

Introduction

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During the past two decades financial systems world-wide have developed rapidly in terms of size, industry structure, and the range of products and services produced. In Australia the size of the financial system, measured by total assets, has approximately doubled relative to nominal GDP in the past twenty years, while in a number of other countries the growth has been even more dramatic. More importantly, there have been major changes in the range and mix of financial-sector activities and in competitive conditions for the participants. Examples include the spectacular growth in financial-market trading, including the newly developing derivatives markets, considerable product innovation in retail and commercial banking, and the development of new payment and transaction technologies. At the same time, the competitive environment is being reshaped by the increasing scope for new providers of financial services to enter traditional markets, or for existing providers to cross traditional boundaries.

These developments have stimulated considerable debate about the future of the financial system. Among the issues raised have been the likely roles of the established financial institutions, the extent to which traditional dividing lines within the financial sector will remain meaningful, and possible implications of further structural change for regulatory and supervisory policies. The papers commissioned for this volume are aimed at exploring those issues. They are divided into three parts: the papers in Part I present the recent trends, place them in historical and international perspective, and analyse some of the main driving forces; those in Part II consider possible future developments and their implications for finance-industry participants; and Part III focuses on issues for financial regulatory policy.

Historical Perspectives

The process of financial change can be viewed as being driven by a combination of demand and supply factors. On the demand side, rising real incomes and long-term demographic trends are likely to have contributed both to the overall growth in financial activity and to broad shifts in its composition. In particular there is a strong tendency internationally for the relative size of financial sectors to increase as real incomes rise; that is, as societies become wealthier, an increasing proportion of wealth tends to be held in financial form. Rising financial wealth in turn has generally been associated with a shift in its composition, with a greater proportion held in financial investment products as opposed to more traditional deposit instruments. This trend is likely to have been stimulated in part by the increasing focus on retirement savings as populations age.

Another important influence on the demand for financial services has come from major shifts in the financing requirements of governments. Particularly important were the increases in government deficits in the 1970s and 1980s, which created major additional demands for services associated with marketing, trading and investing in

government securities. In many countries, including Australia, this occurred at a time of high and variable inflation which meant that existing methods of selling government debt under administered interest rates became increasingly ineffective. The result was a general move to market-based methods of issuing government securities which complemented and stimulated the growth of financial markets more generally.

Notwithstanding the importance of these influences it is arguable that supply-side factors – that is, factors related to the cost structure and competitive environment within the financial sector – have been at least as important in shaping longer-term developments.

Financial regulatory policies played an important part in the process. Before the main steps in deregulation were taken in Australia in the late 1970s and early 1980s, key parts of the financial sector were subject to interest-rate and balance-sheet controls that limited their ability to compete for business, and banks in particular were losing market share to less regulated intermediaries over an extended period. This shrinkage of the regulated sector was one of the factors that eventually encouraged the move to deregulation. The trend in market shares shifted markedly in the post-deregulation period. There was a substantial recovery in banks' market share, although this has occurred in the context of a more competitive environment open to new entry from both domestic and foreign institutions. There has also been a major financial cycle as the sector overexpanded in its initial response to deregulation and has subsequently gone through a painful readjustment. The overall story, familiar to observers of the Australian financial sector, has numerous parallels in other countries.

The similarity of international experiences also points to the importance of more fundamental common forces driving the financial innovations to which regulatory policies were responding. In particular, the development of the industry has been powerfully shaped by rapid technological improvements and associated financial product innovations over the past two to three decades. Finance is an information-intensive industry involved with collecting, storing and interpreting detailed information about clients and markets, and processing and recording large volumes of transactions. It is not surprising that developments in information technology have transformed the cost structure of the industry, reducing production costs for many services and making available a wide array of new products and delivery systems: financial derivatives, ATMs, EFTPOS, securitised mortgages, telephone banking, to name just a few. Technological improvements have undoubtedly also contributed to reduced entry costs, particularly for new competitors offering specialist product lines. This in turn has increased the contestability of markets for a number of products, as has been illustrated recently by the growing competition from new players in the home mortgage market.

Prospects

There is a widespread perception that the process of change in the financial sector is set to continue as some of the main forces for change remain in place. In many respects the United States' financial system is in the vanguard of these developments. For example, the process of securitisation – the replacement of traditional bank intermediation by funding through securities markets – has gone much further there than it has in Australia, and may be indicative of the direction of further change for the Australian

system. There is now an active debate in the United States about the ‘decline of traditional banking’, reflecting the fact that traditional forms of intermediation are giving way to newer methods of meeting underlying financial demands. The emphasis in this debate is specifically on ‘traditional’ banking rather than on banks *per se*, since banks have continued to compete successfully for some of the newer lines of business, such as securitised lending and other fee-based activities. Nonetheless, in terms of total assets, banks have experienced a long-term decline as a proportion of the United States financial system.

In Australia there is little evidence, at an aggregate level, of the sort of decline in traditional banking that has been seen in the United States. Indeed in the post-deregulation period banks have significantly recovered market share on a total assets basis. Profits, after being hit by major increases in loan write-offs in the late 1980s and early 1990s, have recovered to high levels. Nonetheless the early stages of a process of increased competitive pressure on banks’ core business activities can be clearly observed, with possible longer-term implications for their profitability and role in the financial system.

Central to this process has been the unbundling of the banks’ traditional product mix. In simplified terms, traditional banking can be viewed as the provision of deposit, loan and transaction services. In this structure these core services were produced and priced jointly, and banks’ competitive position was supported by extensive branch networks and access to low-cost deposits. Competition from outside the group of full-service providers was limited. The pricing structure that evolved for this product mix generally involved very low fees for transaction services, with revenues for the banks being earned mainly from the net interest margin.

A significant challenge to this market structure has come from the emergence of much stronger competition on a product-by-product basis, stimulated by specialist suppliers of individual product lines. Leading examples have been cash management trusts, on the deposit side, and mortgage originators on the lending side; another example has been the recent move by a number of life offices to increase their home mortgage lending. The common thread is that these institutions have been able to offer deposit or loan products on a stand-alone basis at highly competitive rates, placing considerable pressure on the banks to price their key products on a similar basis. The process has been facilitated by the growth of securities markets, which provide a funding vehicle for specialist lenders and an investment vehicle for institutions like cash management trusts. In other words, they allow the basic functions of deposit-taking and lending to be offered separately from traditional full-service banking.

On the deposit side the resultant competition has contributed to a trend increase in banks’ relative deposit costs, a trend that has been reinforced by declining inflation which compressed the margin between market and ‘low-cost’ interest rates. More recently, competition to cut mortgage lending margins has been intense. The net effect of these forces on bank margins is in turn creating pressure on the banks to cut costs and to reduce their cross-subsidisation of transaction services. Banks have also sought to offset these competitive pressures in other ways, for example by expanding in other areas of business such as their involvement in funds management.

Many of these developments are still at a relatively early stage and are likely to have important ongoing consequences for the finance industry as they are worked out more

fully. The full impact of the new competitive pressures on bank profits is yet to be seen. More generally the combination of lower entry barriers and the ability to unbundle basic product lines suggests that financial businesses will have to re-examine their pricing structures and re-assess areas of comparative advantage. Cross-subsidisation is likely to come under further pressure as new competitors continue to focus on the more profitable lines of business that are the traditional revenue sources for cross-subsidies. This in turn suggests an increasing tendency for financial enterprises to examine and price each line of business on a stand-alone basis, with fewer fixed points of comparative advantage available to the established institutions.

None of this necessarily means a diminishing role for banks but it does imply an increased potential for the nature of banking business to change, and for a relative shift away from the traditional style of on-balance sheet intermediation. On the other hand, banks may well find enhanced opportunities to compete in newer markets where entry barriers are low. Their expanded activities in funds management, investment banking and in financial markets are examples of areas where this has already occurred. It can also be argued that banks are likely to retain a strong comparative advantage in at least some of their traditional core activities such as small business lending and retail deposit accounts.

Regulatory Policy

In considering the regulatory policy implications of all these trends, it is useful to keep in mind two main objectives of regulatory policy: investor protection and systemic stability. The two objectives give rise to very different types of regulation (using the term 'regulation' here in a broad sense to include financial supervision). The investor protection objective is generally related to regulations with a *product* focus, aimed at setting standards of business conduct with respect to particular markets or activities; examples include prospectus requirements or insider trading laws. In contrast, the systemic stability objective gives rise to regulations with an *institutional* or *prudential* focus, such as capital standards and the supervisory regime for banks. This follows from the nature of systemic risk, which is essentially the risk that insolvency of an individual institution will threaten the stability of the financial system as a whole. Since only institutions can be insolvent, the systemic stability objective implies a regulatory focus on institutions rather than products. Unless institutional groupings exactly correspond with product differences, the combination of the two objectives implies a distinct role for both types of regulation.

From a macroeconomic perspective it is the systemic stability objective of regulatory policy that is particularly important. The financial system trends already outlined are relevant to this aspect of regulatory policy in two ways.

First, any blurring of distinctions among the main groups of financial institutions is bound to raise difficult questions as to where the boundaries for prudential regulation are to be drawn. It is usually regarded as desirable to avoid extending the institutional coverage of prudential regulation too widely. A major reason for this comes under the generic heading of 'moral hazard' – the problem that bringing institutions under a prudential regime might encourage assumptions that they have implicit government

backing. On the other hand, once a set of boundaries is in place, financial institutions often innovate around them, particularly where artificial legal distinctions are made between institutions performing similar functions. These considerations suggest a need for balance between the aim of avoiding too wide an ambit for prudential policies, and that of finding a reasonably natural set of institutional boundaries that will not be quickly overtaken by financial innovation.

The extent of actual or prospective blurring of institutional boundaries is a matter of some debate. In simplified terms (and ignoring some specialised fields such as insurance) we can define two main types of legal entity engaged in financial business. The first group, financial intermediaries, comprises those institutions whose main business involves borrowing, lending and transaction services at agreed nominal values, principally the banks, merchant banks, building societies, credit unions and finance companies. The other main group, the funds managers, have as their core business the investment of members' funds on a 'best-endeavours' basis. Within the intermediaries group, the special status of banks is widely argued to have become less meaningful as business becomes increasingly mobile across the institutional groups; the point is underscored by the historical shifting back and forth of market shares between banks and non-bank intermediaries as regulatory policies changed. A more robust distinction has traditionally been made between intermediaries and funds managers. This distinction is relevant to the issue of systemic risk because funds managers are not subject to insolvency risk in the same way as intermediaries. An important area of current debate is the extent to which this distinction will remain robust in the face of increasing cross-market penetration between the two groups of institutions.

A second major implication for regulatory policy concerns the changing nature of systemic risk. Traditionally the main sources of systemic risk have been viewed as related to payments-system risk, depositor runs, or more general problems of balance-sheet insolvency. Aside from liquidity support facilities from the central bank, standard policy approaches to these risks have tended to focus on promoting balance-sheet soundness, through specific balance-sheet requirements such as capital adequacy rules as well as general supervisory oversight.

Increasingly, however, systemic risk is seen as coming not only from traditional balance-sheet items but also from banks' involvement in securities and derivatives markets. Since bank exposures to these markets can be difficult to measure and can change virtually continuously, these activities are not amenable to being monitored and controlled by the regulatory authorities using rule-based systems and standard balance-sheet analysis. Rather, they point to an important shift in the nature of prudential policies – towards much greater reliance on the analysis of markets and evaluation of risk-management systems, rather than the older more mechanical approaches.