commission style structure).

Quantitative Measures

A range of quantitative measures have been compiled by the Council.

- Operating expenses of regulators (dollars and as a per cent of total financial assets of financial institutions)
- Size of regulated sector (numbers of regulated participants (licensees, exchanges, clearance and settlements systems) and financial institutions, turnover of payments cleared)
- International comparison of direct costs of regulation (as a per cent of GDP)
- APRA consultations (number of consultations, reviews and visits with organisations regulated)
- ASIC activities and results (investigations, enforcement actions and assistance)

Regulatory consistency issues

Wallis Outcome 4: Ensure the regulation of similar financial products is more consistent and promotes competition by improving comparability

Wallis Outcome 5: Introduce greater competitive neutrality across the financial system

Assessment of Present Position

A major theme recurring in Council discussions has been the appropriate balance between institutional and product-based regulation. While accepting that there are merits in the move towards product-based regulation, the Council's view is that although consistency is an objective of virtue, there may be circumstances where it would not be appropriate.

There has been significant achievement in progressing towards the Wallis vision, with the following relevant examples:

- all deposit-taking institutions now fall under the one regulatory umbrella;
- the Financial Services Reform framework has been successfully legislated and is in the process of implementation. This is considered a model of commendable process; and
- friendly societies now fall within the life insurance framework.

Further, reforms to the superannuation, insurance and health insurance industries will promote even greater intra and inter-sector consistency.

The Council has noted that in general, the regulators (APRA and ASIC) have tended to operate independently, whereby they seek consistency in regulatory approach across products for which they are responsible but do not always effectively deal with consistency between products that span the regulators. Some of these issues were discussed under the section dealing with the role of the regulators.

The HIH Royal Commission raised additional issues about the regulatory boundaries in the insurance regime, with particular reference to the need for greater coordination among APRA and ASIC. The appropriate scope of insurance regulation, in light of the operation of mutuals, state government agencies and foreign insurers, is also a live issue.

Emerging Issues

Further gains could be made in relying on disclosure-based regimes to achieve both corporate and prudential regulatory requirements. Disclosure-based regimes should lessen the compliance burden for industry and reduce the need for increased regulatory intensity. There is potentially further progress to be made in moving the prudential framework towards disclosure and market monitoring.

The Council has noted in the past that risks appear to be emerging in the non-regulated sectors (for example, hedge funds and re-insurance), underlining the need for regulators to monitor developments in wholesale markets.

Market efficiency and consumer outcomes

Wallis Outcome 6: Establish more contestable efficient and fair financial markets resulting in reduced costs to consumers

Assessment of Present Position

The Council notes that Australia's financial system is relatively concentrated, but considers, on balance that this has contributed to favourable outcomes for consumers in what may otherwise have been an unstable global environment. Critical mass and scale among service providers have allowed considerable efficiency gains to be made within market structures that foster intense competition among larger firms. Consumers have benefited from cost savings, the emergence of alternative providers and through access to new technologies.

Some industry sectors, especially superannuation, remain relatively high-cost. Removing a number of remaining taxation and structural impediments (such as preservation rules and lack of fund choice) can be expected to encourage further rationalisation and efficiency. The funds management industry remains fragmented, possibly due to low barriers to entry. Better consumer outcomes may be driven through the improved disclosure regime and some rationalisation.

- The recent reforms by the RBAin the credit card market, while controversial in character, are directed at promoting efficiency in the payments business and contestability in the credit card segment.

Members have noted some industry views that the division of responsibilities between the ACCC and ASIC was not clear in respect of consumer protection issues. Members have also discussed the need for regulators to examine overseas approaches to consumer protection.

There has been growth in community banking, which remains, however, a relatively small component of the banking sector. There has been a high symbolic value on a local branch, and local communities are often willing to contribute money for this. The deal between Australian Council of Social Service and Bendigo Bank is an example.

Emerging Issues

A range of major reform initiatives, including the Financial Services Reform Act, interchange fee reform and the implementation of the Basel II capital requirements are creating a strong potential for further industry concentration. Increased compliance costs are making firm scale more critical, particularly in the manufacturing or wholesale components of the financial system. At the front-end or retail level, smaller niche firms are expected to prevail, providing consumer choice.

Industry, particularly the larger banks face a considerable challenge to reverse a decline in customer satisfaction levels despite increasing access and quality of service. The major banks have recently focussed on this issue through the Banking Code of Practice and in-house measures. Customers are increasingly willing to make comparisons and seek alternative service providers intensifying competitive forces and placing increased pressure on margins. The home loan market remains competitive.

Funds will continue to flow rapidly into the wealth management sector. There will be considerable challenges for that industry in delivering acceptable returns in a more volatile global marketplace and in ensuring that such activity delivers positive value to conglomerate business. Increasing expectations on the regulatory infrastructure to deliver better comparability and disclosure may emerge. Achieving greater efficiency in superannuation is important.

From the consumer perspective, credit card reform is expected to generate considerable interest. The RBA also believes that reform of interchange fees on debit cards, used in EFTPOS transactions, is necessary. It is working closely with an industry based EFTPOS working group to deliver a result that provides benefits to merchants and consumers and is workable for the industry.

Consumer indebtedness is very high and although debt service levels have remained manageable, buffered by a growth in household wealth, the household balance sheet will be tested by any turn in economic cycles.

In this context, the housing sector has become a high profile issue as prices have risen and affordability fallen. Regulators have so far responded appropriately to risks (for example, APRA with its home loan health check of banks, credit unions and building societies). Housing, however, exhibits a number of cross-jurisdictional and cross-market issues such as the differentiation between investment advice and real estate sales that will require vigilance by Commonwealth, State and Territory governments.

Quantitative Measures

- Sector composition, entry and exit
- Number of financial products (credit and debit cards, residential mortgage products and personal transaction accounts)
- Margins on lending products
- Estimated costs of fees on deposits or credit
- Access points to the payments system
- Change in transaction and payment types
- Annual inquiries/complaints to main alternative dispute resolution schemes
- Customer satisfaction levels with banking services
- Small business satisfaction with bank service and institutions
- Securitisation of residential mortgages

Regulation of conglomerates and facilitating international competitiveness

Wallis Outcome 7: Provide more effective regulation for financial conglomerates which will also facilitate competition and efficiency

Wallis Outcome 8: Facilitate the international competitiveness of the Australian financial system

Assessment of Present Position

The Wallis perspective was that Australia's general competition framework should prevail over financial system mergers. In addition, Wallis recommended that general foreign investment policy should apply to the financial sector, but that regulation was warranted to ensure ownership diversity. The Government has retained additional policy restrictions on domestic and foreign mergers under the 'four pillars' policy. This may act as a constraint upon efficiency and international competitiveness in time and be brought into question during trade negotiations.

The Council considers that the effect of these restrictions is potentially to distort incentives for firms to pursue economies of scope over economies of scale.

The Council informed the Treasurer of its view that general competition laws and public opinion could be relied upon to achieve appropriate competition and efficiency in the financial system. The Council has had wide-ranging discussions on the issue of appropriate scale of Australian financial institutions and the need to consider it both against the issue of local dominance as well as in the context of international competitiveness.

As part of the Financial Services Reform Act, the shareholding limitation on the Australian Stock Exchange (ASX) was raised from 5 per cent to 15 per cent and that limitation was applied to other licensed financial markets and clearing and settlement facilities that are of national significance. A higher limitation may be approved if it is in the national interest.

Globalisation and financial convergence have opened up new opportunities for market participants to diversify product offerings. The emergence of mixed conglomerate financial institutions (involving a blending of activities previously prevented by the separation of finance and commerce) is one trend yet to firmly entrench itself in the financial landscape, although there appear no particular barriers to such developments. In essence, the approach to sectoral separation appears more flexible now than prior to the Wallis reforms.

The Wallis reforms have made the financial services sector more competitively neutral. For example, Suncorp-Metway's decision to establish itself as a combined banking and insurance operation was not impeded by regulation post-Wallis.

Significant progress has been made by the Government and regulators towards facilitating cross-border operations of financial conglomerates. ASIC, the Australian Accounting Standards Board and more broadly Government officials participate in international fora to consider measures that promote the cross-border operations of companies.

In terms of accounting standards, Australian standards are recognised by accounting standard setters world wide as being of a high quality. However, with Australia comprising less than 2 per cent of the world capital market, participants in markets overseas have little incentive to understand them.

Council members have noted the strength of Australia's regulatory environment and the competitive advantage this could provide in pursuing mutual recognition objectives. However, the

Council is concerned that the regulatory framework for regulating cross-border activities potentially contains some deficiencies. The Council also notes progress in Government discussions with a number of jurisdictions (including the United Kingdom, Hong Kong, Singapore and New Zealand), concerning possible mutual recognition arrangements to facilitate cross border trading in financial products, particularly in the areas of fundraising and collective investment vehicles.

Emerging Issues

As noted above, the prudential regulation framework needs to balance safety and efficiency. Undesirable outcomes could emerge if too great a weight is attributed to financial safety and the consequences of risk-taking are not permitted to eventuate.

The issue of achieving sufficient domestic scale to be internationally competitive has been a recurring theme in Council deliberations. It has arisen particularly in the contexts of rationalising settlements and clearance, the ASX/Sydney Futures Exchange proposed merger, the banking industry and may be expected to arise again in the future.

The Council considers that it has identified some emerging pressures on the 'four pillars' policy. The need for domestic institutions to be internationally competitive is one factor. Another is a tendency for constrained domestic institutions to undertake riskier strategies in order to deliver upon the market's growth expectations. This has the potential to undermine stability.

The relationship between domestic efficiency and competitiveness and international opportunities has been summarised by the Council as follows:

- the domestic uptake of new technology must be quicker than that occurring overseas;
- domestic products must be competitive through rigorous domestic competition; and
- the scale of domestic institutions must be sufficient so as to allow acquisitions of overseas interests.

There appears significant further potential to exploit regional synergies and improve settlement risk-management by further exchange consolidation and cooperation.

CLERP 9 proposes that Australia adopt standards issued by the International Accounting Standards Board (IASB) by 2005. This will facilitate cross border comparisons of financial statements by investors and enable Australian companies to access international capital markets at a lower cost.

Quantitative Measures

- Turnover of Australian financial markets (value)
- Contribution of finance and insurance to GDP
- Contribution of finance and insurance services to exports
- Trend employment in finance and insurance
- Trade in financial services as a share of GDP
- Trade in insurance services as a share of GDP

ATTACHMENT A — SUMMARY OF FINANCIAL SYSTEM INQUIRY EXPECTED OUTCOMES AND RECOMMENDATIONS

EXPECTED OUTCOMES	KEY RECOMMENDATIONS
REGULATORY FRAMEWORK ISSUES **Outcome 1: Create a flexible regulatory structure which will be more responsive to the forces for change operating on the financial system** **Outcome 2: Clarify regulatory goals**	**Recommendations relating to ASIC** Recommendation 1: Corporations Law, market integrity and consumer protection should be combined in a single agency. Recommendation 2: The CFSC should have comprehensive responsibilities. Recommendation 3: The CFSC should administer all consumer protection laws in the financial sector. Recommendation 27: The CFSC should have broad enforcement powers. Recommendation 57: The CFSC should be responsible for regulation of financial exchanges. **Recommendations relating to APRA** Recommendation 30: Prudential regulation should be imposed on deposit taking, insurance and superannuation. Recommendation 31: A single Commonwealth prudential regulator should be established. Recommendation 33: The APRC should have comprehensive powers to meet its regulatory objectives. Recommendation 34: The intensity of prudential regulation needs to balance financial safety and efficiency.

EXPECTED OUTCOMES	KEY RECOMMENDATIONS
REGULATORY FRAMEWORK ISSUES (Contd)	**Recommendations relating to RBA** Recommendation 56: The RBA should remain responsible for system stability. Recommendation 59: The RBA should promote control of domestic and international settlement risks. Recommendation 60: Liquidity management responses should remain the responsibility of the RBA. **Recommendations related to the ACCC** Recommendation 80: The ACCC should administer competition laws for the financial system. **Recommendations related to the PSB** Recommendation 61: A Payments System Board should be formed within the RBA. **Recommendations related to the CFR** Recommendation 112: The Council of Financial Regulators should coordinate a broad range of activities.

EXPECTED OUTCOMES	KEY RECOMMENDATIONS
REGULATORY RESOURCES, ACCOUNTABILITY AND COORDINATION **Outcome 3: Increase accountability of the agencies charged with meeting those goals**	**Recommendation relating to the interaction of the agencies** Recommendation 103: Regulatory agencies should have operational autonomy. Recommendation 111: Regulatory agencies need power to exchange information. **Recommendations relating to the funding of regulatory agencies** Recommendation 104: Regulatory agencies charges should reflect their costs. Recommendation 106: Regulatory agencies should set their charges, subject to approval by the Treasurer. Recommendation 107: Regulatory agencies should be off-budget. **Recommendations relating to the governance of the regulatory agencies** Recommendation 108: Regulatory agencies should have boards with majorities of independent directors. Recommendation 109: Regulatory agencies should improve their reporting. Recommendation 110: A Financial Sector Advisory Council should be created.

EXPECTED OUTCOMES	KEY RECOMMENDATIONS
REGULATORY CONSISTENCY ISSUES **Outcome 4: Ensure the regulation of similar financial products is more consistent and promotes competition by improving comparability** **Outcome 5: Introduce greater competitive neutrality across the financial system**	Recommendation 8: Disclosure requirements should be consistent and comparable. Recommendation 11: Financial institutions' financial reports should meet Corporations Law and prudential requirements. Recommendation 13: A single licensing regime should be introduced for financial sales, advice and dealing. Recommendation 19: Broader regulation of 'financial products' should replace current securities and futures law. Recommendation 36: A single DTI licensing regime should be introduced. Recommendation 44: The APRC should promote more transparent disclosure.

EXPECTED OUTCOMES	KEY RECOMMENDATIONS
MARKET EFFICIENCY AND CONSUMER OUTCOMES **Outcome 6: Establish more contestable efficient and fair financial markets resulting in reduced costs to consumers**	Recommendation 63: The PSB should set performance benchmarks. Recommendation 66: Rights to issues cheques should be extended. Recommendation 67: Interchange arrangements should be reviewed by the PSB and the ACCC. Recommendation 68: The ACCC should maintain a watching brief over the rules of international credit card associations. Recommendation 69: Access to clearing systems should be liberalised. Recommendation 88: Superannuation fund members should have greater choice of fund. Recommendation 95: Institutions should have freedom to set fees and charges based on costs. Recommendation 96: Governments should examine alternative means of providing low-cost transaction services. Recommendation 99: A working party on positive credit reporting should be established.

EXPECTED OUTCOMES	KEY RECOMMENDATIONS
REGULATION OF CONGLOMERATES AND FACILITATING INTERNATIONAL COMPETITIVENESS **Outcome 7: Provide more effective regulation for financial conglomerates which will also facilitate competition and efficiency** **Outcome 8: Facilitate the International competitiveness of the Australian financial system**	Recommendation 12: Accounting standards should be harmonised with international standards. Recommendation 29: The CFSC should participate in global regulatory programs. Recommendation 46: The approach to sectoral separation needs to be more flexible. Recommendation 35: Prudential regulation of DTIs needs to be consistent with international requirements. Recommendation 79: Section 50 of the Trade Practices Act should continue to apply to the financial system. Recommendation 82: The Trade Practices Act should provide the only competition regulation of financial system mergers. Recommendation 83: The 'six pillars' policy should be removed. Recommendation 84: Merger assessments should take account of changes occurring in the sector. Recommendation 85: General foreign investment policy should apply to the financial system. Recommendation 86: Foreign investment regulations for the funds management industry should be reviewed. Recommendation 92: Australia should adopt international standards for electronic commerce. Recommendation 93: International harmonisation of law enforcement and consumer protection should be pursued.

ATTACHMENT B — STATISTICAL APPENDIX

SERIES A — REGULATORY RESOURCES, ACCOUNTABILITY AND COORDINATION

Measure 1 — Regulators' expenses

	APRA[1]	ASIC[2]	PSB[3]	Total	
	($ million)	($ million)	($ million)	($ million)	(per cent total financial assets of financial institutions)[4]
1998-99	48.6	24.9	n/a	73.5	0.0049
1999-00	51.5	23.6	0.10	75.2	0.0044
2000-01	53.1	23.2	0.14	76.4	0.0041
2001-02	59.2	44.2	0.14	103.5	0.0050
2002-03	67.1	45.3	0.15	112.6	0.0054[5]
2003-04	72.0	58.3	N/A	N/A	N/A
2004-05	74.2	56.8[3]	N/A	N/A	N/A
2005-06	77.2	57.4[3]	N/A	N/A	N/A
2006-07	79.4	57.2	N/A	N/A	N/A

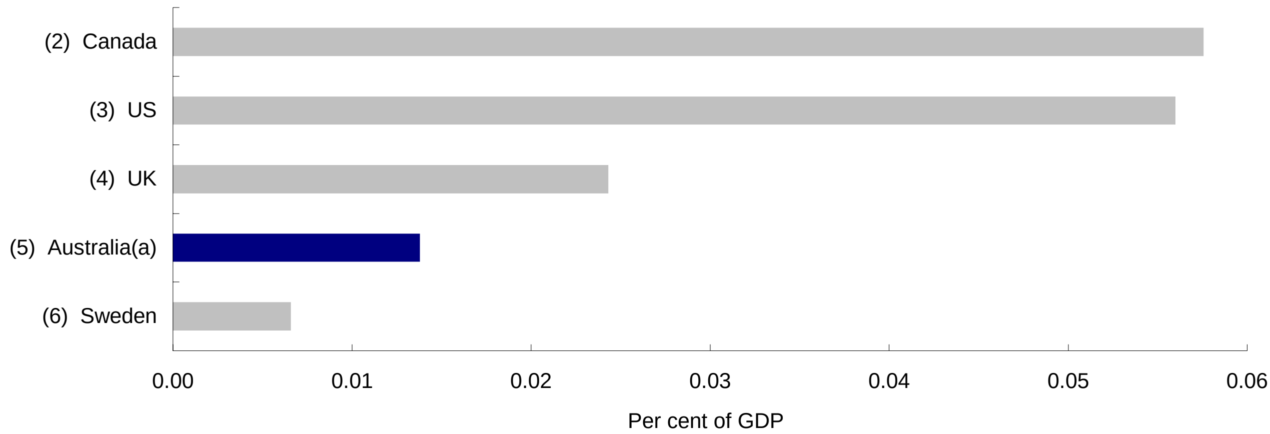
(1) Data from Portfolio Budget Statements — Treasury Portfolio 1999-00, 2000-01, 2001-02, 2002-03, 2003-04. Portfolio Part C Agency Budget Statements Treasury APRA and ASIC Tables 2.1 Resources for Outcomes. The APRA amount is the total. The ASIC amount is for ASIC output 1.1.3 (compliance, monitoring and licensing of participants in the financial system) only.
(2) The direct cost of the PSB, made up of remuneration and allowances paid to non-official Board members. The RBA advises that it has a long-standing involvement in payments system policy issues through the Payments Policy Department (which existed prior to Wallis and now serves the PSB). Some portion of the costs of this Department would be attributable to regulation, but the amount is difficult to quantify.
(3) Estimated at the same percentage of total ASIC costs as for 2002-03.
(4) Source: RBA Bulletin statistics table B01.
(5) Estimate (Dec 2002) used for total financial assets of financial institutions for end of year total 2002-03.

Measure 2 — Size of the regulated sector

	ASIC[1]	APRA	PSB[4]
	Number of licensed dealers advisers, fund managers and insurance brokers.	Number of financial institutions	High Value Payments cleared: daily turnover ($billion)
1998-99	3 398	197 616	98.4
1999-00	3 705	3 502[2]	103.3
2000-01	3 917	4 549	119.5
2001-02	4 040	3 964[3]	123.5
2002-03	N/A	N/A	122.6[5]

(1) ASIC Annual Reports 1999 to 2001. Note: These figures include all registered companies, not just financial institutions. Breakdown by sector is not available.
(2) APRA Annual Report 2000. Note: the number of APRA regulated entities fell significantly in 1999-00 with the transfer of self-managed superannuation funds to the ATO. In addition to the 3,502 institutions in 1999-00 there were approximately 8000 'small APRA funds' that remain with APRA.
(3) APRA Annual Report 2001. Note in addition to the 3,964 institutions there were approximately 8,127 'small APRA funds' that were regulated by APRA.
(4) PSB: RBA Bulletin, Table C4 — excludes cash and retail payments. High Value Payments account for around 90 per cent of transactions made in Australia.
(5) Part financial year only. July 2002 - January 2003.

Measure 3 — International comparison of total direct costs of financial sector regulation (per cent of GDP)[1]



(1) Financial sector regulation refers to both prudential regulation and regulation of markets and securities. Country totals are not directly comparable because they have not been adjusted for differences in countries' financial industries, regulatory legislation and labour and other costs. They are also affected by relative strengths of countries' currencies against the sterling on the dates chosen for translation of local currency data into sterling.
(2) The main costs of regulation in Canada come from the Office of Superintendent of Financial Institutions, Canadian Deposit Insurance Corporation, provincial regulators, the Canadian Investor Protection Fund and provincial insurance regulators.
(3) The main costs of regulation in the US come from the Federal Reserve, regional reserve banks, The Federal Deposit Insurance Corporation, Office of Comptroller of the Currency, Treasury, state banking departments, Office of Thrift Supervision. Securities and Exchange Commission, Commodity Futures Trading Commission, self regulating institutions, state commissioners and the Department of Commerce.
(4) The main costs of regulation in the UK come from the FSA and the Financial Services Ombudsman Scheme and the Financial Services Compensation Scheme.
(5) The main costs of regulation in Australia come from APRA, ASIC and the PSB.
(6) The main costs of regulation in Sweden come from the Finansinspektionen.

Source: (a) 2001-02 Total cost (from Measure 1) of APRA, ASIC and PSB. Other data from FSA 2000-01 Annual Report and OECD Main Economic Indicators.

Measure 4 — APRA consultations[1]

	1999-00	2000-01	2001-02
Number of consultations with banks	223	311	235
Number of consultations with life insurance companies	8	9	7
Number of consultations with general insurance companies	33	67	141
Number of consultations with superannuation entities	333	568	998
Number of consultations with friendly societies	46	19	16

(1) Consultations include reviews and visits. As the review methodology has changed dramatically since 1998-99 comparable data for earlier years are not available.

Source: APRA Annual Report 1999-00, 2001-02

Measure 5 — ASIC activities and results

	1997-98	1998-99	1999-00	2000-01	2001-02
Litigation concluded	199	154	173	150	205
New investigations	215	233	234	214	246
Percentage of corporate investigations completed within 12 months[1]	85%	90%	95%	94%	83%
ASX referrals to ASIC	N/A	N/A	N/A	N/A	54[2]
Percentage of market investigations completed within 9 months	70%	74%	83%	82%	n/a
Number of calls on the infoline	89 000	104 000	107 000	123 000	161 000
Percentage of infoline callers assisted on the spot	93%	91%	92%	94%	94%
Web site browses[3]	N/A	1 694 047	3 214 852	4 626 700	6 135 856

(1) In relation to civil matters, investigations are recorded as complete when ASIC determines whether court proceedings should be pursued. In relation to criminal matters, investigations are recorded as complete when ASIC refers a matter to the Director of Public Prosecutions. This measure therefore does not include the court process or the appeals process

(2) 54 referrals made by ASX to ASIC comprised of 8 made in reference to companies, 29 to surveillance and 17 to investigations and enforcement.

(3) ASIC believes that web site browses have increased substantially due to the significant rise in internet access by Australians. ASIC believes that people use their web site to check on the companies they may have invested in and find out information about the directors and other related matters.

Source: ASIC Annual Reports 1997-2001

Series B — Market efficiency and other consumer outcomes

Measure 1 — Financial institutions' share of total institution assets (per cent)

	Sep 1997	Sep 1998	Sep 1999	Sep 2000	Sep 2001	Sep 2002
Banks (other than RBA)	44.4	43.8	43.6	43.1	43.9	46.9
Superannuation funds	14.6	14.5	15.7	16.7	15.4	13.9
Life Insurance offices	11.1	10.8	10.6	9.9	8.9	8.0
Other managed funds[1]	7.1	7.9	8.5	8.7	8.4	8.3
General insurance offices	4.7	4.9	4.5	4.2	4.2	3.8
Money market corporations	6.0	5.2	4.1	4.3	4.8	4.3
Finance companies[2]	3.0	3.4	2.9	2.5	2.4	2.3
Securitisation vehicles	2.0	2.6	3.3	4.0	4.8	5.7
Reserve Bank	3.4	3.2	2.9	3.0	3.1	2.9
Credit unions	1.4	1.4	1.4	1.3	1.3	1.3
Building societies	0.9	0.9	0.9	0.7	0.6	0.6

(1) Other managed funds include cash management trusts, common funds, friendly societies and public unit trusts.
(2) Finance companies include general financiers and pastoral finance companies.
Source: Reserve Bank Bulletin and unpublished Reserve Bank data.

Measure 2.1 — ASIC business information

	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
Australian Financial Services Licensees[1]	N/A	N/A	N/A	N/A	N/A	35
Securities Dealers	1608	1547	1833	2081	2250	2302
Investment Advisers[1]	241	227	231	224	224	223
Futures Brokers	97	99	108	120	121	119
Futures Advisers[1]	51	40	64	65	70	74
General Insurance Brokers	N/A	N/A	N/A	1043	975	977
Life Insurance Brokers[1]	N/A	N/A	N/A	225	263	293
Foreign Insurance Agents[1]	N/A	N/A	N/A	12	14	17
New Managed Investments Schemes Registered	144	313	502	1780	787	599
Prospectuses Lodged	602	683	707	1033	2744	2089

(1) AFS licence commenced on 11 March 2002 and will progressively replace these categories. Licences and registrations for those other categories ceased after that date.
Source: ASIC Annual Report 2001-02 p 78

Measure 2.2 — Number of providers, entrants and exits

	Member Institutions (2001)[1]	Member institutions (2000)[2]	1 July 1998-30 June 2000	
			Entrants	Exits
Superannuation (non-life & APRA regulated)	N/A	3,916	999	956
Building societies and credit unions	218	227	2	39
Finance companies 3	n/a	186	36	38
General insurers (private sector)	97	162	18	25
Money market corporations	N/A	93	9	15
Payments system 4	N/A	54	4	4
Banks	52	51	3	4
Friendly societies (APRA regulated)	38	48	2	13
Life insurers	33	42	2	6

(1) APRA unpublished data
(2) Money market corporations and finance companies data are as at 8 January 2001. General insurers data are as at 29 January 2001. All other data, except small super funds, are as at 15 March 2001. Name changes have not been included as an entry or exit.
(3) Finance companies also covers general, pastoral, intra group and other finance companies.
(4) The payments system comprises the banks, Australian Settlements Limited, Credit Union Services Corporation (Australia) Limited and the Sydney Futures Exchange Clearing House.
Source: APRA and RBA unpublished data.

Measure 3 — Estimated costs of fees on deposits or credit

Financial Product	Fees[1] (per cent)			Change in Interest Margins since 1996 (% points)
	1997	1998	1999	
Household deposit account	0.23	0.30	0.36	-1.25[2]
Household loan	0.28	0.32	0.31	
Business credit (average)	1.12	1.04	1.00	-1.00[3]

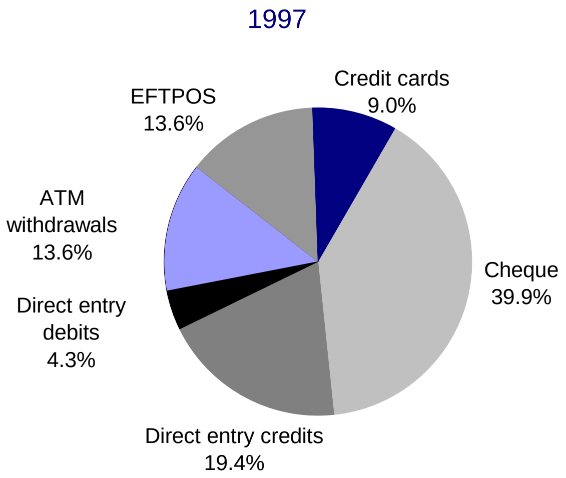
(1) Level of fees as a per cent of deposits or credit.
(2) Weighted Average (Household products).
(3) Weighted Average (Business lending).
Source: RBA Notes on Bank Fees in Australia, 22 May 2000. No updated comparable data

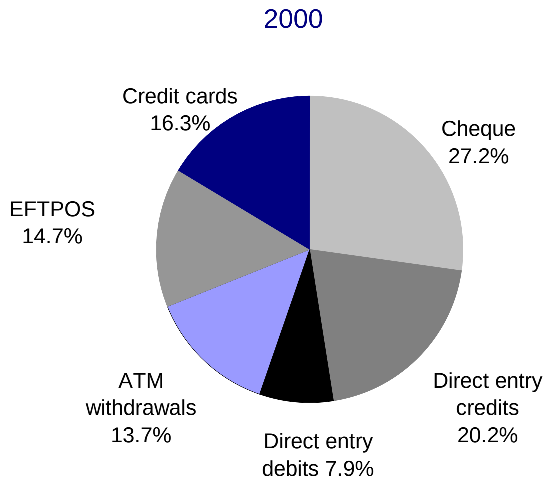
Measure 4 — Access to financial services

Method	June 1997	June 1999	June 2000	June 2001	June 2002
Bank Branches	6 121	5 358	5 003	4 712	4 728
Non-bank Branches	1 391	1 358	1 208	1 428	1 236
Bank Agencies	6 992	6 528	5 043	*	*
Non-bank Agencies	1 760	1 417	887	*	*
GiroPost	2 627	2 724	2 814	2 814	2 962
ATMs	8 182	9 387	10 818	11 915	11 714
EFTPOS	164 199	265 391	320 372	362 848	402 084
Total	191 272	292 163	346 145	383 717	425 724

Source: APRA Points of Presence Survey, RBA Bulletin and APCA Payment Statistics.
Note: Excludes access to the payments system through phone and internet banking.
* The definition of agencies in APRA's ADI Points of Presences does not equate with those provided by previous data.

Measure 5 — Analysis of the payments system





Measure 6 — Annual enquiries/complaints to main ADR schemes

Scheme	1997-98		1998-99		1999-00		2000-01		2001-02	
	Enq	Comp	Enq	Comp	Enq	Comp	Enq	Comp	Enq	Comp
Australian Banking Industry Ombudsman	45 032	4 710	48 955	5 067	54 649	5 978	61 729	6 872	64 635	7 992
Financial Industry Complaints Scheme (FICS)[1]	8 057	927	19 250	1 173	11 255	618	7 737	3 514	7 151	3 481
Insurance Enquiries and Complaints	56 612	1 838	56 909	2 102	56 855	2 325	68 252	2 516	75 487	2 557
Superannuation Complaints Tribunal	8 752	1 456	10 364	1 322	10 603	1 599	8 733	1 856	11 993	2 023

(1) FICS data are for year ended 31 December 2000. Change in measure in 2000-01.

Measure 7 — Overall satisfaction with banking services (percentage very satisfied)

	Average	Credit Unions	Building Societies	Smaller Banks	Large Banks
Overall Satisfaction (1999)[1]	24	66	63	20	13
Overall Satisfaction (2002)[2]	25	64	62	26	11

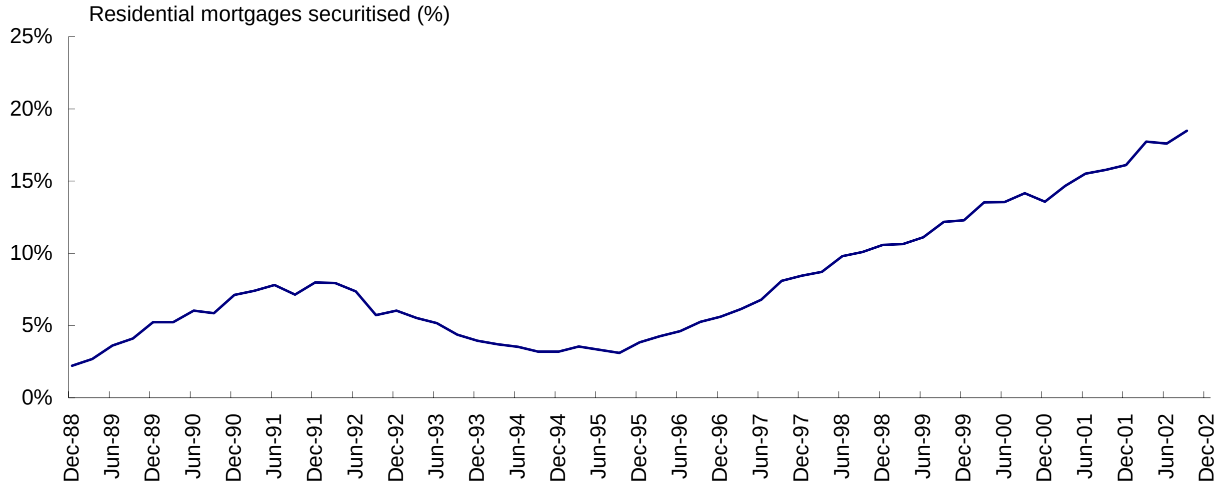
(1) The Long Kiss-off, October 1999 survey by the Australian Consumers Association (ACA) of 15,000 CHOICE subscribers.
(2) Banks: bad and getting worse, November 2002 survey by ACA of 3804 CHOICE members.
Source : Australian Consumers' Association CHOICE Survey: Everyday Banking and Savings.

Measure 8 — Percentage of small businesses happy with service/institution

	August 1995	August 1999
Happy with Bank Service	78%	68%
Happy with Financial Institutions		
Four Majors	78%	65%
Other Banks	80%	75%
Other Financial Institutions	89%	86%

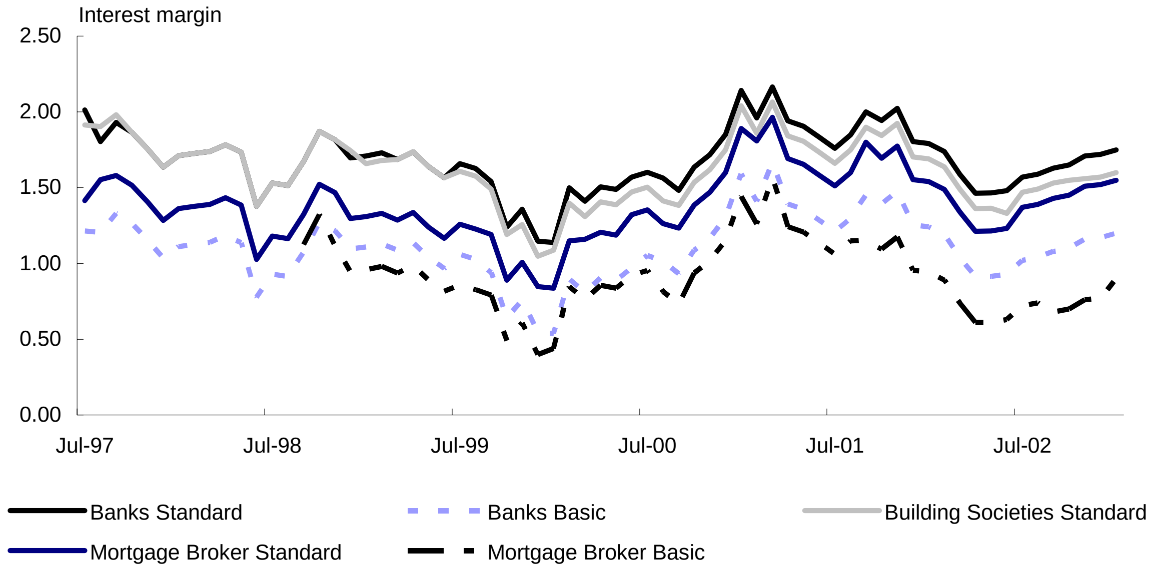
Source: Yellow Pages® Small Business Index, Attitudes to Banks and Other Financial Institutions, November 1999.

Measure 9 — Proportion of residential mortgages securitised



Source: Reserve Bank of Australia – B and D Tables.

Measure 10 — Margins on conventional loans (mortgage rate spread with 90 day T Bills).

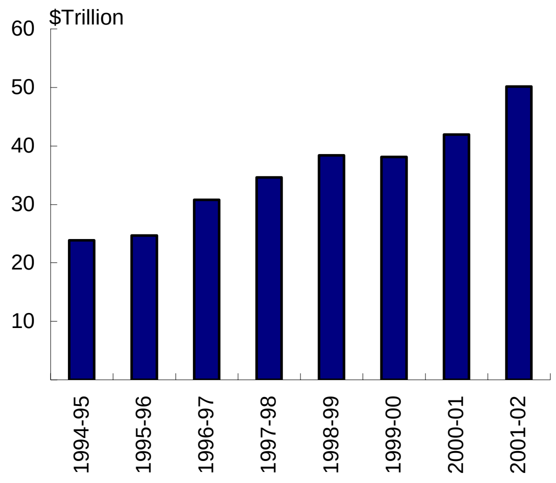


Source: RBA Table F4

Series C — Regulation of conglomerates and facilitating international competitiveness

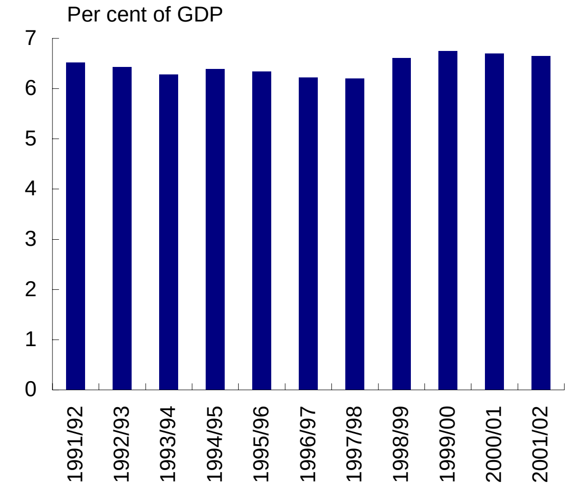
Measures 1–4 — Various financial sector indicators of efficiency and competition

Turnover of Australian financial markets (A)



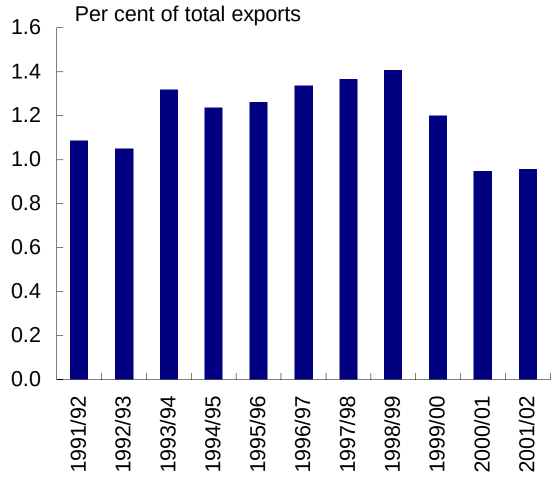
Source: AFMA 2002 Financial markets Report

Finance and insurance to GDP (B)



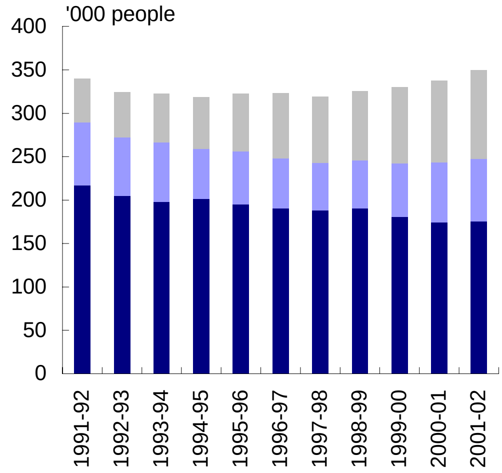
Source: ABS Cat. 5206.0

Contribution of financial and insurance services to Exports (C)



Source: ABS Cat. 5302.0

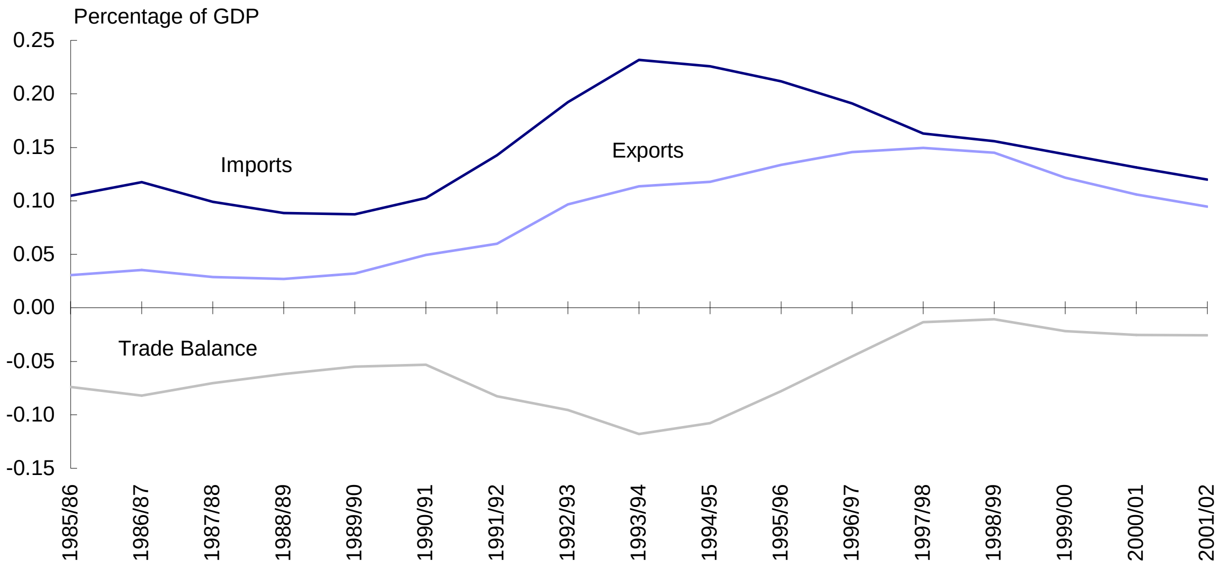
Employment in finance, insurance and services to finance and insurance (D)



Source: ABS Cat. 6203.0

(1) Services to finance and insurance consists of financial asset broking services, services to finance and investment, and services to insurance.Financial asset broking services primarily include trading in stocks, shares or other financial assets or in underwriting financial asset issues. Services to finance and investment primarily include provision of nominee or other services to the field of finance or investment (except insurance and superannuation) and incorporated stock exchanges. Services to insurance primarily consist of providing insurance broking or agency services, or other services to insurance such as consultant, claim assessment or adjustment services. Also included are foreign based insurance underwriters mainly engaged in broking domestically, as well as people engaged in managing or carrying out the operations of separately constituted superannuation funds on a commission or fee basis.

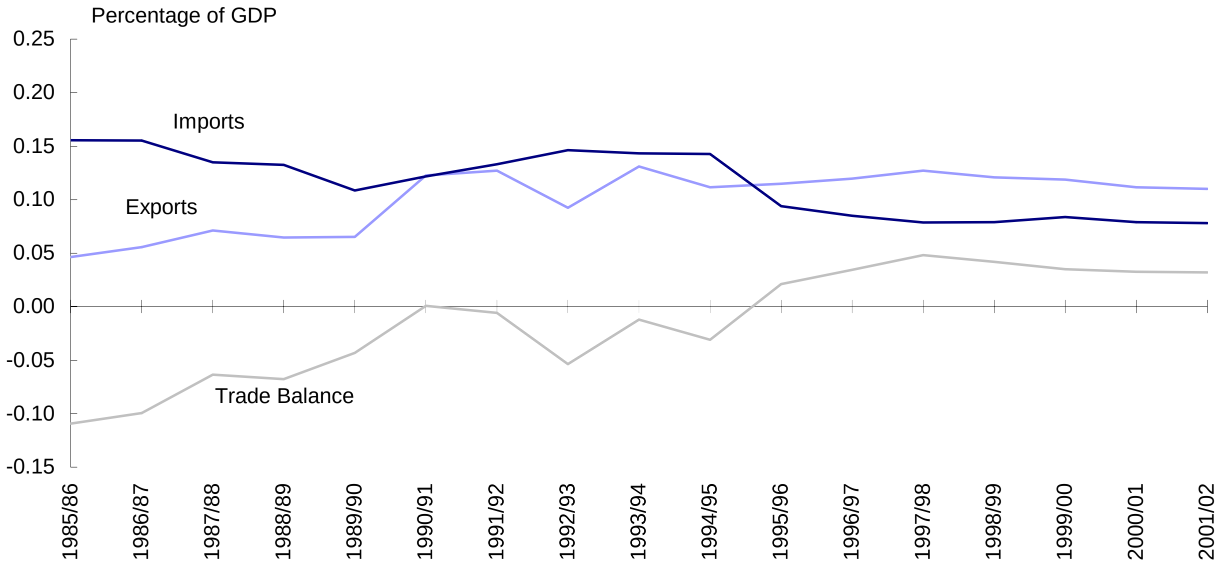
Measure 5 — Trade in financial services[1]



(1) Trade in financial services covers financial intermediary and auxiliary services conducted between residents and non-residents. Included are intermediary service fees, such as those associated with letters of credit, bankers' acceptances, lines of credit, financial leasing and foreign exchange transactions, commissions of commodity futures traders, services related to asset management, financial market operational and regulatory services and security custody fees. Financial services also include Financial Intermediation Services Indirectly Measured (FISIM) which estimates the value of the services provided by financial intermediaries for which no explicit charges are made. Computer and information services are also included in the measure.

Source: ABS Cat. 5302.0.

Measure 6 — Trade in insurance services[1]



(1) Insurance services cover the service charges component included in premiums earned, rather than taking the whole of the premium, together with any commission or fee income earned by agents and brokers in placing cross border premiums. The insurance enterprise performs a service in pooling the risks of policy holders and managing claims and, after deducting its fee from premiums paid, it redistributes the bulk of premiums back to policy holders by way of claims. The insurance service charge component of insurance services is estimated as premiums earned (adjusted for premium supplements) less claims incurred (average over 5 or 20 years).

Source: ABS Cat. 5302.0.