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Financial Restructuring in Australia

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Abstract:

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Over the past two decades, the Australian financial system has undergone massive restructuring, with the promise of more to come following the deliberations of the Wallis Inquiry[1]. The objective of this paper is to outline the nature of that restructuring, explain the reasons underpinning the restructuring, identify its consequences, and examine the lessons which might be learnt from the restructuring process. To achieve those aims, it is first necessary to clarify what is meant by the term “financial restructuring” and that is addressed in section one of the paper. This is followed by an overview of the general causes of financial restructuring in section 2, and an outline of specifically Australian factors contributing to financial restructuring in section 3. Section 4 outlines the major elements of financial restructuring in Australia[2], and the conclusion in section 5 examines some consequences and unresolved issues.

1. The Meaning of Financial Restructuring

A recent theme in the academic literature on regulation of financial systems has been the need to distinguish between *financial institutions* and the *economic functions* performed by those institutions (Merton and Bodie, 1995). A further strand of literature (Allen and Gale, 1994, for example) has focused on financial innovation and the possibility of different *financial instruments* being created or new *financial techniques* being developed to perform the same economic functions. In discussing financial restructuring, it is important to recognise that the

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[1] A Financial System Inquiry, chaired by Mr Stan Wallis was appointed by the Federal Government in June 1996 and is due to complete its final report by the end of March 1997. A discussion paper (FSI, 1996) was released in November 1996.

[2] Analyses of financial restructuring in Australia can also be found in Edey and Gray (1996), Oster and Smith (1994) and Tease and Wilkinson (1994).

nature of the economic functions[3] performed by the financial system has not changed, although the efficiency of that performance may, hopefully, have improved over time through changes in the structure and operating characteristics of financial institutions and markets or innovations in financial instrument design.

Financial restructuring, then, manifests itself in a number of different forms. One is that of changes in the relative significance of different types of financial institutions (banks versus non bank financial institutions (NBFIs) for example). Another is that of changes in the competitive market structure within particular institutional groups (concentrations ratios in banking, for example). While both of these aspects of restructuring are readily visible and measurable, their basis in "official" institutional classifications makes them often meaningless in a deregulated financial environment where equivalent economic functions can be performed by a variety of institutional types in a variety of ways. Only where there is some special characteristic of, or activity performed only by, a particular type of financial institution, is a focus on changes between or within institutional groups appropriate.

An alternative aspect of financial restructuring is that of changes in the organisational forms of financial firms. One characteristic of such changes is in the range of activities undertaken by financial firms, such as can occur with the development of financial conglomerates spanning a wide range of financial services, or more simply with an incursion by one type of financial institution into activities previously the preserve of another type. Decisions to undertake certain activities either within the firm or through use of consultants and markets also fall into this category. An alternative characteristic (often overlooked, but significant and important) is that of changes in the ownership and governance structures of financial institutions, as can occur with demutualisation, corporatisation, privatisation etc.

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[3] Merton and Bodie identify: clearing and settlement, pooling and diversification, resource transfers, risk management, information provision, efficient contracting, monitoring and incentive arrangements, as economic functions performed by the financial system.

Yet a third aspect of financial restructuring concerns the processes by which economic functions are performed within the financial system. New or different financial instruments can be developed, which enable similar functions to be performed in different ways or more efficiently, or which enable functions previously performed jointly to now be performed separately. The enormous growth in financial derivatives in the last two decades is well known in this regard, although the impact this growth has had upon the way in which financial institutions operate is often less well known. In addition to new instruments, development of new financial techniques and new markets are also important aspects of restructuring. Modern financial techniques such as portfolio insurance, programme trading, securitisation, new forms of underwriting and securities issuance procedures, all change the way in which economic functions are performed by the financial system and impact upon the types and activities of financial institutions. Yet another development within this category is the development of new, and changes in importance of existing, financial markets - either over the counter (OTC) markets or organised exchanges. The emergence world wide since the start of the 1980s of financial futures markets or, in Australia, secondary markets in public sector securities are illustrative of such developments.

A final aspect of financial restructuring concerns the nature of financial regulation and the structure of the regulatory system. In financial markets this is particularly relevant, because these markets have been, arguably, the sector of the economy to attract most regulatory interest over many years. Moreover, the nature of regulation constrains the activities of participants and influences the structural development of the markets in line with Kane's (1981) *regulatory dialectic* model. Also important is the design of, and assignment of regulatory responsibilities among, regulatory bodies, since this may influence the evolution of financial structure. Participants in the financial markets will respond to imbalances in regulatory burdens or benefits, while regulatory bodies (under the *private interest* model) will seek to influence the development of the financial structure in ways most beneficial to their interests.

2. The Causes of Financial Restructuring

The previous section has identified a number of different facets of financial restructuring, involving relative growth of financial institutions, changes in the organisational form of financial institutions, changes in financial instruments and techniques, development of new markets, and changes in regulatory techniques and regulatory structure. In this section, a brief overview of the general causes of financial restructuring is provided as a prelude to identification of peculiarly Australian causes and forms of financial restructuring.

Financial restructuring is an ongoing, endogenous, process according to Kane's (1981) model of the *regulatory dialectic*. In this view, market participants are continually responding to extant regulation and exogenous factors by financial innovation, which alters the force of regulation and prompts regulatory change and, in turn, further market responses in an ongoing process. In this view, financial restructuring cannot be seen as a transition phase from one stable equilibrium to another in which a new institutional structure, set of financial products, or regulatory structure will emerge as a sustainable outcome.

Although Kane's model has considerable merit it does not, by itself, explain why financial history has been characterised by some periods of rapid structural change and others of relative tranquillity. For example, the two decades prior to the late 1970s appear (in hindsight) to have been ones in which the Australian financial system (and those of other countries) experienced only moderate structural change relative to the following two decades (to date). "Exogenous" factors clearly play a role, and a number of them are well known.

Changes in technology play a key role in prompting financial restructuring. Advances in computer and telecommunications technology have enabled the development of new financial instruments, new service delivery mechanisms, new methods of settlement etc.. Likewise, financial innovation has been a major influence on financial restructuring, as advances in knowledge have enabled the development of new instruments and techniques.

Real sector changes can lead to financial restructuring. Government policies, such as taxation changes, competition policy, social security policies, privatisation, can all have significant influences on the financial sector by altering the flow of funds through the economy and affecting the relative return on differing financial sector activities. So also can macroeconomic conditions, most notably unexpected changes in interest rate, asset prices, aggregate demand, which may force structural adjustment as unprofitable financial firms are forced to exit from their industry. Finally, micro economic or industry level changes can influence financial structure, the most obvious example being the often quoted requirement that financial firms need to grow large to be able to service increasingly large business firms.

Last but by no means least among this list of determinants of financial restructuring is government financial sector policies, most recently (in a long term historical context) taking the form of deregulation or liberalisation. In Australia, this has played an important role in the restructuring process of the past two decades.

3. Key determinants of Australian financial restructuring

The Australian financial system has been profoundly influenced by the process of financial deregulation which has occurred since the late 1970s. At that time, the banking sector was heavily regulated, foreign (and, it was believed, other) entry into banking was prohibited, public sector security markets were rudimentary, and financial market prices (exchanges rates and interest rates) were subject to government regulation. NBFIs, which were subject to less regulation, had grown more rapidly than banks over the previous decade (although some of the institutions involved were bank subsidiaries).

The deregulatory process which began at the end of the 1970s saw interest rate controls progressively abolished (a process completed by 1986), the exchange rate fully deregulated (1983), activity restrictions on banks largely removed, removal of "captive market" requirements (which forced banks and life offices to hold significant amounts of government securities), allowance of foreign bank entry, deregulation of the stockbroking industry (both of entry restrictions and price fixing), introduction of tender systems for government debt issues. A calendar of major deregulatory events, extracted from the 1996 Annual Report of the Council of Financial Supervisors, is reproduced as **Appendix 1.**

Subsequently, policies towards supervision or regulation of the financial system have followed a process which some have referred to as “reregulation’. In accordance with international agreements, banks (and other depository NBFIs) have been subject to capital regulations, through the imposition of minimum capital requirements linked initially to counterparty or credit risk (since 1987) and more recently to market risk arising from trading activities. Minimum risk based capital standards are also being applied to life offices and stockbroking firms. Greater supervision of banks’ internal risk management systems has also been put in place.

Rather than a process of “reregulation” it is perhaps more appropriate to see these developments as the prudent response of the government as a defacto insurer of the liabilities of certain financial institutions, endeavouring to prevent the moral hazard inherent in any insurance type arrangement. As part of the supervisory process, marked changes have also been made in the supervisory structure. The Insurance and Superannuation Commission (ISC) was established in 1987 to supervise the insurance and superannuation industries. State based powers over securities regulation and supervision of NBFIs, which impeded a nation wide policy, have been standardised and the Australian Securities Commission (ASC) and Australian Financial Institutions Commission (AFIC) established (in 1991 and 1992 respectively) to supervise companies and the securities industry, and NBFIs respectively. Concerns over the possibility of inconsistent regulation has led to the formation of a Council of Financial Supervisors in 1992, comprising those two bodies, the Reserve Bank (RBA) and the ISC.

In addition to the financial deregulation process, the Australian financial system has been profoundly influenced by a number of other government policy changes.

The introduction by the Labor government in 1986 of its retirement incomes policy aimed at encouraging self funding of retirement rather than reliance on government pensions has been particularly important[4]. Although the nature of retirement incomes policy continues to change, compulsory participation in superannuation schemes and tax incentives for superannuation savings have affected the composition of private sector savings - if not the quantity. In particular, a much greater proportion of private sector wealth is now under the management of fund managers rather than deposited with financial intermediaries. The consequences of this shift are profound, involving as they do a relative increase in demand for marketable securities by fund managers and a relative decline in funds available to traditional originators of loans, and are contributing to the separation of loan origination activities and funding and the development of new securities markets.

Major changes to the Australian taxation system have also been important[5]. Taxation of (real) capital gains was introduced in 1985 and a dividend imputation tax system introduced in 1987. The latter change, by eliminating the double taxation of dividends for Australian investors in Australian tax paying companies, has had two major effects. First, the tax advantage enjoyed by debt finance over equity has largely disappeared, leading to a realignment of flows of funds into equity and out of debt. (It can also be argued that this has affected the relative expected rate of return on equity and debt when compared to that overseas). Second, since companies have an incentive to distribute more of their after tax earnings than before (so that shareholders enjoy the benefits of the imputation system), external financing by companies has increased relative to internal financing (although some part of that reflects the growth in such mechanisms as dividend reinvestment schemes).

The effects of the inclusion of real capital gains in income subject to tax has had less effect, although in conjunction with the decline in inflation since the late 1980s this change has reduced the tax incentive for negative gearing of real estate investments.

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[4] Robinson (1992) provides an overview of the development of retirement incomes policy.

[5] VanHorne, Wachowicz, Davis and Lawriswsky (1994, Chapter 2) provides an overview of the Australian tax system

Changes in attitudes and policies towards government ownership or involvement in the economy have also been important. At the end of the 1970s, government owned banks and insurance companies were significant participants in those industries. Since the latter part of the 1980s, the trend towards privatisation has seen governments exit from direct ownership of financial institutions. Privatisation has also had the effect of creating a number of large corporate entities requiring funds from the private sector (both as equity and debt) and reducing government borrowing requirements. Also important has been the devolution of many government financing responsibilities from the Federal government to State Central Borrowing Authorities, which has created a range of new public sector securities markets.

Finally, it would be remiss not to mention the impact of the economic experience of the late 1980s on the restructuring of the Australian financial system. Following the financial deregulation of the mid 1980s and the abandoning of monetary targeting, the Australian economy experienced a major asset price boom, fuelled partly by a significant lowering of credit standards by financial institutions. In the late 1980s, the breaking of the asset price spiral saw a number of financial institutions post losses and experience capital adequacy problems, leading to mergers and takeovers - the most significant being those seeing the end of the State owned banks in Victoria and South Australia.

4. The Australian Financial Restructuring Experience

To summarise the Australian financial system restructuring experience, it is useful to start at an aggregate level and proceed to more microeconomic issues. Thus this section will initially focus on “Non-financial sector” changes which affect the flow of funds through the financial system, following that with an overview of developments in financial markets in aggregate. Changes in the composition of financial markets are then examined, followed by developments in structures and operations of financial firms, and in restructuring of the methods of financial services provision. Finally, the perspective returns to the broader level to examine restructuring of financial regulation.

4.1 "Non-financial" sector influences on financial restructuring

The non-financial sector comprises the household, business, government and overseas sectors who are ultimate suppliers and users of funds. For each sector, there have been major realignments of financial flows in the past two decades.

Trends in the household sector's asset holdings are shown in **Figures 1** and **2.** Two points stand out. The first is the increase in financial assets and liabilities relative to GDP. The second is the marked increase in the share of assets held with fund managers (life offices and superannuation in particular) and in securities.

Whether the relative increase in the size of financial assets and liabilities of the household sector is a long term trend is open to speculation. One possible explanation might be found in demographic trends and retirement income policies. With the ageing of the population, the tendency of younger members to be borrowers and older members to be lenders, plus the policy direction of savings (which might have otherwise been used as individual equity in real asset accumulation) into long term holdings of financial assets, a shift of this form might be expected. On this view, the aggregate ratios could be expected to eventually stabilise at a higher level than was common in previous decades. It is worth noting that the increase in (gross) leverage of the household sector has occurred during a period when continual concerns about low levels of household saving have been expressed. As **Figure 1** also indicates the ratio of net financial assets (financial assets minus financial liabilities) of the household sector to GDP has shown some increase.

The change in the composition of asset holdings reflects several factors. One important influence has been the changes in government retirement incomes policy referred to previously. A second may be the effect of taxation policy changes (also outlined previously) which have increased the relative attractiveness of equity type investments. A third influence may be the nature of demand for the services provided by deposit type financial instruments which may have income elasticity close to unity.

The structural changes outlined have some important consequences. First, it is worth noting that the increase in (gross) leverage of the household sector has occurred during a period when continual concerns about low levels of household saving (and thus low growth in net wealth or “own equity”) have been expressed. Thus the household sector would appear to have become more highly leveraged and exposed to financial risk. Second, the relative shift in asset holdings means that household portfolios appear to have greater exposure to risky assets (rather than “safe” assets such as bank deposits). Whether the household sector is in fact bearing greater financial risk (since ultimately financial transactions simply repackage risk), and the implications for its real decision making, is an issue worthy of further study. Finally, it is worth noting that less reliance by individuals on intermediated deposit products combined with a deregulated, more complex, financial sector has seen the rapid growth of the financial advising and planning industry.

Figure 3 illustrates the major change which has occurred in the balance sheet of the corporate sector. Following a marked increase in debt financing in the 1980s, there has been a significant shift towards the use of equity finance. This can be explained primarily by the introduction of the dividend imputation tax system which removed the tax bias towards debt finance. Also important has been the growth in external finance, reflecting higher dividend payout ratios following imputation, although some part of that measured increase in external financing reflects growth of dividend reinvestment schemes which lead to distributed earnings flowing automatically back as equity investments..

Over the long term, government debt on issue relative to GDP has fluctuated significantly (see **Figure 4**), reflecting developments in government budgetary outcomes and variations in the growth rate of GDP. In the latter part of the 1980s, Commonwealth debt on issue declined as budgetary stringency, a slowing of inflation, and a transfer of financing responsibilities to the States took effect. While that trend has been reversed, and total public sector debt/GDP has increased in recent years, longer term prospects would appear to be for a decline for several reasons. First, privatisation policies mean that sale of assets generates funds which can be used to repay outstanding debt and the future financing requirements of privatised businesses are taken out of the government arena. Second, although the move to a low inflation environment has removed one of the major causes of a declining debt/GDP ratio, the political aversion to significant debt financing seems likely to inhibit growth in debt. Within the overall public sector, it is also worth noting that the relative significance of Commonwealth debt relative to that issued by State Central Borrowing Authorities has declined, leading to the development since the mid 1980s of secondary markets in State debt.

The final real sector influence warranting attention is that of the nature of the external accounts (involving the overseas sector). The continuing current account deficit has meant that financial flows in Australia have been significantly influenced by the need for capital inflow, either in the form of overseas borrowings by corporates, financial institutions and government, or through equity investments and asset purchases by foreigners. **Table 1** illustrates these trends. Facilitating these financial flows has been an important activity for the financial sector and an influence upon its structure. In particular, domestic financial institutions have had incentives to develop offshore reputations, and international financial firms have had an incentive to establish some Australian presence to attract this and related business. One outcome of this process is that the proportion of total borrowings by intermediaries which is sourced from overseas has increased from 4% in 1985 to 16% in 1995.

Table 1

Australia's External Assets and Liabilities ($bill)

	Gross Foreign Borrowing		Gross Foreign Investment	Australian Investment Abroad		Net Foreign Liabilities	Net Foreign Debt
	Public	Private	Total	Equity	Total		

1980	6.82	6.31	39.88	3.79	13.55	26.33	6.86
1985	29.87	26.32	111.62	11.69	33.76	77.86	51.21
1990	71.97	90.80	266.61	57.26	96.22	170.39	131.65
1995	100.26	123.73	401.74	90.32	140.75	260.98	181.97
1996	97.66	137.82	436.70	95.54	151.97	284.74	187.80

4.2 Financial Markets in Aggregate

Two dominant, apparently paradoxical, features of aggregate financial market activity can be seen in **Figure 5.**. First, total assets of financial institutions has increased quite markedly both in dollar terms (as shown), and also relative to GDP (from just over 100 to around 200 between the late 1970s and the mid 1990s). At the same time, the extent of direct financing has also grown significantly and there has also been a significant increase in the extent of borrowing from overseas. The growth in assets of financial institutions reflects a number of possible influences including: ongoing financial "deepening" as economic development occurs; financial reintermediation following the 1980s deregulation of financial institutions; the excessive lending boom of the mid 1980s following deregulation; or the lifecycle savings influences mentioned previously.

Although financial institutions and financial service provision have increased in relative size based on asset measures, national accounts figures tell a different story. After an increase in the 1980s, the share of GDP contributed by the financial sector has tended to decline since the start of the 1990s, as shown in **Figure 5**. Likewise, the contribution of the financial sector to aggregate employment has tended to fall. This can be seen as the result of a number of influences. First, the technological revolution has led to a replacement of labour with capital in many of the activities undertaken by financial firms. Second, increased competition and deregulation have led to financial firms focusing upon increases in efficiency, reducing labor usage and thus, to the extent these cost savings are passed onto customers rather than reflected in higher profits, measured value added. .

4.3 Financial Market Composition

Table 2 provides snapshots of the institutional structure of the Australian financial system from the late 1970s to the mid 1990s. Significant changes are evident compared to the picture at the end of the 1970s. The share of banks in total assets has increased significantly, as has the share of the banking conglomerates. The share of pension funds (and approved deposit funds) has increased significantly, and life offices have experienced some increase in their share of total assets. Combined with the growth in the unit trust (mutual funds) industry, the share of *fund managers* relative to *intermediaries* in total assets of the financial sector has increased substantially. Declining in relative importance has been the NBFI sector, as building societies have converted to banks, banks have moved some finance company business and merchant bank business back into the banking arm, and merchant bank subsidiaries of foreign banks have been replaced by branches of those banks. In addition, the number of banks has increased markedly, although the number of government owned banks has declined dramatically.

What is not immediately obvious from **Table 2** is the increase in relative importance of direct finance vis a vis intermediated finance which has occurred. Growth in securitisation since the late 1980s (but particularly since the mid 1990s) is one aspect of this trend, as is the increase in direct equity holdings of individuals, and the increasing use of offshore debt markets by Australian corporates. Also hidden in **Table 2** is the continual blurring of boundaries between financial institutions which make institutional definitions less and less relevant.

A further feature of the financial restructuring which has occurred has been the growth and deepening of markets for financial instruments[6]. **Table 3** illustrates, and shows how the

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[6] A recent survey of developments in the markets for major financial instruments can be found in RBA (1996)

turnover in various financial markets has boomed since the mid 1980s. Notably, futures (and forward/swap) markets have grown to the extent where they rival the physical markets in many cases.

Table 3

Financial Market Turnover: Daily Average ($ billion)

Year ended June	1980	1985	1990	1995
Commonwealth Bonds -physical	0.1	0.3	1.2	6.0
Commonwealth Bonds - futures	-	-	1.7	6.0
State Government Bonds	-	-	2.0	2.9
Bank Bills -physical	-	0.3	1.7	1.0
Bank Bills - futures	-	0.5	11.4	19.0
Equities - physical	0.03	0.07	0.23	0.47
Equities -futures	-	0.07	0.19	0.44
Promissory Notes	-	-	0.5	0.8
Foreign Exchange - swap	-	0.8	7.5	14.0
Foreign Exchange - spot	-	2.0	8.6	7.2
Foreign Exchange - forward	-	0.3	1.4	1.0

Source: Edey and Gray (1996)

4.4 The Structure and Operations of Financial Firms

In conjunction with the blurring of institutional boundaries, quite marked changes have occurred in the structural organisation and range of operations of Australian financial firms.

Financial Conglomerates

Financial conglomerates are financial institutions with significant activities across a range of activities encompassing some or all of banking, insurance, funds management and securities business. **Appendix 2** provides an overview of the extent to which major financial firms within Australia now take the form of financial conglomerates. Prior to the start of the

1980s, banks were limited in their involvement with merchant banks etc., precluded from a role in stock broking, and a clear distinction between life insurance and deposit taking institutions existed. Particularly with the sale of the State Bank of NSW to the life insurance group Colonial in 1995, the distinction between life offices and banks has been broken. More generally, as can be seen, there is a significant spread of interests across the financial spectrum by most major financial firms This creates a number of issues for the appropriate structure of such groups and for regulation. Developing organisational structures which enable synergies to be gained from conglomerates, ensuring that different “cultures” can be assimilated, creating appropriate “Chinese Walls”, and developing firewalls which prevent financial problems in one part of an organisation threatening the safety of claims on other parts of the organisation are among such issues..

Government Exit as Owners

Privatisation of government financial enterprises has proceeded apace since the late 1980s. State banks have been sold to private sector competitors - although a privately owned bank in Queensland has recently been purchased by that state government. The Commonwealth bank has been floated. Governments have also tended to exit the general insurance industry, and plans for the Australian Industry Development Corporation’s sale have been mooted from time to time.

Foreign Entry

In 1984, foreign entry into Australian banking was first allowed (as subsidiaries) and subsequently entry as branches of foreign parents has been permitted. The number of foreign banks has increased markedly in recent years, although some part of that increase reflects conversion of merchant bank subsidiaries into bank branches.

Demutualisation

A significant trend has been the conversion of financial firms to joint stock company status. Stockbroking firms, which could only take the form of partnerships until 1984, have largely changed to joint stock form or become part of larger financial conglomerates, and the

Australian Stock Exchange is currently examining the merits of demutualisation. A large number of building societies have converted from mutual status, as well as some converting to bank status. In addition, the large mutual life offices have begun the process of demutualisation.

At least two hypotheses can be advanced to explain these trends[7]. One, the *efficiency* hypothesis argues that organisational form will adapt to that most suited to the economic environment. On this argument, mutuals and cooperatives have lost any natural advantages of inherent safety through the emergence of public perception of government protection of depositors etc., as well as losing advantages of superior information about customers as they have grown large. An alternative hypothesis, the *expropriation* hypothesis, sees incentives to conversion arising from the opportunities to convert communal wealth (accumulated over years of successful operations) to private wealth in the conversion process. Both hypotheses have different degrees of relevance for different instances, but the general issue of why demutualisation has become such a significant phenomenon in the past decade warrants further attention.

Capitalisation

Following the deregulation of activities in the 1980s, regulatory bodies have addressed the problem of limiting risk for customers of financial institutions (and ultimately the taxpayer) by the imposition of minimum (typically risk based) capital standards. These were introduced for banks in 1987, for other deposit taking institutions supervised by AFIC in 1992, for life offices under the 1995 Act, and are under consideration for stockbroking firms. Consequently there has been a major increase in the capitalisation of financial firms in Australia, together with a significant degree of financial innovation in terms of developing alternative financial instruments to straight equity which meet capital adequacy requirements.

The introduction of risk based capital adequacy requirements has had a major influence upon the activities of financial institutions. In particular, in conjunction with deregulation, it has

[7] See Davis (1996)

caused them to focus upon the appropriate pricing of various financial products to ensure an adequate expected return for the risk involved. In addition, the linkage of capital required to balance sheet size, together with the measurement treatment of the goodwill component of capital involved in a takeover, plays an important role in influencing expansion and merger plans of financial institutions.

4.5 Financial Services Provision

Major changes have been occurring in the nature of provision of financial services. A dominant influence has been the developments in electronic technology which have led to the electronic delivery of many financial services. The role of EFTPOS and ATMs, and the likely future impact of rechargeable cards cannot be understated. Such developments have contributed to the relative decline in employment in the financial services industry as computer technology has enabled both back room (recording, settlement etc) and front room (cash provision etc) tasks to be automated.

These developments have also contributed to the perceived need for a significant physical restructuring of financial services firms. Banks generally view their branch networks as too extensive and costly. Not only has technology removed many of the benefits of a bricks and mortar presence, but the deregulation of interest rates has seen the competitive strategy of the regulated era of providing convenience services by locational decisions lead to excessive branches becoming millstones around the banks' necks. (Some part of the current interest in mergers of Australian financial services firms can be traced to a view that this may be the least cost method of rationalisation / restructuring, while the perception that there may be scale economies in the new technology is also relevant.)

Electronic delivery is extending into further areas with the beginnings of electronic prospectus provision replacing physical provision. This has potentially enormous ramifications, since it widens the potential audience of investors and reduces the cost of information provision. The possibility exists that this may dramatically increase the flow of funds from retail investors into securities and mutual fund type investments. The reduction in the cost of information provision via electronic means also raises a number of consumer / investor protection concerns, since misinformation can also be more easily provided.

Not only have delivery methods been restructured, the financial instruments through which financial services are performed have been restructured. Financial innovation has been a feature of the last two decades, and new financial products have been created and become commonplace. The plethora of derivative financial instruments is well known, but the characteristics of more traditional products have also often changed. At the retail level, floating rate housing loans, for example, have been supplemented by fixed rate mortgages, mortgage offset accounts etc.. Inflation indexed securities have been introduced at the wholesale level, and hybrid securities such as converting preference shares have become popular with corporates.

On major consequence of these developments has been a restructuring of the pricing policies of financial institutions. Unbundling has tended to occur, with component parts of particular financial products being priced separately and with greater reference to their respective costs. Explicit account keeping fees and charges on retail transactions accounts are one example, while the replacement of whole of life insurance policies with term life and investment vehicles is another.

4.6 Regulatory Restructuring

Regulatory restructuring has taken three main forms

The Nature of Financial Supervision

At the end of the 1970s, financial regulation involved a relatively heavy handed approach of imposing limits on the activities of financial institutions. This has been removed and eventually replaced over time by a regulatory regime which attempts to ensure that capital adequacy is in place for risks taken, and that market and supervisory discipline will constrain excessive risk taking. Unfortunately, the experience of the 1980s demonstrates that the timing of these changes was not well coordinated. Regulatory constraints which inhibited the actions of financial managers were removed before market or supervisory discipline was established.

At the time of writing, a major issue regarding the appropriate form of government regulation and supervision concerns the extent of government protection of customers of financial firms. De facto government guarantees of bank deposits are widely perceived as existing, and can be argued to provide a competitive edge to banks - which extends over the wide range of activities which they engage in as financial conglomerates. The possibility that the Wallis Inquiry might recommend the introduction of some form of deposit insurance scheme, or of limiting the range of activities of institutions receiving explicit government protection, is one which would induce further significant structural change in the industry. Without such change, the trend of recent years of banks capturing an increasing share of the financial market could be expected to continue, making the current concerns over possible mergers increasing concentration in banking increasingly relevant.

Organisation of Prudential Supervision

Major changes have occurred in the structure of supervisory arrangements. State governments eventually agreed to act in a coordinated fashion in both the areas of securities regulation and supervision of state based financial institutions. Consequently, the Australian Securities Commission was formed in 1991 and has been able to operate nation wide approach to companies and securities regulation. Likewise the Australian Financial Institutions Commission was established in 1992 to provide a consistent national approach to the supervision of building societies, credit unions, and friendly societies. Other regulatory bodies are the Reserve Bank (responsible for bank supervision) and the Insurance and Superannuation Commissioner.

This multiplicity of regulators creates some problems of possible overlap and inconsistency of regulation. Much recent discussion has focused on the question of whether an *institutionally based* regulatory structure, such as this, is appropriate. Deposit taking institutions are, for example, subject to regulation by two different bodies (RBA and AFIC) while many institutions (particularly conglomerates) are supervised by several regulatory bodies. More generally, given the possibility of similar functions being performed by differently styled financial products, financial engineering techniques provide the opportunity to evade regulatory constraints.

In practice, these problems have been addressed by the formation of the Council of Financial Supervisors, a semi-formal gathering of the regulatory authorities to ensure a coordinated approach. The nature of an appropriate structure for regulation is being addressed by the Wallis Inquiry.

Competition and Consumer Protection

A final area of relevant regulatory policy is that related to competition and consumer protection. Financial institutions and markets are subject to oversight by the Australian Competition and Consumer Commission (ACCC) as well as by the supervisors discussed above. There has been for some time a policy in place (referred to as the “Six Pillars” policy) which suggests that mergers among the four biggest banks and two largest life offices would not be permitted. In addition, an unwritten policy of “four plus one” has been suggested as guiding official responses to bank takeovers , whereby state based markets should have at least one regional bank in addition to the four majors. The Wallis Inquiry deliberations will impact upon these policies and thus potentially have an important influence on shaping the market structure of the financial system.

The ACCC and other regulators have paid particular attention to the role of information provision in financial markets and this has led to the development of codes of banking practice, the consumer credit code, greater disclosure requirements etc. There is little doubt that a major change in recent decades has been in the extent of information provision to users of financial services, although whether they are better informed, given the increased complexity of the financial system and financial products, is open to debate.

5. An Assessment

Restructuring is an ongoing process reflecting changes in profit opportunities induced by market developments or by regulatory changes. It is to be hoped that restructuring would generate a (continually changing) financial system structure with desirable efficiency and other characteristics such as systemic stability, fairness etc. The obvious question which arises is: has the restructuring process in Australia had such effects?

The process of restructuring has not been without its problems. During the latter half of the 1980s, many financial institutions made extremely poor lending and investment decisions, suggesting that unfettered competition in financial markets at that stage of development did not lead to an optimal allocation of financial resources. Since then, market discipline, corporate governance and internal control mechanisms have (hopefully) improved sufficiently to ensure that poor management and excessive risk taking will not be permitted to continue unchecked (although the ability of capital markets to accurately assess trends in the fundamental value of such opaque institutions as banks, and discipline management in any form other than *ex post* is open to debate).

The ability of the financial system to allocate financial resources in a socially optimal way is, however, still subject to much debate. A continual theme is that of whether small business and new ventures are able to access finance on appropriate terms and conditions which would enable value adding activities to take place. This was the focus of the Industry Commission Report (1991), one of the priority areas for investigation identified by the Wallis Inquiry Discussion Paper, and the subject of a 1997 study underway by the Department of Industry into the scope for an alternative stock market catering to smaller firms. While plausible explanations for the public perception of “underfinancing” of small business can be found in differences in perceptions of risk and expected return between owners and prospective financiers, the extent to which financiers’ views are appropriate or not remain a matter for concern. However, government policies, involving tax concessions, to promote finance for such ventures, such as the Management Investment Companies (MIC) Scheme of the 1980s, the more recent Pooled Development Scheme, and such industry specific schemes as providing tax concessions for investment in film making, have not had obvious success. Of interest, though, tax concessions for large scale infrastructure financing (involving the ability to issue bonds paying non taxable interest) have aroused significant interest and usage.

A further area of ongoing debate concerns the extent to which the prices charged for services, and interest rates paid and received, by financial institutions are fair and reasonable. Particularly in the retail area, consumer perceptions appear to be that financial institutions exploit their market power to generate excessive profits at the expense of customers, and debate has been stimulated by the unbundling of financial products and explicit pricing of various services. At least some part of these perceptions is unfounded, with few customers properly understanding the nature and extent of the resource costs involved in providing financial services. On the other hand, the possibility that financial firms do have some degree of market power which enables them to make above normal profits on some activities (or use those to cross subsidise other activities) should not be immediately dismissed. The impact of the recent emergence of housing mortgage brokers and securitisation in bringing about a relative reduction in housing loan interest rates charged by banks and other lenders is indicative of a prior situation of less than perfect competition in that particular market.

Any ability of financial institutions to charge excessive prices for financial services to particular customers hinges upon a number of factors. One is the cost to customers of switching between suppliers. Another is the extent to which customers are unable to accurately assess the true prices or returns which they are paying or receiving because of inadequate information or inability to interpret such information. Both are influenced by the third factor, that of the institutional structure of, and competition in, financial markets - which has been the subject of considerable recent debate in Australia. Financial market restructuring has seen the four major banks increase market share, and with some bank managements displaying interest in mergers between those banks (and takeovers of regional banks), concerns have been aroused about trends towards excessive concentration of market power.

Ultimately, the institutional structure of Australia's financial markets will be strongly influenced by government policy, taking into account issues of efficiency, system stability, political interests etc. While much attention in this regard is being directed at the issue of mergers involving large financial institutions, a more important consideration is that of ensuring that entry barriers to financial service provision are low and thus that the markets are at least contestable. Regulatory entry barriers (such as licensing requirements) need to be examined. Implicit government advantages to particular incumbent institutions (such as the de facto guarantee of bank deposits) need to be replaced by customer protection methods which are competitively neutral. Official oversight of prices charged for access to common use facilities needed for participation in particular financial services (such as payments services) seems necessary. Recommendations of the Wallis Inquiry in areas such as these seem likely to be among the major influences upon the future restructuring of the Australian financial system.

Table 2

Total Assets of Financial Institutions: Percentage Composition

	1979/80	1984/85	1989/90	1994/95
Reserve Bank	8.0	6.7	3.3	3.7
Banks				
Trading	22.6	23.6		
Savings	15.1	13.4		
Other	1.1	0.9		
Total	38.7	37.8	42.7	44.2
Non-bank financial corps				
Permanent building societies	7.0	5.7	3.0	1.4
Credit co-operatives	1.3	1.7	1.1	1.4
Authorised money market dealers	1.1	0.6	0.6	0.8
Money market corporations	4.3	7.1	7.0	5.2
Pastoral finance companies	0.9	1.4	0.3	0.3
Finance companies	11.8	8.2	5.3	3.2
General financiers	1.3	1.2	1.6	1.0
Total	27.7	25.8	19.0	13.2
Life offices & super funds				
Life insurance offices	9.1	8.0	11.2	12.0
Super funds - public	4.3	5.7		
Super funds - private	3.9	4.4		
Super funds -total	8.2	10.1	8.6	12.4
Approved deposit funds			1.0	1.2
Total	17.2	18.0	20.7	25.5
Other managed funds				
Cash management trusts		0.5	0.6	0.6
Common funds		0.5	0.9	0.4
Friendly societies	0.2	0.4	1.1	0.9
Public unit trusts	0.8	2.5	3.6	4.2
Total banks, NBFIs & managed funds	84.5	85.5	88.7	89.0
Other financial institutions				
General insurance offices	5.9	5.9	4.3	5.4
Intra-group financiers	0.5	1.3	2.1	
Other (FCA) fin corps	0.1	0.1	0.6	0.7
Securitisation vehicles			0.7	1.0
Co-op housing societies	1.0	0.5	0.3	0.2
	100.0	100.0	100.0	100.0

Figure 1

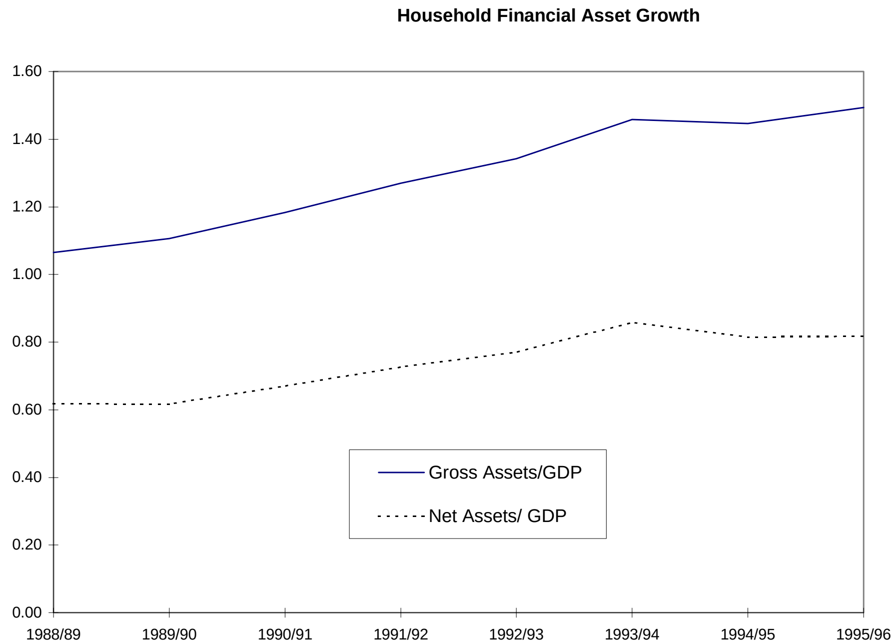
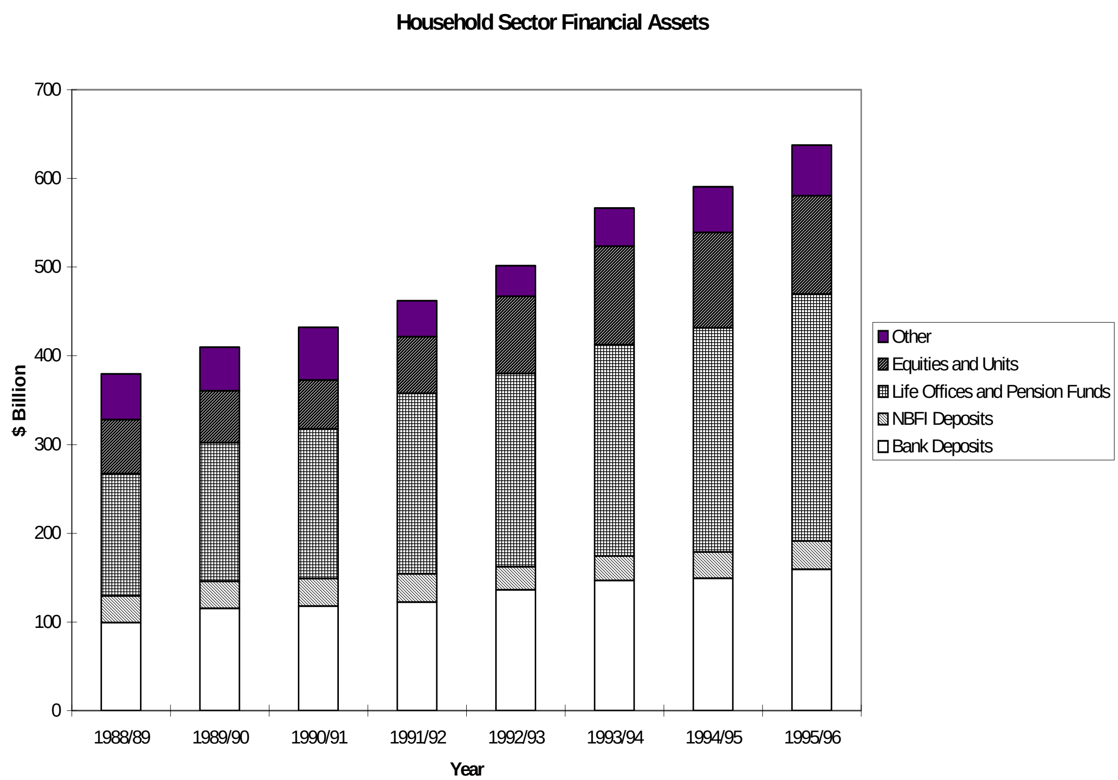

Household Financial Asset Growth
1.60
1.40
1.20
1.00
0.80
0.60
0.40
0.20
0.00
1988/89
1989/90
1990/91
1991/92
1992/93
1993/94
1994/95
1995/96
Gross Assets/GDP
Net Assets/ GDP

Figure 2



Household Sector Financial Assets
700
600
500
400
300
200
100
0
$ Billion
1988/89
1989/90
1990/91
1991/92
1992/93
1993/94
1994/95
1995/96
Year
Other
Equities and Units
Life Offices and Pension Funds
NBFI Deposits
Bank Deposits

Figure 3

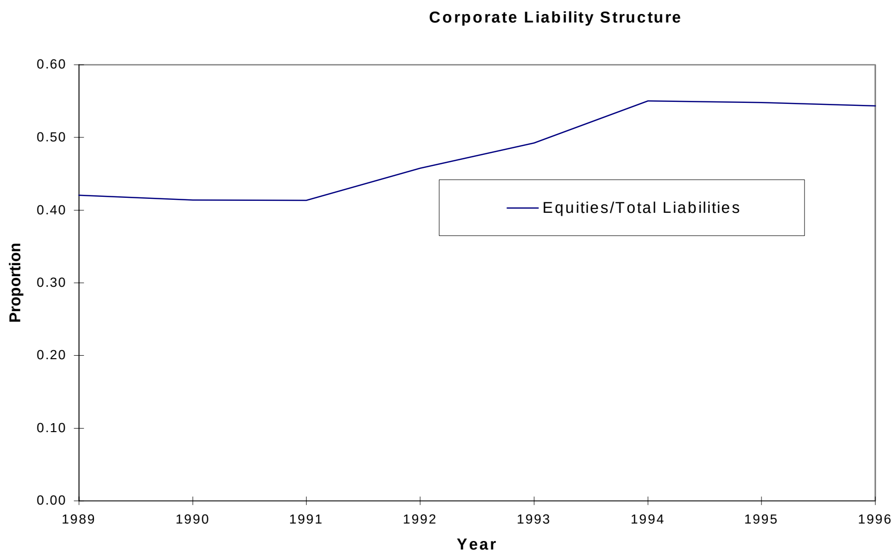

Corporate Liability Structure
0.60
0.50
0.40
0.30
0.20
0.10
0.00
Proportion
Equities/Total Liabilities
1989
1990
1991
1992
1993
1994
1995
1996
Year

Figure 4

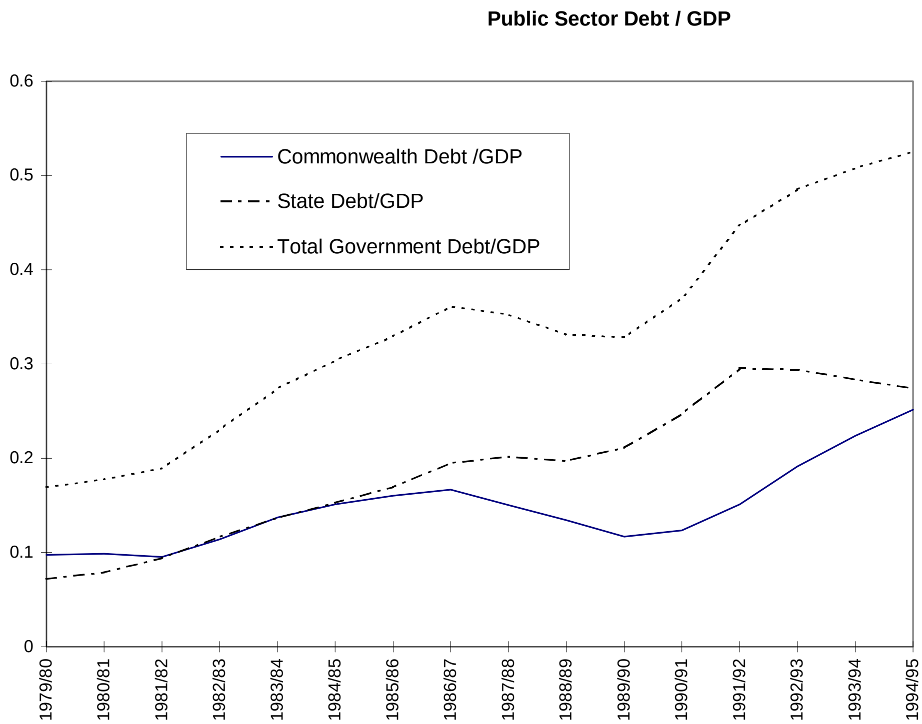
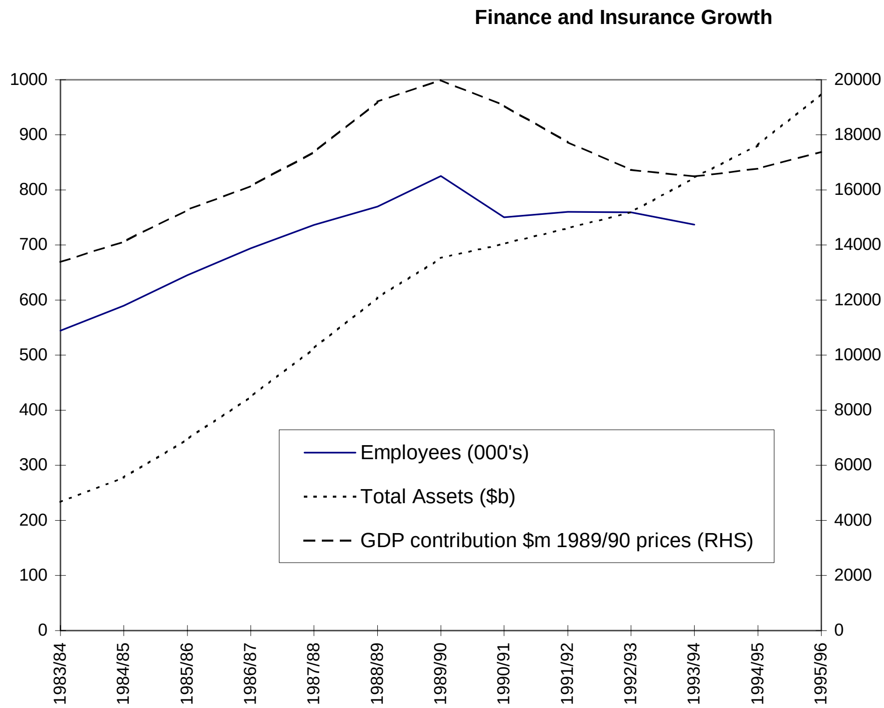

Public Sector Debt / GDP
0.6
0.5
0.4
0.3
0.2
0.1
0
Commonwealth Debt /GDP
State Debt/GDP
Total Government Debt/GDP
1979/80
1980/81
1981/82
1982/83
1983/84
1984/85
1985/86
1986/87
1987/88
1988/89
1989/90
1990/91
1991/92
1992/93
1993/94
1994/95

Figure 5


Finance and Insurance Growth
1000
900
800
700
600
500
400
300
200
100
0
20000
18000
16000
14000
12000
10000
8000
6000
4000
2000
0
1983/84
1984/85
1985/86
1986/87
1987/88
1988/89
1989/90
1990/91
1991/92
1992/93
1993/94
1994/95
1995/96
Employees (000's)
Total Assets ($b)
GDP contribution $m 1989/90 prices (RHS)

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