

# Summaries of the Papers

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## **The Evolving Structure of the Australian Financial System**

*Malcolm Edey and Brian Gray*

During the past two or three decades structural change in the Australian financial system has been rapid. The system has grown substantially in assets and volumes of activity, has become much more open and competitive, and has undergone some significant shifts in market shares. There has also been much innovation in financial products and delivery systems. In analysing these historical trends a useful distinction can be made between two major parts of the financial system: the financial intermediaries (or credit institutions), of which banks form the largest part; and the funds managers, typified by superannuation funds and unit trusts. Although the overlaps between these two institutional groupings are increasing, their historical trends have been driven by rather different forces.

Within the intermediaries sector two broad processes of change have been evident. The first involved the interaction between regulatory policy and financial innovation. Prior to the main thrust of financial deregulation in the late 1970s and early 1980s, banks lost market share to less heavily regulated institutions, a trend that eventually gave impetus to the move to deregulate. In the post-deregulation period, these trends in market share were reversed and, in the process, the system was opened to greater competition.

The second main historical process has been a shift in the economics of production of banks' traditional financial services – what is often referred to as a process of 'unbundling'. This entails a move toward production and pricing of key products on a stand-alone basis, stimulated by the development of specialist suppliers such as mortgage managers or cash management trusts. Competition from these sources has put pressure on the traditional full-service suppliers (the banks) to cut margins and to reduce cross-subsidies.

In the funds-management sector, and particularly the superannuation funds, the driving forces have been somewhat different. Policy changes in the areas of taxation and compulsory contributions have had an important impact on the structure of the industry. However, the most important factor behind the rapid growth of the industry since the early 1980s has been the high average rate of return accumulated on fund investments over that period. The available data do not yet show the increases in net new contributions to the funds expected to result from increases in compulsory contributions.

Notwithstanding the historical differences between the two sectors, there have been increasing areas of overlap between them. For example, banks have become more active in funds-management business through subsidiaries, and funds-management institutions have become more active in areas of traditional bank business such as mortgage lending. These developments pose a challenge for regulators as to where are the appropriate regulatory boundaries between the different groups of institutions.

## **The Role of Institutional Investors in the Evolution of Financial Structure and Behaviour**

*E. Philip Davis*

In the period since 1970 there have been widespread changes in financial structure in all the major economies, as banks have been deregulated and capital markets have developed. The broad directions of change have been remarkably similar. They include a sharp increase in the overall size of financial systems and an increase in the market shares of institutional investors or funds managers. Banks' market shares have correspondingly tended to decline, while securities markets have grown rapidly in both size and sophistication. The broad trends can be summarised as an increasing role for institutional investors and securities markets, and a declining relative role for traditional banking.

Conventional approaches to explaining these trends have focused primarily on the behaviour of banks. However, a good case can be made that the development of institutional investors themselves has been an important driving force. The growth and impact of these institutions can be analysed in terms of six basic functions that financial systems are expected to fulfil. The six functions are:

- clearing and settling payments;
- pooling of funds;
- transferring economic resources;
- managing uncertainty and controlling risk;
- providing price information; and
- dealing with incentive problems.

While the institutional forms taken by financial systems are subject to evolution through time, these basic functions are relatively fixed. The growth of institutional investors can be viewed as reflecting changing comparative advantages in performing each of these functions, as well as an increased demand for certain functions by end-users. With respect to the demand side, an important factor has been population ageing, which is likely to have stimulated the demand for long-term accumulation products that institutional investors typically provide.

Conditions for further expansion in the relative size of the institutional investment sector appear to remain in place, and the growth has shown little sign of easing. Further change in this direction could have important implications for monetary policy, for international financial linkages, and for corporate financial structures. There appears to be a great deal of scope for expanding international diversification by these investors, and for increased cross-border financial flows as a result. In the area of corporate finance, significant changes in financial structure and control could be implied if there is a major increase in the share of finance provided by institutional investors.

## **Alternative Models of Financial System Development**

*Stephen Prowse*

Dramatically different systems of corporate finance have emerged among the major industrialised countries in the postwar period. At one end of the spectrum are the market-dominated systems of the Anglo-Saxon countries, characterised by active markets for corporate debt and equity securities, arm's-length relationships between banks and non-financial businesses, and high levels of mandated public disclosure. At the other end are the bank-dominated systems of Japan and Germany, where banks are much freer to take the role of active investors in firms and where securities markets are correspondingly less important.

Historically the Anglo-Saxon financial structures, typified by firms in the United States and the United Kingdom, have had much lower debt ratios than firms in Japan and Germany and, within that structure, a higher reliance on non-bank sources of debt. In most respects the financial structure of Australian companies is similar to those in the United States and the United Kingdom, except that markets for corporate debt securities in Australia are much less developed.

The large differences in corporate finance among the industrial countries are the products of three aspects of the legal and regulatory environment of each system. The first relates to the regulatory environment for 'universal banking': banks in Japan and Germany (universal banks) have been allowed to be active equity investors whereas Anglo-Saxon banks have not. The second aspect is the degree of regulatory suppression of corporate securities markets, while the third relates to the degree of mandated disclosure in those markets. These regulatory aspects are much more favourable to the development of securities markets in the Anglo-Saxon countries than in Japan and Germany. In particular it can be argued that mandated disclosure, which is relatively strong in Anglo-Saxon systems, is a public good that promotes market development.

Evidence on the relative merits of the two systems is inconclusive. In any case, the different financial systems of the industrial countries appear to be coming closer together. Corporate finance systems are being transformed by technological change, globalisation of markets and the increasing importance of small firms in the economy. These changes have put pressure on Japan and Germany to deregulate securities markets, allowing increased access by firms to non-bank sources of finance. In the Anglo-Saxon countries small business finance markets are growing and institutional investors appear willing to take on a more active role.

These developments suggest a degree of convergence toward a system with characteristics of both the polar models: where financial institutions are free to be active owners and where active security markets for corporate finance are available. But complete convergence seems unlikely, as institutional history will continue to matter.

## **Banking in the 21st Century: The Transformation of an Industry**

*David T. Llewellyn*

Banks have been under competitive pressure as a result of financial innovation and fundamental technological changes that have affected the very core of banks' business. These pressures will continue and banks will become increasingly exposed to competition from securities markets, from non-bank financial institutions and from non-financial firms undertaking their own banking activities. It may be that traditional banking business is in decline, although this need not imply that banks as firms are in decline provided they make appropriate strategic responses to these pressures. Banks have enduring core competencies in information processing and in monitoring and control of debtors, and these strengths can be applied in areas quite separate from traditional 'banking' business.

The changes affecting banks and their strategic responses have implications for the structure of the banking industry, the nature of banking operations and for the organisational structure and activities of banks as firms. It seems likely that the traditional structure of an integrated bank will become increasingly inappropriate in the modern financial system, where markets and other institutions may provide banking services more cheaply than is possible for a vertically and horizontally integrated banking firm.

Financial innovation and declining entry barriers have enabled a process of 'deconstruction', whereby financial services that were once provided as bundles can now be subdivided into their component parts. The logical outcome of this process is that each component of a financial service can be provided separately by those firms possessing a comparative advantage in their production. This implies that the provision of financial services can increasingly be undertaken by specialist firms, and in particular that certain classes of loan will be securitised rather than held on banks' balance sheets.

Similarly, if financial service providers can become more specialised, it is likely that the structure of the banking industry will evolve to reflect this. Thus while technological change has allowed significant scale economies to be reaped in bank processes, these need not imply that all banking firms need to become very large to take advantage of these economies. Instead, an industry structure denoted as 'contract banking' may arise, where the banking firm that has a primary relationship with the ultimate customer subcontracts with both internal and external suppliers for various components of each financial service. In this way, a bank will effectively become a broker of financial services mediating between financial suppliers. There will be room for a spectrum of banking firms, from the small and specialised to the large firms built on scale economies.

## **Australian Industry Perspectives on the Future of the Financial System**

*Robert Joss, William Ferguson, Tony Cole and Rob Ferguson*

Deregulation, globalisation and technological change have generated a transformation in the structure of the finance industry and the services it provides, creating benefits for customers of financial institutions and challenges for the institutions themselves. Four views of the implications of these changes for the financial sector were presented from various parts of the industry. All concurred that there were substantial changes occurring, quite separate from the effects of deregulation, that required a response from industry participants and from banks in particular.

Banks will increasingly have to examine their business on a product-by-product basis and focus only on those for which they possess a competitive advantage over alternative providers. These competitors may not be under the same regulatory constraints, may be tax-advantaged in some cases, or may have very different cost structures from the banks. Superannuation funds will become increasingly important in Australia as a result of two factors: the scheduled increases in mandatory contributions and the heightened demand for long-term wealth-accumulation products that arises as households become wealthier.

These changes are not occurring so rapidly that institutions and regulators will be unable to respond appropriately. Moreover, banks are likely to retain a key role in the financial sector because of their core competencies, arising from their branch networks, infrastructure for large-scale information processing, and their role in the payments system.

The impact of financial market globalisation will be greatest on wholesale markets and on investment banking businesses. Some consolidation of the investment banking industry around a smaller number of players is expected as a correction to the current excess capacity. This suggests a likely diminution of the role of the larger Australian banks in funding large and highly creditworthy corporations, and possibly a smaller role for Australia as a regional headquarters for global investment banking operations.

The requirement for a global presence will also be felt in other areas of banking business. This could create pressures for increased concentration of the domestic industry, with fewer large banks and smaller banks engaged in niche markets or as specialist providers.

## **Regulating the New Financial Markets**

*Richard Dale*

Regulation of financial markets is generally based on three main rationales. The first is that consumers cannot be expected to have the skills to assess the health of a financial institution and therefore need to be protected from loss in the event of its insolvency. A second rationale arises from the moral hazard problem of financial firms being able to take on more risk than is optimal because of the official protection that regulation provides. Finally, regulation is justified as a means of preventing systemic or contagious

disturbances where failure spreads from one firm to other previously solvent firms. This last reason, while a matter of debate in the academic literature, commands general acceptance among practitioners.

With these goals in mind, the regulatory system must be appropriate to the financial system as it stands. The financial sectors in many countries have been transformed by the globalisation of communications and of markets, by the increasing integration of different types of financial firms and by innovations in the range of financial products available. The challenge for regulators inherent in these changes is evidenced by the collapse of the Barings group and the circumstances leading up to it.

Increasing globalisation and sophistication of financial markets have a number of regulatory implications. Globalisation could result in greater risks of cross-border systemic contagion, making it appropriate for national regulatory systems to take account of this risk, and also to ensure that competitive distortions do not occur because of national differences in regulation. It is also necessary for regulators to have a clear view of the true risk position of an institution, which may change swiftly and dramatically through the use of sophisticated risk-management products such as derivatives.

The response of regulators has included some element of reaction to all of these changes. International co-ordination of prudential requirements for banks is in its early stages. Increasing conglomeration of different types of financial institutions has also induced some increases in the level of co-operation between regulators of different parts of national financial systems. The increasing sophistication of financial products has induced regulators to make greater use of banks' internal risk-management systems.

Much remains to be done before the regulatory scheme is fully consistent with the developments in financial markets. In particular, regulators of securities markets have not adjusted to these changes as much as have bank regulators. International co-ordination and regulatory convergence are still at a very early stage and have been hampered by a lack of co-operation on the part of multilateral peak organisations of the various regulatory authorities. There is still as yet no consensus on the degree to which a securities firm should be regulated, particularly if it forms part of a conglomerate financial institution together with a bank. Finally, in many cases, prudential regulation and assessment of the risk position of financial institutions have not kept up with financial innovations such as the use of derivative products.

## **Regulatory Policy Issues in Australia**

*Graeme Thompson*

Two broad types of financial regulation can be identified. The first type, prudential supervision, may be defined as supervision directed at institutional solvency. It is exercised over institutions whose main business involves dealing in fixed-value obligations: banks and credit institutions; insurance; and defined-benefit superannuation funds. The second type of regulation, product regulation, is concerned with disclosure, market conduct and fair treatment of consumers with respect to particular products or services. Prudential supervision is motivated importantly by concerns with financial system stability, while product regulation is primarily concerned with safeguarding the

interests of imperfectly informed investors. As long as financial products are not uniquely identified with institutional groups, the two types of regulation will inevitably overlap to some extent, although this need not imply any inconsistency between the two.

Structural changes in the Australian financial system raise a number of issues for regulatory policy, and for prudential supervision in particular. The first concerns the organisation of prudential supervision: the question of whether there could be efficiency gains from combining the main supervisory agencies. Arguments for combining these agencies generally focus on potential overlaps between the current jurisdictions or on the argument that many institutional groupings are becoming less meaningful. However, some institutional distinctions remain robust, including a basic distinction between intermediaries and managed funds. There are strong arguments for keeping the prudential authorities for those two groups separated, in order to avoid encouraging perceptions of official support for financial institutions being spread too widely.

A second issue concerns the supervisory role of the Reserve Bank, where the issue revolves around the potential for synergies or for conflicts between the RBA's two main functions of monetary policy and bank supervision. International practice as to the organisation of these two functions is varied. Some central banks combine the two functions while in other countries there is a separate bank supervisory agency. But even where the functions are separated, central banks' general concern with financial system stability has led to arrangements for close liaison with the supervisory agency, and commonly to central banks also devoting substantial resources to banking system analysis.

Finally, there are two related issues concerning the competitive impact of supervision policy and the conduct of that policy. The increasing sophistication of financial products points to a need to develop new techniques of financial supervision with greater flexibility. Rule-based approaches to supervision are likely to become less useful because they fail to capture the rapidly-changing risk associated with financial and derivative markets. This suggests a need to supplement the traditional methods with approaches based more heavily on public disclosure and on the evaluation of risk-management systems in financial institutions.