Submission to the Financial System Inquiry

The following is the Executive Summary of the Reserve Bank's Submission to the Wallis Inquiry into the Financial System.

Executive Summary

1. The RBA welcomes the Government's decision to hold a Financial System Inquiry. The financial system and the institutions charged with its supervision have been evolving over recent years in response to the challenges that competition, globalisation and technology have presented. The particular value of the Inquiry is that it permits a stocktaking, whereby the system is seen in its entirety, and where future challenges can be evaluated. It also presents all participants with the opportunity to have their views evaluated in the same arena as their competitors – and in the full light of public scrutiny.
2. This submission adopts a top-down approach, outlining some general principles which should underlie a sound, competitive and innovative financial system. In keeping with the RBA's responsibilities, it emphasises the need to take into account the long-run stability of the system. That is, regulation should not produce habits of mind in the public or managers of financial institutions that encourage excessive risk taking that could lead to financial crises, but should also not inhibit people from taking calculated and understood risks. The submission recognises that financial crises cannot be ruled out, and therefore the system of regulation should be also one that can minimise contagion within the financial system and the flow-on effects to the rest of the economy.
3. It is unlikely that this emphasis will be a feature of most other submissions. They will rightly be mainly concerned with issues of competitive neutrality. Is the burden of regulation too high? Does it bear more heavily on one set of institutions or products than another? Is there duplication? Are newly-evolving institutions escaping the regulatory net? These are all important issues, and there are a number of improvements that will be suggested to the Inquiry by financial institutions, regulators and by the RBA. It is the RBA view, however, that in evaluating these suggestions for change, they should be judged not only by competitive neutrality criteria, but also by the need to promote system stability.
4. There is general agreement that there are three main areas of regulation; prudential, consumer protection and competition policy. The body of this submission is directed at the first. On the latter two,

the RBA puts forward some observations towards the end of the submission, but the main point is that both consumer protection and competition policy have an existing body of law and, in the main, it is intended to apply to all industries in Australia, not just to the financial sector. Any proposals for change must take that into account. Prudential regulation, on the other hand, is directed solely to financial institutions and concerns problems that are unique to them.

5. The first general principle of prudential regulation is that the type of regulation must be based on the risks being incurred. While it is possible to think of a spectrum of risk, it is not a continuous one; there is still an important division into two categories of product which are different in kind.
   - In the first category are those products which involve a binding contract on the part of the institution offering the product that it will not fall in value. The main products here are bank deposits and insurance policies. If the institution providing these cannot repay the amount they have specified in advance, they become insolvent. It also happens that some of these institutions are very important for system stability as their failure could become contagious.
   - In the second category are the various investment products which involve an undertaking to manage funds on a 'best endeavours' basis and whose return is based on the value of the underlying assets. With these products, it is the investor that bears the risk, not the institution. The value of these investments could fall without it implying insolvency for the managing institution.

6. It is important to note that this distinction is made in relation to institutions' liabilities, ie the promises they have made to customers from whom they have accepted money. The type of regulations that should be applied needs to be based on the nature of these promises, not, as is sometimes claimed, the type of assets held by the institutions. While there has been increased blurring of assets held by different types of institutions (eg more mortgages held by superannuation funds and life offices than a decade ago), there has been much less blurring on the liabilities side.

7. The regulatory framework should recognise the different risks involved in the two types of product, both to the public and to the institutions that provide them. In the first case, it is the institution that has to be regulated with a view to minimising its chance of becoming insolvent. This is prudential supervision *per se*. The second form of regulation is product based and mainly relies on stringent disclosure rules, including informing the public that the investment may fall in value. It is stretching the definition to call these disclosure rules prudential regulation.

8. Because of the different nature of the two types of regulation, the RBA sees no merit in combining them in the one institution, sometimes referred to as a 'mega-regulator', or 'mega prudential supervisor'. Indeed, there is a danger to the long-run stability of the system in so doing because of the 'moral hazard' involved. If all financial products were under one government regulator, the public could see them all as being equally safe – 'the Government stands behind them all'. This could have implications for the public purse in the event of a financial disturbance (or even a large fall in asset values). The extra risk from the moral hazard is that institutions would be deterred from competing on safety, and they would be encouraged to take greater risks to maximise returns. (A recent well-publicised case of this concerned the Savings and Loans institutions in the US.)

9. While there may be some scope for consolidation of supervisory management, the RBA regards the 'mega-regulator' model as fundamentally

flawed, and would not favour it even if the RBA became the 'mega-regulator'. There are few examples of 'mega-regulators' around the world if we mean by it a combined supervisor of banks, insurance companies and investment products such as unit trusts and managed funds. There are only four in the OECD area – Norway, Sweden, Denmark and Japan (where it is the Ministry of Finance). The financial instability in three of those four countries over the past decade does not suggest that this is a promising model to follow.

10. An argument for a 'mega-regulator' is that it would help harmonise regulations by allowing inconsistencies to be thrashed out within the one organisation. This could yield some benefit at the margin, but the differences between regulatory regime will remain large. The rules of prudential supervision applied to a bank will still be very different to those applied to an insurance company, and neither will resemble the sort of product disclosure for unit trusts, regardless of whether the supervisors are in the same institution or not. The growth of conglomerates whereby the same corporate entity offers both banking, insurance and investment products provides a challenge to supervisors, although it has been happening here and abroad for more than a decade. Again, a 'mega-regulator' is only one of several approaches to this issue. The more common response worldwide is to opt for a lead regulator. That is the approach being undertaken in Australia under the leadership of the Council of Financial Supervisors – the co-ordinating body of which the RBA, ISC, ASC and AFIC are members.

11. On the issue of who should be the bank supervisor, it will come as no surprise to learn that the RBA believes it should retain that role. A central bank, in addition to its monetary policy responsibility, must always take some responsibility for financial system stability and will be expected to do so by the public. Even those central banks that are given a narrow remit that excludes bank supervision always retain responsibility for the payments system on the grounds that it is vital to the stability of the financial system. The RBA believes that this extends to bank supervision, given banks' importance for stability, their role as lender to small and medium business, their susceptibility to runs, and the fact that these runs can become contagious with drastic consequences for system stability. The central bank is also in the unique position of being a participant in the financial markets on a daily basis, and is the only institution capable of injecting funds at short notice (either to the whole system or on a lender-of-last-resort basis to a particular bank). In addition, familiarity with markets is becoming more important as a potential financial crisis may be initiated in a market rather than by a bank failure (as in October 1987 in the US).

12. A number of arguments for and against the central bank being the bank supervisor are evaluated in the body of the submission and in Appendix C. There is no room to rehearse them here, other than to point out that they do not argue the central bank will be a bad supervisor, rather that supervision may interfere with monetary policy. These issues have been debated in a number of countries over recent years with varying results, but the only two instances where responsibility has been shifted has been in Finland and Hong Kong where it was moved from a formerly independent supervisor to the central bank.

13. With bank supervision in the central bank, where does this leave insurance companies given that both are to be prudentially supervised? If the only aim was to minimise the number of supervisors, there might be a case to put them with bank supervision, but other considerations would argue strongly against it. First, there are few, if any, synergies. The structure of the balance

sheets of banks and insurance companies are completely different and the skills required to supervise them are also different with actuarial assessment crucial to the latter. Second, insurance supervision is similar in many ways to the supervision required of superannuation. They are both very long run, concerned with retirement income, and actuarially based. Even though accumulation-type superannuation funds are, strictly speaking, an investment product, the social cost of inadequate return and community expectation are such that some form of quasi-supervision will be required to make sure that trustees maintain an appropriately diversified portfolio and do not take excessive risks (or become excessively risk averse). With over 120,000 superannuation funds, this is a demanding and labour-intensive task and, in conjunction with insurance supervision, justifies the existence of a specialised supervisor such as the present ISC.

14. To date this summary has covered banks, but not mentioned other retail deposit-taking institutions such as building societies and credit unions. These institutions have balance sheets which are similar to banks and are currently supervised by AFIC and the State-based supervisory authorities using rules which are closely based on the ones the RBA uses to supervise banks. Again, if the aim was to minimise the number of supervisors, there is a case to have these institutions supervised by the RBA. On the other hand, there is no case on the grounds of system stability, and being under the wing of the RBA would marginally increase the moral hazard.

15. An anomaly in the Australian financial system is that merchant banks, usually owned by foreign banks, are able to undertake wholesale banking business in Australia without a banking authority. This is a hangover from the days when foreign bank entry was not permitted, and these merchant banks provided much-needed competition for domestic banks. Now that foreign bank entry is open, there is a case to expect foreign banks wishing to do banking business to gain authorisation and so face the same supervision regime. It is also becoming increasingly difficult to justify our failure to supervise these unauthorised subsidiaries of foreign banks as expected by the Basle Committee on Banking Supervision.

16. Finance companies are a different case. They do not take deposits, but finance themselves through the issue of debentures under the prospectus disclosure provisions of the Corporations Law subject to the ASC. Their liabilities are relatively long term, and they are not subject to runs or contagion. Several have failed over the past two decades without threatening system stability. The RBA sees no case to change their present regulatory regime.

17. At present the RBA separately authorises financial institutions (banks and non-banks) that trade in the foreign exchange market. In the case of non-banks, this means supervising part of an institution without first-hand knowledge of the solvency of the whole. Two solutions to this unsatisfactory arrangement are to either confine foreign exchange trading to banks, or to cease separate authorisation of foreign exchange dealers. The RBA favours the second alternative, which will bring the treatment of the foreign exchange market into line with other markets such as the bond market.

18. The present authorisation procedures for banks, including the restrictions imposed by the *Banks (Shareholdings) Act 1972*, have been reviewed in line with recommendation 9.2I of the National Competition Policy Review. In the RBA's view, these restrictions are in the national interest even though they involve a marginal reduction in the degree of competition in banking. The only improvement that warrants consideration is to streamline the process of granting

authorisations. This could be achieved by allowing the RBA to grant authorisations, with a right of appeal to the Treasurer.

19. The RBA does not see a case for a bank licence fee or for a charge for the cost of supervision. In the latter case, the cost of supervision is well below the implicit tax imposed on banks by the penalty interest rate on Non-Callable Deposits.

20. In regard to the payments system, the major issues are risk, entry and challenges from new technology. Settlement risk has been a major concern over recent years, but is in the process of being largely eliminated by the introduction of Real-Time Gross Settlement. The right to entry to the settlement system has also been the subject of controversy but, with building societies and credit unions gaining membership through their special service providers, all significant providers of payments services are now members.

21. A recent subject of concern has been the fear that unsupervised competitors might provide an alternative payments system which would bypass the banks. A close examination of the services currently (or prospectively) offered on the Internet suggests that this is unlikely. In order to become a significant provider of payments services, an institution must accept deposits, in which case it will effectively become a bank and be supervised as one.

22. On competition policy, the RBA believes that the same broad principles which are used to evaluate mergers in other industries should be used to evaluate mergers in the financial services sector. This would mean taking a fresh look at the 'six pillars' policy which prevents mergers between any of the four largest banks and the two largest life offices. The 'four plus one' interpretation of the *Trade Practices Act*, whereby a regional bank presence is required in each State, should also be examined. It would be a much more serious step, however, to re-define competition policy in a way which effectively reduced the number of major banks in Australia to two.

23. On consumer regulation, the RBA believes there is scope for considerable rationalisation. Many financial institutions face rules on consumer protection imposed by State regulations, the ASC, ISC and Industry Codes of Conduct. The RBA plays a minor role in this area through the Australian Payments System Council and some Industry Codes of Conduct. It would be prepared to vacate this area if a more unified system of consumer protection was devised. Something along the lines of the UK Personal Investment Authority seems the most promising avenue.