Deregulation, Banks, and Building Societies

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1. The modern development of Building Societies in Australia can be traced mainly to the growth of the Societies since the mid 1960s, although their history extends much further back than that. In the mid 1960s, the societies benefited from the creation of the Housing Loans Insurance Commission, and the extension of the Federal Government First Home Deposit scheme to include deposits at Building Societies. The former of these developments meant that:

   (a) default risk of societies' assets was reduced - which would have helped increase the perception of safety of their deposits, and

   (b) the societies could make loans with much higher loan/valuation ratios than previously (and than those of savings banks), thereby improving their competitive position in the market.

   The latter development (inclusion of their deposits in the Government scheme) would also have helped improve the credit standing of societies by giving their deposits the government "seal of approval".

From their initial beginnings right through until the 1980s, the societies were a very specialised form of financial institution. They accepted retail deposits (in reality often shares in the society, but marketed as deposits), and used these funds almost exclusively for home mortgage lending. Many of the societies were cooperative institutions, reflecting their origins as "self-help" organisations. They were restricted to activities within their state of origin, and regulated by state governments.

2. During the 1980s, there was major deregulation of the Australian financial sector which changed the nature of the financial institutions operating in the Australian financial sector. Most of this deregulation occurred at the Federal level and focussed upon the banking sector, although the state regulators of building societies also provided those institutions with greater freedom from regulation.

Deregulation took several forms.

(a) Constraints on the range of activities allowed to institutions have been relaxed.

(b) Restrictions on the composition of portfolios have been relaxed.

(c) Controls over interest rates which could be charged or paid have been abolished.

(d) Constraints on holding company arrangements have been reduced.

(e) Legislative barriers to entry to "Banking" which were generally believed to exist have been reduced. (The Final Report of the Campbell Inquiry, para 24.12 makes reference to this perception, but places more emphasis for lack of new applicants for entry on the heavier regulation of banks which applied prior to the 1980s.)

A number of phases of deregulation can be discerned from the welter of changes which have occurred during the 1980s.

(a) The first occurred in December 1980, when the Federal government removed all controls on bank deposit interest rates (except that on cheque accounts).

(b) The second, mid 1982, saw interest rate ceilings existing on bank loans raised, banks allowed to enter short term deposit markets not previously permitted to them (14-30 days in wholesale markets and 1-3 months in retail markets), the "tax" effect of reserve requirements reduced, Reserve Bank guidelines limiting bank lending growth over the last two years to 10 and 12 per cent were removed (and ended as a technique of monetary management), and the scope for Savings Banks to expand lending to the private sector greatly enhanced.

(c) The third phase in the deregulatory process was that of deregulation of the foreign exchange market culminating in the floating of the exchange rate and removal of most exchange control regulations in December 1983 and authorisation of 40 new foreign exchange dealers in June 1984.

(d) The fourth phase is that commencing in late 1984 (although partly foreshadowed earlier). Banks were given freedom to pay interest on cheque accounts and compete freely in short term deposit markets. All remaining loan interest rate ceilings other than those on housing mortgages were scrapped, and a 12 per cent prime assets ratio began to be phased in to replace the 18 per cent LGS convention. Late 1984 also saw applications invited for foreign bank licenses of which 16 were announced as successful in early 1985. Concurrently, freedom of entry into merchant banking was announced (as a temporary--later continuing--measure) enabling foreign banks to enter or rationalise existing Australian interests. Additionally, Australian banks were allowed to obtain full interests in merchant banking subsidiaries while the deregulation of the stock market in 1984 has allowed banks to acquire stockbroking interests.

(e) The fifth phase of deregulation saw most of the discriminatory regulation of banking which remained removed, and replaced by an alternative approach to

Reserve Bank oversight. In April 1986 the 13.5 per cent interest rate ceiling on home mortgage lending was scrapped for all new Savings Bank loans made, in mid 1988 the SRD ratio was replaced by the non-callable deposits ratio, the prime assets ratio has been reduced, and the distinction between Trading and Savings banks has been abolished. In place of the direct controls on bank activity, the risk asset weighting approach to capital adequacy of banks (details of which were announced in 1988) has been implemented.

(f) The most recent phase has been the emergence of alternative supervisory and regulatory arrangements, hopefully more suited to a financial sector in which activities are less regulated. The development of capital adequacy requirements by the Reserve Bank (and proposed for non bank financial institutions (NBFIs)) is one example. Another is the proposed Australian Financial Institutions Commission which will, on the basis of common state legislation, oversee NBFI's activities. Other developments have included the formation of the Australian Payments System Council and changes in Credit Legislation in various states.

Underpinning the deregulation process have been a number of factors. One was the growth of financial institutions outside the regulated banking sector, which raised concerns about the efficacy of controls over a declining share of the financial system. A second was the impact of high inflation in the 1970s and consequent upward pressure upon nominal interest rates, which indicated the distortions created by regulation. Financial innovation was a third factor, since financiers were able to evade regulations by developing other unregulated products and changing the nature of financial activities. A fourth factor was the general change in the climate of economic opinion which began to see regulation as not necessarily socially beneficial. A final factor of importance in understanding the whole process involves recognition that the regulatory structure had grown up ad hoc over (primarily) the post war years. Regulations were interweaved in a complex, mutually supporting, set of arrangements, so that removal of any one could be expected to affect the impact of many others. Once the initial "equilibrium" regulatory structure was disturbed, the process could not stop until some new "equilibrium" was reached.

The main beneficiaries of the deregulatory process (in terms of institutional shares of financing) have been the banks. (Whether it is bank customers or shareholders who have obtained most benefit is a controversial matter). Prior to the 1980s, building society growth generally exceed that of the banking sector. Since that time, the growth rate of the banks has been larger (even when adjustment is made for conversion of building societies to bank status). While building societies have also been deregulated by their State government regulators, the extent of change has not been as great. While societies can now generally undertake personal lending, commercial lending, credit card lending, etc., they have been constrained in how much can be lent for purposes other than residential property, need ministerial approval for foreign exchange dealings, are potentially subject to ministerial controls on interest rates charged, and face constraints on interstate expansion. (The regulations vary from state to state: the preceding comments are a summary of major issues, more information on which can be found in the booklet The Legislative Framework of Permanent Building Societies published by the Australian Association of Permanent Building Societies in 1988).

With the introduction of the Australian Financial Institutions Commission, regulation should become standardised across the states. As part of that development, the regulations faced by various building societies and other NBFIs will change somewhat.

3. One feature of recent experience has been the conversion of several building societies to bank status. The prospect of further conversions is also apparent. That also has required conversion from cooperative to corporate status, because of the requirements of the Banking Act. Several reasons can be advanced as to why the change to bank status may be desired, although much of the explanation may be simply a reflection of managerial preferences in organisations where the owner - depositors -shareholders do

not exert significant control. The first reason is that the organisations may prefer the different set of regulators (and regulations). The second is that benefits may be seen to exist from a more diversified range of activities which is not possible as a building society. The third reason is that geographical expansion (across state borders) may be seen as advantageous. Fourth, being of "bank" status may bring benefits to the organisation in terms of its image and thus the terms on which it can attract funds. (That, of course, involves a judgement as to whether any costs associated with bank status rather than building society status are outweighed by the perceived benefits.)

4. These conversions of building societies to bank status have occurred at a time when the traditional distinctions between banks and other financial institutions such as building societies have become blurred.

That raises the issue of how categories of institutions can be identified from each other. Several possibilities can be suggested.

(a) The nature of financial intermediation undertaken is one possibility. For example, some institutions may specialise in "retail" intermediation, others in wholesale: some may create new financial instruments, others may invest solely in existing assets.

(b) The nature of liabilities offered by the institution is another possible distinguishing characteristic. For example, unit trusts are distinguishable from deposit taking institutions because the yield on their liabilities is not known ex ante. (Of course, many deposit taking institutions also offer similar investments, and as the interest rate resetting period of deposits becomes shorter (and if automatic continuation of the deposit occurs) deposits become largely indistinguishable from trust liabilities.

(c) The nature of assets held may also distinguish categories of financial institutions. Building societies have been characterised by an emphasis on residential lending. Among unit trusts, distinctions are made based on the nature of investments.

(d) Complementary financial services provided is another area in which institutions vary. Life insurance offices provide both insurance and intermediation services. Merchant banks provide advice to their corporate customers and generate much income by way of fees for these services. Banks once provided and had firm control of the payments system, building societies and other institutions now play a role in that system. Originally this role began with third party cheques, expanded into provision of chequing facilities through agency arrangements, and is now enhanced by issue of payments orders and the development of electronic funds transfer point of sale (EFTPOS) systems.

(e) Certain institutions may have a special place in the financial system, by virtue of historical accident leading to an entrenched position or because of some arrangement with the government. The authorised short term money market dealers fall into this category, as do the banks. Only these institutions have Exchange Settlement Accounts at the Reserve Bank to which net inflows and outflows of funds can be credited. Other institutions use as their transactions accounts, deposits with other members of the financial system. This puts the banks and the dealers at the apex of the financial system in terms of the transmission of changes in liquidity.

(f) Certain institutions may have special relationships with government which bestows upon them certain benefits and costs. Banks come under the supervision of the Reserve bank which is charged with protecting bank depositors. While this does not guarantee bank deposits, there is, I believe, a general community perception that an "implicit guarantee" exists. Stability of the financial system would be undermined if deposits at banks were seen not to be "risk free". Institutions such as Building Societies have special relationships with their State governments, and while these may serve to help protect depositors, they do

> not have the same effect. Collapses of merchant banks have been seen recently to occur without undermining the financial system, although they may impinge on other merchant banks. (And severe "failures" of state owned bank subsidiaries have not led to major crises in customer confidence in those banks because of their particularly special relationship with governments). Likewise, organisations labelled as building societies or credit unions have been exposed to harmful effects from collapses among their members. While these events have caused dislocation in the financial system, the overall stability of the financial system has not been put at risk, as would occur with the collapse of a bank.

It is I believe the "labelling" of certain institutions as banks, by virtue of their meeting the requirements for a banking license and thus entering into a special relationship with government, that provides the principal distinction between banks and other financial institutions. That label is a valuable acquisition (as evidenced by the restrictions on its use) which places the organisations so labelled in a favourable position when dealing with the public. Deposits in such organisations are perceived as being risk free, customers do not feel obliged to check the credit standing of the organisation, and banks are thus able to attract funds at lower interest rates than their non-bank competitors. Whether this gives them a competitive advantage over those competitors depends upon the costs imposed by the relationship with government.

5. Any attempt to distinguish between banks and other categories of financial institutions by virtue of differences in activities, is I suspect unlikely to prove satisfactory. Whereas once such differences existed, they were often a product of regulation, or reflected the appropriate specialisation given the then state of technology. In a deregulated environment, where constraints on the range of activities do not apply and in the light of modern technology, it must be asked whether one would expect to see financial institutions specialising in particular activities. Some specialisation is likely to occur in conjunction with the emergence of super (hyper!) market financial institutions, but those patterns of specialisation may be purely transitory. Convenience may warrant describing certain institutions as belonging to a particular category, but these descriptions should be recognised as being for convenience only.

Changes in the patterns of financing both within and between institutions change over time in response to regulatory and economic conditions. The banks, for example, sought to evade the force of restrictions on banking activity from the 1950s through to the 1980s by development of their Finance Company subsidiaries. In that way the banking groups were able to engage in lending activities which because of higher credit risk required the charging of interest rates above those permitted to banks. Partly because of the extension of the "bank" image of safety to their subsidiaries, the bank finance companies became the dominant institutions of this type. During the 1980s, the deregulation of the banking sector was a major factor in the marked slowdown in Finance Company growth. Banks are now able to pursue the lending activities which were previously transfered to the finance companies within the bank entity, and are now able to offer deposit interest rates which are competitive with those available on finance company debentures. More recently, banks have moved into the area of funds management and offering of superannuation products as demand for those products has expanded.

Another example of the effect of regulatory change can be seen in the effects of the replacement of the Statutory Reserve Deposit (SRD) requirement with the Non Callable Deposits ratio applying to banks. The SRD requirement acted in part like a tax on deposit based financing through the trading banks, because of the below market interest rate paid on SRDs. Banks responded, particularly in the 1980s, by developing the bank accepted bill market, which grew at quite rapid rates until the late 1980s. Bill financing enabled the banks to earn fees for acceptances which enhanced the credit status of the bill, without incurring the SRD "tax" which only applied to deposit based financing. Since the replacement of the SRD requirement in 1988 with a requirement that encompasses all bank liabilities, the incentive to bill financing has gone and growth in that market has stagnated.

6. A further regulatory change has been the removal of the distinction between Trading and Savings banks. Savings banks were previously limited in their dealings with business customers, and were restricted to primarily investments in public sector securities and housing loans. These restrictions reflected the original motivation for establishment of Savings Banks in the 1800s as a vehicle to encourage thrift among the working classes, although they were developed primarily upon the granting of Savings Bank licences to private banks in 1956 and subsequent years. Because of those restrictions upon their range of activities, it was the Savings bank subsidiary of the Bank holding companies which Building Societies most closely resembled. (In practice, of course, the Trading-Savings bank distinction was primarily an accounting one: common facilities and staff were used).

7. The ultimate effects of deregulation on the comparative positions of banks and building societies cannot at this stage be determined. In part, the future development will depend upon the objectives of those responsible for the organisations. Building Societies were, primarily, non-profit organisations whose primary objective was to provide housing finance and savings facilities to their members. Those objectives are still important, but provision of a wider range of services has become the norm, reflecting a

general objective of service to members. Often, achieving that objective will require financial activities in wholesale financial markets which at first glance appear to be far divorced from the traditional retail emphasis.

The customers of building societies have also changed. There is now greater emphasis on business lending, and the societies also tap wholesale markets for funds, rather than relying solely on retail deposits. Banks also have changed, and expanded into areas which they were previously precluded from by regulation. Borrowings in short term wholesale deposit markets and lending to borrowers with higher credit risk are two obvious examples. These changes are just some of the many ways in which a convergence of activities of banks, building societies, and other financial institutions has occurred, blurring pre existing classifications based on activity differences which were in turn induced primarily by regulation. Notably, there appears to be a change in the emphasis of regulation from one based on institutions to one based on activities, although the fact that institutions are under the ambit of different regulators creates coordination problems for consistency of activity based regulation.

8. While building societies and banks were, in the past, distinguishable because of the range of their activities and customers, such distinctions are an outcome of commercial decisions and regulatory forces. They do not provide a fundamental basis for comparing or classifying

institutions. For that, we must look to the causes of why such outcomes may emerge, and two possibilities appear to exist. The first is the objectives of the institution's controllers, and here, the "provision of housing finance" objective and generally non-profit orientation enabled one to distinguish building societies from banks and other organisations. That was at best, however, an imperfect discriminator, and one which has become less appropriate with the increasingly competitive financial sector. Even non profit commercial enterprises are forced to act much like profit oriented bodies if they are to survive in a competitive environment. That market constraint is being reinforced by regulatory constraints which require even cooperative bodies to develop a permanent capital base, and this further serves to blur distinctions.

The second area in which a distinction can be made is in the area of "image", the perception which society has of particular organisations. The label of "bank" brings with it connotations of safety and confidence, and the existence of a group of financial institutions with such characteristics is a necessary condition for the sound functioning of a modern financial system. To achieve such a position the supply of the "label" must be subject to control such as occurs in Australia under the provisions of the Banking Act. It is that special relationship which exists between banks and the government which creates a special image of banks. This gives them a special place in the financial system - and requires that they be subject to particular regulation to prevent their exploitation of the competitive edge given by that special image. Notably, the importance of this relationship was one of the major themes identified by the Martin Report[1].

The difficulty in drawing a dividing line between banks and other financial institutions was also emphasised by the Martin Report (pp 38-42), which recommends that the Reserve Bank develop such a definition. The danger in such a task is that old divisions based on obsolete regulatory constraints or technology may play a role. While the fundamental economic functions of financial intermediaries (of liquidity production, risk reduction, cost reduction, etc.,) are unchanged, many of the techniques and methods used to carry out these functions were not in existence when earlier legislative and judicial distinctions were formulated.

Particularly in the light of the proposed dual-regulator regime of the Reserve Bank and AFIC, there will be only one clear distinction between financial intermediaries in Australia - which supervisor they come under. Since activities of both groups will overlap (and change over time) and intermediaries will be able to apply to become a "bank" supervised by the Reserve Bank or an NBFI supervised by AFIC, a distinction based on activities will not be durable.

[1] House of Representatives Standing Committee A Pocket Full of Change: Banking and Deregulation, November 1991, AGPS