An Industry Perspective on the Future of the Australian Financial System

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As three of the four industry perspectives are being offered by bankers, I have decided to concentrate my brief remarks on the likely impact of funds management and particularly compulsory superannuation on the financial system and its regulation.

Over the next half century the OECD member countries will experience a pronounced, synchronised demographic cycle. Very high aged and total dependency ratios will pose fiscal problems for governments and erode the household sector's saving capacity.

A decade before ageing begins its impact on Australia we are already experiencing a chronic savings deficit. This is most easily seen in our current account deficit which has averaged a little over $4^1/_2$ per cent of GDP over the past 15 years. Through that period there has not been one whole year in which the deficit has been less than 3 per cent of GDP – the level which the government's economic advisers suggest is the highest average level which is sustainable in the longer run. One consequence of this long run of deficits has been a large increase in the level of Australia's foreign debt and other obligations – from 21.4 per cent of GDP in 1980 to 58.5 per cent in 1995.

There are differing views among economists about whether current account deficits (and savings shortfalls) matter. I belong to the camp who think they do. It seems obvious to me that countries with large net foreign obligations have less national economic sovereignty. Perhaps partly because they have been persuaded by people like me, both major political parties in Australia seem to agree we have a problem.

The scarcity of domestic and international saving seems likely to be a dominant feature of the environment in which our financial system evolves and functions until mid-way through the next century. In this environment there will be little cheap money around. Investment returns should be high on average and the cost of servicing our overseas debt and obligations will also be high.

As Malcolm Edey and Brian Gray showed in the first paper presented at this conference, government intervention and regulation have played a dominant role in the past evolution of our financial system. Government's response to the savings problem is already affecting its future. That response contains three strands – compulsory superannuation, fiscal contraction and building a community expectation of less adequate publicly provided pensions. All will have significant impacts on the financial system.

Compulsory superannuation and declining confidence in the public pension system will combine to increase the flow of household savings into superannuation funds. Life offices and superannuation funds are already receiving around 50 per cent of the total flow of household investments in financial assets, a dramatic increase on the 20 per cent they received in the 1970s.

The net impact of compulsory superannuation will increase dramatically over the next few years. Compulsory contributions will rise from their current levels of 6-7 per cent of earnings to 12 per cent. Additional government co-contributions of up to 3 per cent are scheduled for most employees. As the level of contributions increases it becomes more and more difficult for individuals to offset the impact of the system by reducing their other saving. As compulsory retirement saving was phased in, people responded by reducing their existing saving. Not surprisingly existing superannuation and other long-term savings were the first to feel this effect. To date the system's impact has largely been on the way long-term savings are held rather than its level.

Because of compulsory preservation, it is difficult to see that compulsory superannuation savings can be as close a substitute for 'other' savings – people will still need to hold transactions and precautionary balances. For these reasons it seems likely that the second half of compulsory superannuation will have a larger impact on total saving than the first half.

Overall then, compulsory superannuation should increase total saving and funds management's share of the total, but it will not 'crowd out' bank deposits. Because of the interaction of inflation and taxation of full nominal interest, and because of their place in the risk/return spectrum, bank deposits are not a wealth accumulation vehicle. They are largely held for other reasons for which superannuation balances cannot substitute.

The proposal to create Retirement Savings Accounts (RSAs) which enjoy superannuation tax concessions will partly overcome the taxation issue and might therefore divert some of the superannuation flow to the balance sheets of the banks. Because of the relatively poor underlying returns bank deposits offer for long-term investors, however, the appeal of RSAs is likely to be limited to those with small balances and those who place a high premium on convenience or the regulatory comfort provided by the 'bank' label.

Fiscal contraction will also have an impact on the financial system. As superannuation assets grow very rapidly the supply of one of the major asset classes – government bonds – will stagnate or contract as governments have less need to issue new debt. While it is probable that the asset allocation patterns of superannuation funds will continue to move towards real or growth assets, there will be a continuing increase in the absolute demand for debt instruments. Some of this will no doubt be satisfied by increased take-up of foreign government paper, a trend we are already seeing for risk-diversification reasons. But it is also likely that interest will grow in private sector debt instruments.

Past attempts to establish a corporate bond market in Australia have not been successful. Domestic lenders' preferences for the highest quality credits have resulted in wide margins for other borrowers who have therefore found offshore issues more attractive. More recently, floating-rate issues backed by mortgages have had a better reception.

What does the future growth of compulsory superannuation mean for banks and for their roles as providers of transaction services and credit? My short answer is not as much as many people think.

As institutions, the primary focus of superannuation funds is on accumulation. Their systems are designed around that function. They could not become providers of transaction services without reinventing themselves. It is hard to see a business need which will be sufficient to justify the costs involved. Any challenges to banks as transaction service providers will come from elsewhere. In the long run, of course, this is a vital issue for the banks as it is their role in the payments system which underpins their special position in the regulatory system. Indirectly, the funds management industry might help create increased opportunities for non-bank competitors to enter the transaction services market. As the banks are forced to unbundle their products and charge an economic price for transaction services it will become increasingly attractive for telecommunications companies and others to enter the market.

It is useful to consider the impact of compulsory superannuation on the banking system's credit provider role on a sector by sector basis. Loans to individuals account for almost 40 per cent of the total assets of Australian banks and lending for housing represents more than 80 per cent of loans to individuals. We have recently seen the banks' dominance of this sector come under attack through securitisation. A significant contribution to this has come from the superannuation members' home loan scheme. This product is not home lending by superannuation funds. The lending and servicing of borrowers, and the securitisation, is being provided by a life office. Superannuation funds have provided the initial financial contributions and their investment managers may invest in the securities generated (as they have in securitisations more generally). The badging of the retail product has assisted the life office in its marketing of loans. The payoff for superannuation funds has been in the promotion of brand loyalty.

In the past, market shares in household credit have shifted dramatically between the banks and non-banks. These shifts were generally in response to regulatory changes and at times imposed high costs on borrowers, both in terms of access to credit and its price. Such factors have little to do with current market developments. Traditional banking has been losing market share to more competitive products. The banks are now responding and, while their recent dominance of the sector might not be restored, should be able to retain a strong presence. It is through this process that deregulation is providing benefits to consumers.

The second sector is credit for small and medium business. I am aware of efforts being made by National Mutual to replicate their home loans product for small business lending. The banks have a comparative advantage in business and risk assessment for small business borrowers. This flows from their role as providers of transaction services and their continuing presence on the ground in business centres. It will be difficult for funds managers to challenge their dominance. I will be surprised if the degree of success is even close to that in housing. Nevertheless the additional competition will be beneficial. Again the motivation for superannuation fund participation in the scheme seems largely to be promotion of the fund to people who may have a role in deciding what fund a firm's employees should join.

As to the larger end of town, I have already suggested that as government debt-issues contract, funds managers might look again at this market. The banks can probably expect new competition for prime corporate business. I would note that this is already a highly competitive area with competition between the banks and from overseas keeping margins low. It is not clear that the banks have a lot to lose in terms of profitability or that the funds have that much to gain.

Players in a deregulated market have to expect challenges from new directions. Just as the banks have cherry-picked the markets of the non-bank sector, life offices and funds managers will cherry-pick the banks' most profitable services. Bundled services and cross-subsidised services will feel the pain as the market ensures users pay. As this progresses the banks will find that the removal of cross-subsidies will also open the previously subsidised services to competition. That was always going to occur under deregulation and represents a move to more efficient markets.

In sum, banks will be under continuing pressure in most areas of their business from non-bank competitors, including the investment managers employed by superannuation funds. In assessing their future business prospects, however, it is important to note that the banks' own subsidiaries are aggressive competitors in the funds-management business. While compulsory superannuation poses threats to some bank businesses, the banks themselves have been quick to seize the opportunities it also provides. While the portion of the business the Reserve Bank prudentially supervises seems likely to shrink, there is no reason at all to expect the businesses in a broader commercial sense to do so.