CHAPTER EIGHT

COMPETITIVE STRUCTURE

Levels of competition

8.1 The structure of the Australian banking industry is a primary consideration in assessing its level of competitiveness. In Chapter 3, the Committee has provided an overview of the industry, including asset and market share ratios. Those statistics paint a broad picture of the industry which has emerged following deregulation.

8.2 On the basis of the figures detailed in Chapter 3, the following observations can be made:

- the banking industry has remained the key institutional group in the financial system, regaining much of the market share lost in the late seventies and early eighties;
- at the national level, the four major banks have retained their market share and, accordingly, their dominant position in the industry;
- at the regional level, vigorous competition for market share is provided by locally based State banks, regionally operating banks and non-bank financial intermediaries; and
- foreign banks have had limited impact in terms of overall market share, although they have made noticeable inroads in the wholesale area, out of proportion to the overall market share gained (see also Chapter 10).

8.3 It is important to recognise that the level of competition in the banking industry is variable and depends on a range of factors, including number of participants, product characteristics and territorial boundaries. The market for banking services consists of a number of sub-markets, all with differing competitive situations.

8.4 The banking industry also is subject to competition from non-bank financial intermediaries. This means that the market for banking services cannot be considered in isolation from the much broader market for financial services.

8.5 In assessing the competitive structure which has emerged since deregulation, the Committee took into consideration the extent to which the expectations of deregulation have been met. Those expectations were outlined by the Campbell Committee, which did not provide a precise picture of the financial structure which would emerge once its proposed changes were implemented, but rather defined certain performance objectives which needed to be met. These included:

- an easily accessible and secure domestic and international payments system;
- healthy competition between a range of institutions for the borrowing and lending business of both the relatively small retail customers and the relatively large wholesale customers; and
- a spectrum of risk opportunities facing investors within an overall financial system which is stable in the sense of being capable of absorbing the failure of some institutions without prejudice to the rest.[1]

8.6 In this chapter, the Committee has focused on whether healthy competition between institutions is evident in the wake of deregulation.

Concentration

8.7 Measuring the level of concentration in the banking industry is an important first step in judging whether deregulation has resulted in improved competition.

8.8 The dominance of the four major banks at the national level, with approximately 72 per cent of market share[2], indicates a high level of concentration in the industry. Various mergers and acquisitions during the 1980s, whereby the six largest private banks became three, contributed significantly to the increased concentration which is evident.

8.9 The concentration ratio in Australian banking, which here is expressed as a measure of the market share held by the four largest market participants, rose from 66.9 per cent in 1978 to 79.1 per cent in 1983. This followed the merger between the Bank of New South Wales and the Commercial Bank of Australia to form the Westpac Banking Corporation, the merger between the National Bank of Australia and the Commercial Banking Company of Sydney to form the National Australia Bank, and the absorption into the ANZ Banking Group of the Bank of

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1 Campbell Committee, p. 531.

2 Reserve Bank Bulletin, October 1991.

Adelaide. The concentration ratio fell to 68.5 per cent in 1988 and 66.9 per cent in 1990, as the impact of new bank entry was felt.[3] However, the Commonwealth Bank's acquisition of the State Bank of Victoria in 1990 has raised the level of concentration again to 72 per cent.[4]

8.10 At the regional level, the presence of State banks and new regionally operating banks suggest that a lower concentration ratio would exist than is evident at the national level. However, in their submission to the inquiry, consumer organisations cited a market share analysis, calculated on the basis of an aggregate national index from State/Territory deposit shares weighted by State population, which indicates that, even at a regional level, the four major banks possess 67.6 per cent of market share.[5]

8.11 On the basis of these calculations, consumer organisations claimed that competition has not been enhanced by deregulation, as the industry remains oligopolistic in structure. They stated:

> Deregulation was supposed to induce greater competition, but its immediate impact was to induce a merger wave. Now, courtesy of a tolerant merger provision in the Trade Practices Act, the banks are bigger, although they do have an international presence.[6]

8.12 In contrast, representatives of the banking industry claimed that both the banking and financial services sector are much less concentrated than they were prior to deregulation. The ABA indicated that following deregulation there are many more markets for financial services products and many more suppliers of those products. The ABA stated:

> It is the view of the banking industry that none of the licensed banks currently operating in Australia is dominant in any of the particular markets within which they operate.[7]

8.13 Particular reference was made by industry representatives to competition in State markets.[8] They pointed to the strong support for locally owned institutions in their home States. This translates into significant market share ratios for local institutions within particular sub-markets, and, according to industry representatives, is one indicator of effective competition in the industry.

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3 Evidence, p. S1132.
4 Reserve Bank Bulletin, October 1991.
5 Evidence, pp. S1412-S1413.
6 Evidence, p. S1413.
7 Evidence, p. S57.
8 Evidence, pp. S57, S351 and S498.

8.14 Industry representatives also referred to the strong competition provided by non-bank financial institutions, which offer products and services which are very close substitutes for those available from banks. It was noted that permanent building societies, credit unions, finance companies and money market corporations compete directly with banks in specific product markets by offering deposit and loan facilities on generally similar terms and conditions to those available from banks.[9]

8.15 Both the Reserve Bank and Treasury supported the industry view that deregulation has resulted in increased competition.[10] The Reserve Bank referred to the presence of foreign banks in Australia and commented:

> ... the foreign banks, as a group, constitute a significant element of competition. Even though they have not made great inroads into acquiring market share, their mere existence is a significant source of competition at the corporate level.[11]

8.16 In terms of the retail market, the Reserve Bank indicated that there are non-bank financial intermediaries which would 'exploit any opportunity that might present itself in the event of the majors going soft on competition'.[12]

8.17 The contrasting views expressed by consumer and banking industry representatives about levels of concentration highlighted to the Committee the difficulties in drawing definitive conclusions about industry competitiveness from a simple analysis of market share. As banks operate in various sub-markets with different product and territorial characteristics, and as the banking industry is an integral part of a wider market for financial services, the competitive situation within the industry is subject to much variation.

8.18 It is evident, though, that the emergence of four major banks in Australia over the last decade has indicated a trend towards greater concentration in the banking industry. In more recent times, this has extended to the wider financial sector with the diversification of bank activities and the growth of financial conglomerates.

8.19 This trend towards increased concentration is not unusual to Australia or to the banking industry. Concentration ratios from eight other OECD countries (Table 8.1) indicate that Australia occupies the middle ground in terms of the percentage of assets of all financial intermediaries held by the largest three, five and ten firms.[13] Equally, a comparison with 15 other Australian industries (Table 8.2)

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9 Evidence, pp. S57 and S351.

10 Evidence, pp. 429, 626, 2527 and S3015.

11 Evidence, p. 627.

12 Evidence, p.627.

13 Evidence, p. S1133.

shows that banking is eighth in terms of the proportion of total turnover accounted for by the four largest firms.[14] While it is difficult to draw any definitive conclusions from comparisons between industries, because of the varying circumstances and factors impacting on the manufacturing and service sectors, such comparisons provide a broad perspective of general industry concentration levels within Australia.

8.20 Increased concentration in the banking industry has generated concerns about the anti-competitive effects which may result. In particular, there are fears that existing concentration levels may lead to individual firm dominance in the market.

Industry dominance

8.21 The Campbell Committee identified two principal concerns about the trend towards increased concentration of ownership and control in the financial system, and the potential effect of financial deregulation on this trend. These were:

- that a particular group or category of institutions (eg banks or life insurance companies) may assume a position of undue dominance in the financial system (group dominance); and
- that a small number of large institutions may dominate the financial system (individual firm dominance).[15]

8.22 Ten years on from the Campbell Committee, these concerns have not dissipated. On the contrary, the mergers and acquisitions of the 1980s, as noted at paragraph 8.9, have fuelled previous fears that deregulation might accelerate the trend towards increased concentration in the financial system. As the key institutional group of the financial system, the banking industry has attracted particular attention in this regard.

8.23 The fears of group dominance of the financial system have been given increased impetus as banks in a deregulated environment have been able to expand beyond their traditional areas of activity. This has seen the emergence of financial conglomerates with interests in banking, superannuation, insurance, investment advice and even activities such as travel. Issues relevant in this regard are discussed in Chapter 11.

14 Evidence, p. S1132.

15 Campbell Committee, p. 534.

TABLE 8.1: CONCENTRATION RATIOS IN 1983
(percentages of total assets)

Country	All financial intermediaries		
	3	5	10
Germany	16.6	24.0	38.2
Italy	17.5	25.5	40.4
Spain	17.6	26.3	35.7
Japan	22.9	29.6	41.5
Australia	30.4	46.4	65.5
France	33.1	47.3	60.9
Belgium	35.8	52.1	67.7
Switzerland	44.8	51.8	59.3
Sweden	52.0	60.4	67.5

Source: Evidence, p. S1132

TABLE 8.2: CONCENTRATION RATIOS IN SELECTED AUSTRALIA INDUSTRIES: 1987-88
(proportion of total turnover accounted for by largest four firms)

Industry	Ratio
Tobacco	1.00
Pulp & Paper	.93
Beer	.91
Glass	.87
Butter	.85
Motor vehicles	.81
Iron & Steel	.80
Banks	.69
Poultry	.65
Bread	.60
Cotton	.56
Household appliances	.49
Cosmetics	.40
Footwear	.40
Knitwear	.33
Pharmaceuticals	.25

Source: Evidence, p. S1132

8.24 In relation to the banking industry, a particular concern identified by the Committee was the fear of decreased competition if further concentration in the industry was to occur through the merger of one or more of the four major banks. The evidence received by the Committee indicated not only concerns about concentration of financial power in too few hands, but also reflected a more general concern about the degree of concentration which has been allowed to occur across a wide range of Australian industries. The extent of this concentration was noted by the Australian Financial Review in 1989 when it stated:

> It is a rare industry in Australia that has more than three participants. Some of these oligopolies are intensely competitive, but as a rule they are not, by their nature.[16]

8.25 Treasury indicated that, during the 1980s, there was a great deal of competition from a range of financial institutions, but that this competition had lessened in more recent times. Treasury commented:

> Probably at the present time we have rather less competition, because although most of the institutions are there, a number of them are suffering from the same problem.[17]

8.26 While discussion of the future structure of the banking industry was to a large degree speculative, the Committee was interested in comments that some participants in the industry expected a 'shakeout' to occur in the foreseeable future.[18] Consumer representatives considered that a rationalisation of numbers is inevitable, with the likelihood that concentration levels will remain stable or even increase.[19] More telling were public statements from foreign bank executives that a large withdrawal of foreign banks could occur within the next five years.[20] The principal reason given was the difficulty faced by the foreign banks in combating 'the formidable bulwarks of oligopoly and entry barriers set up by the incumbent domestic banks'.[21]

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16 Australian Financial Review, 22.2.89, cited in EPAC (1989).

17 Evidence, p. 2548.

18 Evidence, p. S849.

19 Evidence, pp. S1415-S1416.

20 Evidence, p. S849.

21 R A Ferguson, 'Foreign Banks in Australia - A Strategic Reassessment' in Economic Society of Australia, Economic Papers, Vol. 9, No.3, September 1990, p. 4.

8.27 On the basis of this evidence, the Committee examined the existing mechanisms for ensuring that concentration in the banking industry did not lead to individual dominance of the industry. These mechanisms are:

- the requirement under section 63 of the Banking Act that the Treasurer approve any merger or takeover of a bank; and

- the merger provisions contained in section 50 of the Trade Practices Act which prohibit mergers or acquisitions which would result in or substantially strengthen a position of dominance in a substantial market.

8.28 The most recent use of the Treasurer's powers occurred with the blocking of a proposed merger between ANZ and the National Mutual Life Association in May 1990. According to the then Treasurer, the merger was not allowed to proceed because it was contrary to the national interest. The Treasurer indicated that, in making the decision, the Government was concerned that competition would be substantially diminished as a result of the merger.[22] Thus, it would appear that, in this case, a substantial lessening of competition test was used as the basis for exercising the Treasurer's discretion for preventing mergers or acquisitions in the banking industry.

8.29 As for the TPA, section 50 has never been used to prevent a merger involving a bank. The Trade Practices Commission (TPC) indicated that it is far from clear that a merger between two banks would lead to dominance, and thus be preventable under the existing merger provisions. It noted that there are various interpretations of the term dominance, although generally it is accepted as meaning one participant in a market having a majority market share (well over 50 per cent) and also being in a position where it can act without reference to others in the market.[23] According to the TPC, the question of whether a merger between two of the major banks would be caught by section 50 depends on which banks were to merge and the market which was considered.[24] Nevertheless, it stated:

> The possibility of a duopoly emerging under deregulation would appear incapable of being prevented by s.50 if the present dominance test is retained and such a result would seriously impact on the Government policies in this area.[25]

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22 Treasurer's press release, transcript of press conference by the Hon P J Keating, MP, 23.5.90.

23 Evidence, p. 3505.

24 Evidence, p. 914.

25 Exhibit 73a, p. 20.

8.30 The TPC indicated that it sees a need to return to the original mergers test, as enacted in 1974 but amended in 1977, which would prohibit mergers or acquisitions which would result in a substantial lessening of competition in a substantial market.[26] This was supported by the consumer organisations.[27] The TPC argued that the dominance test was crafted to assist the traded sector of the economy become internationally competitive, but has permitted, without challenge, mergers in the non-traded sector of the economy which may not have benefited the community.[28] Under the TPC's proposal, an authorisation procedure would be included which would allow mergers resulting in a substantial lessening of competition to proceed if there is a demonstrated public benefit.[29]

8.31 Another option suggested by the TPC was for mergers in sensitive industries, such as banking, to be referred to the TPC for examination. According to the TPC, this would mean that competition and public benefit issues could be examined on a consistent set of principles for all industries, without limiting the government's power to make decisions about such mergers on competition or other grounds.[30]

Conclusion

8.32 It is evident that deregulation has led to a significantly more competitive environment within the banking industry and the financial system as a whole. There is a far greater number of institutions competing for market share than was the case prior to deregulation. Also, the substantial erosion of traditional lines of demarcation has allowed bank and non-bank financial intermediaries to compete across a broader range of activities for a more varied spread of business.

8.33 While foreign bank entry may not have met expectations in terms of competition in the retail banking sector, the presence of foreign banks in Australia remains an important competitive spur to domestic banks, principally in the wholesale area. (Issues relevant to foreign banks are discussed further in Chapter 10).

8.34 Despite the increased number of competitors, though, the level of concentration in the banking industry has remained high. The entry of new banks in the wake deregulation may have resulted in an initial drop in market share for the incumbent nationally operating banks. However, the more recent consolidation of market share by the major banks following a series of mergers and acquisitions has reinforced a high level of industry concentration.

26 Evidence, p. 3495.
27 Evidence, p. 955.
28 Evidence, pp. 3495-3496.
29 Evidence, p. 3495.
30 Exhibit 73a, p. 25.

8.35 It is not possible for the Committee to predict the competitive structure which will emerge as the banking industry continues to develop in a deregulated environment. The Committee concurs with the Campbell Committee that precise details about the institutional structure can be regarded as incidental provided certain performance objectives, as outlined in paragraph 8.5, are met.

8.36 In this regard, healthy competition between institutions for the retail and wholesale business of consumers must remain a principal performance objective for the industry. The level of competition in the industry must be a fundamental consideration in any future proposals for structural change within the banking sector.

8.37 The concerns which exist among various sections of the community about the trend towards increased concentration in the banking industry are shared by the Committee. There are dangers that increased concentration, by reducing the number and influence of competitors, ultimately could affect the level of industry efficiency, as the incumbent banks would be under less pressure to generate improved performances. Equally, there is greater likelihood of collusive or anti-competitive practices emerging, with consumers having less opportunity to move their business to alternative institutions. Clearly, such outcomes would be counter to the aims of financial deregulation.

8.38 The Committee considers that further concentration in the banking industry could have significant implications in terms of the competitiveness of the industry. It is of the view that any arrangement or agreement which would lead to further concentration should be subject to careful scrutiny, and should be required to demonstrate substantial public benefit before being allowed to proceed.

8.39 The Committee acknowledges the TPC's concerns about the existing mechanisms for dealing with mergers and acquisitions which may result in the substantial lessening of competition in a market. As the Committee's investigations were focused specifically on the banking industry, it is not in a position to comment on the need for broad changes to the merger provisions of the Trade Practices Act, particularly as those changes would have implications beyond the terms of reference of the inquiry. In any case, the issue of the appropriate merger test for the TPA is the subject of a 1989 report from the House of Representatives Standing Committee on Legal and Constitutional Affairs, as well as an existing inquiry by the Senate Standing Committee on Legal and Constitutional Affairs.

8.40 In terms of the banking industry, though, there is considerable merit in the TPC's suggestion that any mergers or acquisitions in that industry be referred to the TPC for examination. The banking industry occupies a crucial position within the Australian economy, and as such deserves special attention to ensure that matters of public interest are given appropriate consideration. In light of the concerns about levels of concentration in the banking sector, it would be in the public interest if mergers or acquisitions in the industry were the subject of close scrutiny. As the TPC has primary responsibility for competition matters, and as it

also has expertise in assessing both the structure of arrangements and their potential market effects, it is appropriate that the TPC be involved closely in the process of determining the acceptability of mergers and acquisitions in the banking sector.

8.41 Bearing in mind that the Banking Act provides the Treasurer with a discretion to approve or disallow bank mergers and acquisitions, the Committee considers that, in exercising this discretion, one factor which should be taken into account by the Treasurer is whether the merger or acquisition in question substantially lessens competition in a substantial market. It is in determining this issue that close consultation with the TPC should occur.

Recommendations

8.42 **The Committee recommends that:**

5. **the Treasurer, in considering proposals for mergers or acquisitions in the banking industry, prohibit any mergers or acquisitions which would result in a substantial lessening of competition in a substantial market, unless public benefit can be shown; and**

6. **the Treasurer, in considering proposals for mergers or acquisitions in the banking industry, refer to the Trade Practices Commission for determination the questions of whether the proposed merger or acquisition would substantially lessen competition in a substantial market, and whether there are any public benefits which would outweigh the detriment from the substantial lessening of competition.**

Bank ownership

8.43 Relevant to the issues of concentration and industry dominance is the question of bank ownership.

8.44 The ownership of banks is restricted by the Banks (Shareholdings) Act, which limits the proportion of voting shares which an individual or associated persons may hold in a bank. The Treasurer's approval is required for a shareholding beyond 10 per cent, and the Governor-General's approval is required for a shareholding above 15 per cent. Foreign interests also must comply with the *Foreign Acquisitions and Takeovers Act 1975*. Approval was given for the foreign banks entering Australia from 1985 to exceed the 15 per cent limit. Now they all are owned 100 per cent by their parent banks.

8.45 The Reserve Bank, in its submission, explained the reasons for applying restrictions on the ownership of bank shares. It noted that a dominant shareholder poses the risk that a bank's deposits might be used for the benefit of such a shareholder, or that public confidence in the bank would be compromised by business problems experienced by the dominant shareholder.[31] Agreeing with the need for such controls, NAB stated:

> The control on bank shareholding provides a means of preventing a shareholder or group of associate shareholders exercising an undue degree of influence or control over a bank. Given the special place which banks have in the financial sector and the need to maintain undoubted confidence in the stability of the banking sector, controls of this nature are considered warranted.[32]

8.46 The main argument against the ownership rules is that they remove an important market discipline, by making it much more difficult for an inefficient bank to be taken over. A further argument is that, by making takeovers more difficult, the ownership rules reduce the capacity of banks to benefit from economies of scale.

8.47 On the question of efficiency, it is important to note that while the ownership rules limit the potential for banks to be subject to takeover, they do not restrict more efficient banks from taking away an inefficient bank's market share.

8.48 It is evident that the concerns which have been expressed about concentration in the banking industry would increase if banks were able to own large parcels of each other's shares. In their submission to the inquiry, consumer organisations referred to existing cross-ownership by banks, suggesting that it is no doubt used as a defensive measure against aggression at the top end of the market.[33]

8.49 In more recent times, the cross-ownership issue has attracted less attention due to the divestiture by some major banks of shares held in other banks.

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31 Evidence, p. S1142.

32 Evidence, p. S427.

33 Evidence, p. S1415.

Conclusion

8.50 The Committee considers that the existing restrictions on ownership of bank shares are appropriate. Not only are they a means of preventing particular shareholders from exercising undue control over a bank, but they also are a mechanism for preventing undue concentration in the industry. The Committee has received no substantive evidence to indicate any need for changes in this area. Indeed, the evidence received has been in support of retaining the existing restrictions on ownership.

Recommendation

8.51 **The Committee recommends that:**

7. the existing restrictions on ownership of bank shares contained in the *Banks (Shareholdings) Act 1972* be retained.

Efficiency

8.52 A principal aim of financial deregulation, as noted in Chapter 5, has been the attainment of increased efficiency of the financial system through the promotion of competition. The premise underlying financial deregulation has been that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention.[34] The development of a more competitive structure within the banking industry and the wider financial system has not been an end in itself, but rather a means to an end.

8.53 The extent to which efficiency gains have been realised in the banking industry following deregulation is an important indicator of the level of competitiveness which has been achieved.

8.54 As noted at paragraph 5.19, efficiency in the banking industry can be assessed against the following criteria:

. the extent to which the operations of industry participants are being conducted at least cost (operational efficiency);

. the extent to which the resources of the industry are being put to the most productive use (allocative efficiency); and

34 Campbell Committee, p. 1.

- the extent to which the industry is adaptable to changes in economic conditions, technology and market practices (dynamic efficiency).

8.55 In terms of operational efficiency, the four major banks advised that the ratios of operating expenses (other than interest and bad debts) to average assets has fallen steadily over recent years.[35] The Committee was told that efforts to reduce unit operating costs have reflected the competitive pressures arising in the deregulated environment.[36]

8.56 The evidence of the major banks was supported by the Reserve Bank, which noted that the operating costs of the major banks fell from an average of 3.9 per cent of assets in the first half of the 1980s to 3.2 per cent of assets in the second half of the decade. It considered that this reduction was achieved by more efficient use of personnel, with assets per employee having risen strongly, and by the introduction of new technology. Relevant also was the fall in the ratio of operating costs to total income from 0.7 in the first half of the 1980s to 0.6 in the second half. The Reserve Bank suggested that these ratios indicate that banks are operating more efficiently than in the early 1980s.[37]

8.57 A study by Milbourne and Cumberworth, cited in submissions from Westpac[38] and Professor Ian Harper[39], also provided evidence of efficiency gains as a result of deregulation. The study showed that real deposits per employee have risen 30 per cent and unit labour costs have fallen by 22 per cent. While it was pointed out that the increase in real deposits per employee may be a reflection of the changing mix of bank business in favour of wholesale activity, which involves larger sums of money without necessarily involving more labour output, the overall conclusion of the study was that deregulation has brought a more efficient financial sector.[40]

8.58 In a similar vein, the major banks argued that gains in dynamic efficiency are evident from the rapid spread of advanced communications and computer technology, as well as through various product innovations.[41] It was noted that Australian banks have been at the forefront of the introduction of automatic teller machines and electronic funds transfer systems, both of which have

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35 Evidence, pp. S259, S338, S439 and S534.

36 Evidence, p. S328.

37 Evidence, p. S1136.

38 Evidence, p. S259.

39 Evidence, p. S637.

40 Milbourne and Cumberworth, Australian Banking Performance in an Era of De-regulation: An Untold Story?, University of NSW, 1990, pp. 16 and 23.

41 Evidence, pp. S259, S264, S328, S498, S517 and S541.

increased access to banking services. In addition, the Committee was told that increased competition has led banks to offer a broader range of products tailored to meet customer needs. These have included:

- variable repayment loans for housing, as well as low start or high start loans, fixed interest loans and mortgage offset accounts;
- interest bearing cheque accounts, cash management accounts and accounts specifically designed for pensioners; and
- sophisticated financial and risk management instruments, such as swaps, futures an options.[42]

8.59 While it may be argued that advances in technology would have changed banking regardless of deregulation, the banks submitted that it has been the spur of increased competition which has accelerated the process of technological development and which has improved the responsiveness of banks to customer needs. Westpac stated:

> Competition forced the transformation of the banking system from a supply driven to a customer driven system.[43]

8.60 Issues relevant to the effect of deregulation on the responsiveness of banks to customer needs are discussed further in Section V.

8.61 In terms of allocative efficiency, the major banks noted that removal of qualitative and quantitative credit restrictions and interest rate controls has enabled more efficient allocation of resources in the economy at large. Westpac indicated that prior to deregulation, the rationing of funds led to occasions when funds were virtually unavailable, with credit worthiness often based on subjective, outdated social conventions.[44] The Commonwealth Bank pointed out that the era of tight regulation was not conducive to the allocation of funds to the most productive areas of activity in the economy. It noted that only since the removal of direct controls have banks been able to perform their most important tasks for the economy, including credit assessment across the whole range of loan applicants, allowing interest rates to ration credit between competing uses, and tailoring products to customer needs.[45]

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42 Evidence, p. S498.

43 Evidence, p. S263.

44 Evidence, p. S266.

45 Evidence, p. S328.

8.62 Recent experiences with lending to the corporate sector, however, suggest that gains in allocative efficiency may not be as evident as is claimed by representatives of the banking industry. It is arguable whether in recent times funds have been directed to the most productive areas of activity in the economy. In response to such suggestions, the Committee was told that the credit assessment function was not fulfilled optimally in recent years because, coming from a background of strong regulation, banks had not adequately developed the information bases, trained staff and assessment infrastructure to deal with the new environment. In addition, it was acknowledged that mistakes were made in credit assessment in the exceptional circumstances of strong and sustained growth in corporate profitability, and asset price inflation.[46]

8.63 The general view put forward by the major banks was that these mistakes were a temporary aberration. They stressed that it is important not to over-emphasise the mistakes of the past. Instead, they highlighted the benefits which deregulation has brought in establishing a more efficient structure for mobilising the savings of the Australian population and making those savings available to borrowers. In this regard, Westpac and the Commonwealth Bank submitted that the main indicator of improvements in allocative efficiency is the fact that lending decisions are no longer made on the basis of arbitrary criteria, but rather are based on an objective assessment of viability and risk relevant to the customer's ability to meet loan repayments.[47]

Conclusion

8.64 Deregulation of the financial system has resulted in substantial changes within the banking industry, both in terms of the way in which banks conduct their operations and in the way in which they have responded to the changing needs of the community. It is clear that a major catalyst for this change has been the increased competition which has been brought about by deregulation.

8.65 In considering whether this increased level of competition has led to a more efficient banking industry, the Committee took into account the evidence available on operating costs, as well as indicators that the industry has adapted to the changes of the more competitive environment. These indicators have included the use of more advanced technology and product innovation.

8.66 While the evidence on efficiency gains was not extensive (availability of information is addressed further in Chapter 21), the Committee was able to conclude that increased competitive pressures arising from deregulation have forced participants in the banking industry to reduce operating costs, through more efficient use of personnel and use of more advanced technology, and to become more innovative in satisfying customer needs.

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46 Evidence, pp. S328-S329.

47 Evidence, pp. S266-S267 and S328.

8.67 However, deregulation has carried with it certain costs. The most visible of these has been the poor lending decisions of the 1980s, which have resulted in high levels of bad and doubtful debts. This is in contrast to reductions in operating costs. With the benefit of hindsight, it is evident that, in a number of cases, the savings of the community have not been directed to the most productive areas of economic activity. The reckless support of elements within the entrepreneurial sector has created a misallocation of resources towards unproductive takeover activity.

8.68 To an extent, the poor lending decisions of the 1980s can be attributed to the new competitive pressures faced by the banks, in that fear of new competitors and the potential loss of market share resulted in banks being less prudent than had been the case previously. At the same time, it is abundantly clear that a lack of preparedness by the incumbent banks for the new wave of competition contributed significantly to the mistakes which occurred and which are acknowledged.

8.69 Despite the difficulties which have arisen, effective competition remains essential to the efficient operation of the banking industry and the financial system as a whole. In this regard, the Committee has made recommendations earlier in this chapter which seek to ensure that there is no lessening of competition in the market for banking and financial services.

8.70 While it is obviously in the interest of banks to become more efficient, the main guarantee that efficiency gains will continue to be pursued is the ever present threat of competition. In this regard, it is not only important to reinforce the competitive structure of the industry, as the Committee is seeking to do, but also to work towards the removal of any remaining barriers to competition, both regulatory and commercial. These are considered in Chapter 9.

CHAPTER NINE

BARRIERS TO COMPETITION

Entry, access and choice

9.1 In assessing the competitiveness of the banking industry following deregulation, the Committee was interested in determining what barriers to competition still exist.

9.2 As noted in Section II, deregulation was based on the premise that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention. In this regard, the Campbell Committee was of the view that deficiencies in competition are largely a product of regulation.[1]

9.3 In recommending the removal of many regulatory barriers to competition, the Campbell Committee indicated that high levels of competition are usually achieved when there are no barriers to entry other than natural commercial ones. It also suggested that the market will work most efficiently if participants have an equal opportunity to compete for business and equal access to information.[2]

9.4 Similar themes emerged in evidence to the current inquiry. Concerns were expressed about remaining barriers to entry, impediments as to choice between market participants, and inequality of treatment between market participants. Evidence was received in relation to the following barriers to competition:

- the existing numerical restrictions on foreign bank entry;
- the prohibition on foreign banks operating in Australia as branches;
- a lack of information for consumers;
- the costs involved in changing banks and transferring accounts;
- access to the payments system;

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1 Campbell Committee, p. 529.
2 ibid, p. 522.

- government guarantees; and
- the commercial advantages of incumbent banks.

9.5 Issues relevant to foreign banks are considered in Chapter 10, while matters of concern to consumers, such as availability of information and account switching costs, are examined in Section V.

9.6 In this chapter, the Committee has focused on issues which relate to inequality between market participants. Such inequality can be either a barrier to entry or a barrier to increased competition. The Committee also has examined particular areas of government regulation relevant to competition in the banking industry.

Access to the payments system

9.7 Participation in the payments system is an important issue not only in terms of competition, but also with regard to the efficiency of the financial system and confidence therein. The issue of access to the payments system is considered in this chapter, while other matters relevant to its operation are examined in Chapter 13.

9.8 The term payments system refers to the mechanisms provided by financial institutions to enable funds, or value, to be exchanged between parties. Traditionally, payments have been made largely with currency and cheques. With the advent of new technology, transfers have been effected increasingly by electronic means. Figure 9.1 illustrates the payments system in 1991.

9.9 As noted by the Campbell Committee:

> The ability of an institution to compete effectively in the provision of payments services (and to an extent attract deposits) depends importantly on its having access to a system for transferring and settling net claims between participants.[3]

9.10 Under existing arrangements, banks and authorised money market dealers are the only institutions which have direct access to the clearing system through exchange settlement accounts with the Reserve Bank. Banks are the only institutions able to issue cheques drawn on themselves. These limitations are a consequence of the need for a high level of integrity, stability and confidence in the payments system. Two previous committees of inquiry reaffirmed the need for such limitations.[4]

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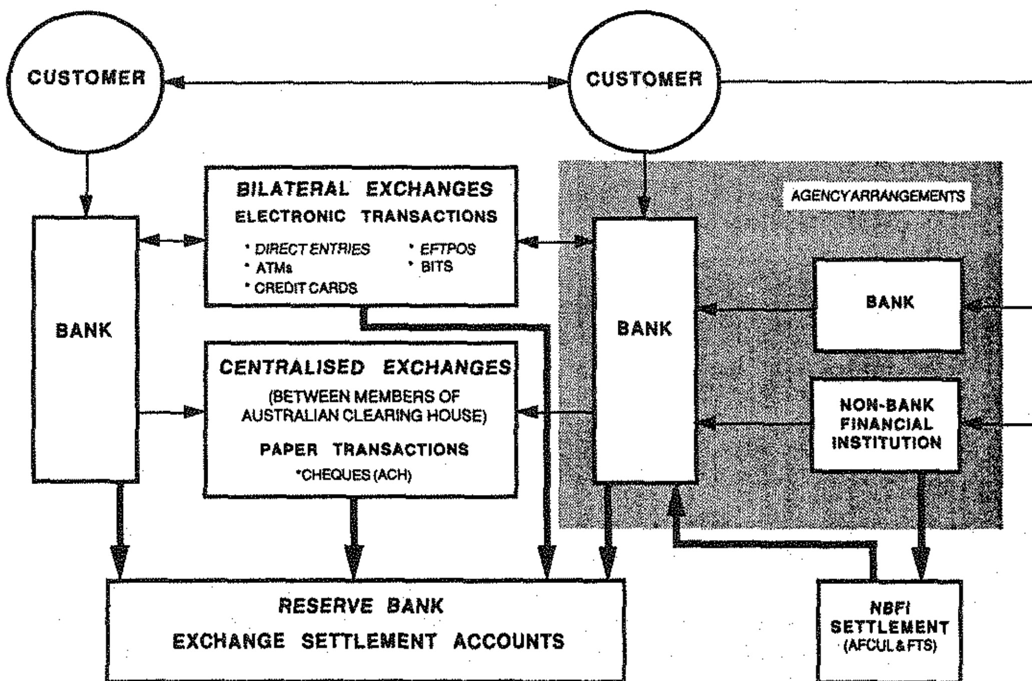
3 ibid, p. 411.
4 Campbell Committee, p. 417 and Martin Review Group, p. 181.

FIGURE 9.1

THE PAYMENTS SYSTEM IN 1991



Source: Australian Payments System Council, The Payments System in Australia.

9.11 Those committees, nevertheless, advocated the entry of new banks into the cheque clearing system, and recommended that non-banks have access by way of agency arrangements with a bank on reasonable commercial terms and conditions.[5] The establishment of a body to oversee the evolution of the payments system also was recommended.[6] This led to the formation of the Australian Payments System Council (APSC) in 1984, which was required to:

- keep clearly in mind the principle of ensuring fair competition among all financial institutions;
- monitor the development of Australia's payments system;
- promote the implementation of standards for electronic funds transfer systems;
- foster links between payments systems; and
- consider how best to facilitate access by non-bank financial intermediaries to the cheque clearing system with suitable commercial and prudential arrangements.[7]

9.12 The ABA indicated that, since deregulation, both competition between and cooperation among providers of payments services has contributed to a substantial increase in access to the payments system. It also advised that further reform is being undertaken in accordance with the findings of a review conducted under the auspices of the APSC.[8]

9.13 The review task force, which reported its findings in February 1990, recommended that existing clearing arrangements be reorganised into four broad functional groupings, with four separate companies to administer each arrangement. The task force reaffirmed the principle that direct access to the settlement arrangements with the Reserve Bank should be available only to those financial institutions which are supervised at the most stringent levels. It noted that, within the context of current clearing and supervision arrangements, this definition only encompasses banks. However, the task force suggested that it would be possible for other financial institutions to acquire direct access to the payments system provided the Reserve Bank is satisfied with their supervisory arrangements.[9]

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5 Campbell Committee, p. 418 and Martin Review Group, pp. 176 and 187.
6 Martin Review Group, p. 204.
7 APSC, *The Payments System in Australia*, 1990, p. 31.
8 Evidence, p. S21.
9 Evidence, pp. S123-S125.

9.14 In terms of non-bank financial intermediaries, the task force recommended that indirect settlement and clearing facilities be available to all financial institutions which are providers of payments services but which are ineligible for or do not wish to have direct access to the payments system. It recommended that such facilities be provided on commercial terms which would not preclude or disadvantage agency participation.[10]

9.15 To implement the task force's recommendations, a steering committee, chaired by the Reserve Bank, was established. The implementation process is continuing.

9.16 However, representatives of non-bank financial intermediaries were critical of the lack of reform in relation to the payments system. The Australian Federation of Credit Unions Limited (AFCUL), representing 373 credit unions throughout Australia, stated:

> Despite the recommendations of both Campbell and Martin to open up the payments system and the formation of the Payments System Council, in the last 10 years very little has occurred to prise open the closed doors of the payments system, with over 80 per cent of all clearing transactions currently performed by the four major trading banks.[11]

9.17 AFCUL argued that the inability of credit unions to gain direct access to the clearing system necessitates the establishment of costly agency arrangements with banks. It noted that such arrangements generally bind non-bank financial intermediaries to a particular bank because of the costs which are associated with changing banks. AFCUL stated:

> Such arrangements simply entrench the domination of the payments system by the major banks, and preclude credit unions from securing the competitive benefits which would otherwise flow from direct settlement.[12]

9.18 AFCUL submitted that the payments system should not be a regarded as a commodity which is owned and controlled in a proprietary sense. Rather, AFCUL indicated that the payments system is a complex web of timing and settlement procedures which, by virtue of national importance and institutional uniqueness, assumes many of the characteristics of a public utility. AFCUL suggested, as a result, the payments system should be administered neutrally by conferring equal status on all classes of participants.[13]

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10 Evidence, p. S125.
11 Evidence, p. S904.
12 Evidence, p. S906.
13 Evidence, p. S903.

9.19 Other organisations commented on the need for equal treatment in relation to the payments system. St George Building Society indicated that entry to the clearing system is its number one priority in terms of removing barriers to competition.[14] Similarly, the Association of Permanent Building Societies advised that its objectives include having the ability to issue cheques in its own name, having the ability to change banks if one bank's cost of clearing a cheque changes, and having direct access to the clearing system.[15]

9.20 In terms of the criteria necessary for direct entry to the payments system, AFCUL submitted that it was discriminatory to confine direct participation to certain financial institutions because of their particular legal corporate status. AFCUL suggested that objective criteria, such as financial ratios, critical mass and adherence to technical standards, should be relied upon in determining the basis for direct entry.[16]

9.21 One suggestion raised with the Committee was the possibility of establishing an industry bank which could act as a vehicle for direct access to the payments system by credit unions or other non-bank financial intermediaries. AFCUL indicated that it had raised this possibility in an informal manner with the Reserve Bank in regard to the credit union company Credit Union Financial Services (Australia) Limited. Despite being able to meet the capital adequacy standards, having a high quality asset book and high levels of liquidity, AFCUL noted that the idea of Credit Union Financial Services being licensed as a limited purpose bank was not received favourably by the Reserve Bank. AFCUL stated:

> Despite us having all the correct prudential applications, simply the colour of our organisation ... means that we cannot get access through the Reserve Bank.[17]

9.22 One of the difficulties arising from such a proposal, as noted by AFCUL, is that it conflicts with the existing policy requirement for a bank to achieve an appropriate spread of risks.[18] This was noted previously by the Martin Review Group, which also considered the suggestion for an industry bank. It indicated that prudent banking limits and more formal restrictions on risk exposure to individual customers would limit, possibly severely, the ability of an industry bank to provide agency facilities to larger non-bank financial intermediaries. In this regard, it acknowledged the force of prudential concerns about an industry bank being a sound vehicle for access to the payments system.[19]

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14 Evidence, p. 844.
15 Evidence, p. 770.
16 Evidence, pp. S903 and S905.
17 Evidence, p. 367.
18 Evidence, p. 367.
19 Martin Review Group, p. 189.

9.23 Nevertheless, the Martin Review Group did not rule out the possibility that arrangements could be devised to overcome such concerns. In fact, while indicating it favoured agency access, the Martin Review Group suggested that if its hopes for wider access to the payments system were not fulfilled via the agency route, the authorities should consult with interested non-bank financial intermediaries about alternative arrangements for access. These could include either access through industry banks or direct participation by non-bank financial intermediaries.[20]

Conclusion

9.24 It is evident that access to the payments system is crucial for any financial institution competing in the market for financial services. Restrictions on access are a significant barrier to competition.

9.25 The question of access, though, cannot be considered in isolation from the broader issues of confidence in and stability of the payments system. The existing restrictions, which limit direct participation to banks and authorised money market dealers, are based on the principle that only those institutions which satisfy the most stringent prudential requirements should be allowed direct access. Given the importance of the payments system to the overall stability of the financial system, the Committee considers that this principle must be upheld.

9.26 Nevertheless, the Committee is conscious of the competitive disadvantages which arise for non-bank financial intermediaries because of their inability to gain direct access. While reforms to the payments system since deregulation have improved the situation, by enabling increased access through agency arrangements at a more competitive price, non-bank financial intermediaries clearly believe the reform process has not gone far enough.

9.27 Many of the Committee's recommendations in this report are aimed at ensuring a strong competitive environment within the banking industry. Access to the payments system, on terms which are fair and equitable, is vital to this aim. In this context, the Committee is of the view that further consideration needs to be given to the question of access for non-bank financial intermediaries.

9.28 The Committee notes that the Reserve Bank is participating in the implementation of reforms to the payments system, as recommended by a task force commissioned by the ABA. As part of that process, the Reserve Bank should investigate the feasibility of alternative arrangements for access by non-bank financial intermediaries. In particular, the feasibility of establishing industry banks as a vehicle for direct access by non-bank financial intermediaries should be explored.

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20 Evidence, p. 190.

Recommendation

9.29 **The Committee recommends that:**

8. **the Reserve Bank, in implementing the recommendations from the review of the payments system commissioned by the Australian Bankers' Association, investigate the feasibility of providing non-bank financial intermediaries with direct access to the payments system, either through the establishment of industry banks, or through some other arrangement.**

Government guarantees

9.30 The issue of government guarantees attaching to State banks and the Commonwealth Bank was raised with the Committee in the context of barriers to competition and competitive equality.

9.31 Westpac submitted that government guarantees impact on efficient allocation of savings, and potentially impact on diversity of choice and the exercise of commercial prudence. It also argued that these guarantees distort capital markets.[21] Westpac advised it is paying 0.5 to 0.6 per cent more for term deposits than the Commonwealth Bank because of the guarantee.[22]

9.32 Westpac suggested this deviation from competitive neutrality can be resolved by privatising publicly owned banks and removing the guarantees. Failing this, Westpac submitted that governments must receive the market price for their guarantees, thereby placing the guarantee at arms length.[23]

9.33 In response, both the Commonwealth Bank and the Reserve Bank acknowledged the competitive advantages which attach to government guarantees. However, they questioned the extent and impact of those advantages.

9.34 The Reserve Bank argued that while the guarantee does distort the market, the extent of that distortion appears to be absolutely minimal. It indicated there are other factors which provide a balancing effect. For example, it noted that government owned banks have traditionally faced difficulties in acquiring capital, and accordingly have set lower growth targets than banks which have been able to turn to the share market. The Reserve Bank pointed out that most private banks benefit from dividend reinvestment schemes, which return a significant proportion

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21 Evidence, p. S254.
22 Evidence, p. 135.
23 Evidence, p. S255.

of the dividend to the banks in the form of new capital. It, therefore, was sceptical about the overall advantage attaching to government guarantees. The Reserve Bank stated:

> ... it is really looking at one side of the ledger and focusing on that and not looking at the totality of the position.[24]

9.35 From a similar perspective, the Commonwealth Bank indicated that while some people may find it reassuring to have a government bank, others prefer specifically not to bank with a government enterprise. In terms of the guarantee's effect in the market place, the Commonwealth Bank noted that while some people are willing to trade an interest rate against a government guarantee, if those funds are insufficient to cover the totality of the bank's business, then the bank ends up having to pay the market rate to cover the shortfall. It submitted, therefore, the advantage is not an enduring one.[25]

9.36 The Commonwealth Bank also suggested the real issue is not whether there is a government guarantee, but rather, whether banks are perceived as being sound. It indicated, in normal times, depositors regard all banks as sound, and are not prepared to trade a lower interest rate for a guarantee. The Commonwealth Bank stated:

> If you have a system with good prudential supervision then that does qualify the attractiveness of a government guarantee.[26]

9.37 Nevertheless, the Commonwealth Bank emphasised that government ownership carries with it a guarantee by government of the bank's liabilities. The Commonwealth Bank stated:

> If it did not do so explicitly it would be under great pressure to do so if difficulties arose, so it is better to be explicit.[27]

Conclusion

9.38 From the evidence available, it is difficult to determine with any precision the value of the government guarantee attaching to the Commonwealth Bank and the State banks. While the guarantee offers some advantage, enabling government owned banks to acquire funds at a lower cost, it is unclear how significant the advantage really is.

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24 Evidence, p. 638.
25 Evidence, pp. 66-67.
26 Evidence, p. 67.
27 Evidence, p. 59.

9.39 It is evident that a government guarantee provides a certain level of reassurance for depositors. However, this should not be overstated. It is, after all, the prudential supervision of banks, rather than a government guarantee, which should be the crucial factor in maintaining confidence and stability in the banking industry and the financial system.

9.40 Regrettably, the recent history of State banks in South Australia and Victoria has demonstrated that this has not been the case. In both situations, a government guarantee was vital in protecting depositors and ensuring the stability of the financial system. The Committee is concerned about the lack of appropriate prudential and supervisory arrangements which were evident. The relevant issues are examined further in Section III.

9.41 The Committee notes that the operations of government owned banks have become indistinguishable from those of privately owned banks. In this regard, it is likely that government ownership of banks, particularly State banks, will diminish over time. The government guarantee in relation to such banks obviously should be phased out if the banks are sold to private interests. Until such time, a government guarantee should continue to apply to government owned banks.

Commercial advantages

9.42 In a number of submissions, it was suggested that established banks, particularly the four major domestic banks, enjoy a number of commercial advantages which can be regarded as barriers to competition. These advantages generally can be classified into two broad categories:

- infrastructure; and
- banking relationships.

9.43 In terms of infrastructure, it was submitted that the extensive branch and agency networks developed by the established banks over a long period of time, coupled with the magnitude of capital investment by these banks in automation and technology, have provided them with advantages over the new banks, particularly in the retail banking sector.[28] Industry representatives acknowledged that the costs of establishing a large branch network are a significant barrier to entry.[29] These costs were cited by foreign banks as being one of the major reasons for their failure to make an impact in the retail banking sector.[30] As far as the Committee is aware, foreign banks have not managed to make significant inroads into the retail banking sector of any country, except where they have acquired an existing branch network.

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28 Evidence, p. S353.

29 Evidence, pp. S59, S261 and S353.

30 Evidence, p. S1257.

9.44 Westpac, though, indicated that a major reason why there have been few new entrants into the retail finance area is that there already is over-capacity in that sector. It suggested this over-capacity is likely to be aggravated by technological developments such as automatic teller machines and telephone banking.[31] In contrast, consumer organisations suggested that even though 31 banking groups operate in Australia, the choice for retail consumers is not extensive, as a much smaller number of banks, say six or seven, are available for retail consumers to choose between.[32] This issue is explored in further detail in Section V.

9.45 In terms of banking relationships, it was submitted that many of the advantages enjoyed by the existing banks simply reflect the preference of Australians to deal with local banks. The Commonwealth Bank suggested that this preference is based on the banking relationships which have been built over many years.[33] Banking industry representatives indicated that long term banking relationships are a particular feature of commercial banking.[34] They did not regard this factor as being unusual to Australia. Indeed, they noted that Australian banks face similar obstacles when seeking to enter overseas markets.[35]

9.46 To an extent, the concept of having a relationship with a bank, which goes beyond the concept of simply conducting business with an institution, contributes to customer inertia. Customers become reluctant to leave their old bank because of the relationship which has been established, and the sense of familiarity which accompanies that relationship. This inertia is, in effect, a barrier to competition. However, it was pointed out that past preferences and customer inertia will erode over time if established banks fail to meet the services and prices of their competitors.[36]

Conclusion

9.47 The commercial advantages enjoyed by established domestic banks, particularly their branch network and their broad customer base, are a barrier to competition in the sense that they make it more difficult for new entrants to gain a share of the market. These advantages have been built up over a considerable length of time and reflect an extensive investment by the established banks.

9.48 It is important to remember these advantages are not exclusive to one bank. Four major banks at the national level, and a number of regionally operating banks, benefit from the networks and relationships which they have established. All of these banks are in vigorous competition against each other for market share.

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31 Evidence, p. S262.
32 Evidence, pp. S1536-S1537.
33 Evidence, p. S354.
34 Evidence, p.S59.
35 Evidence, p. S353.
36 Evidence, p. S354.

9.49 Commercial impediments to competition can be neutralised by ensuring that any regulatory barriers which favour the position of established domestic banks are removed. The Committee has made a number of recommendations aimed at such an outcome. In particular, it has recommended that steps be taken to improve access to the payments system (paragraph 9.29) and to improve opportunities for foreign bank entry to Australia (paragraphs 10.22 and 10.46).

Government regulation

9.50 Two areas of government regulation of concern to the banking industry were raised with the Committee in its consideration of barriers to competition. These were:

- the provisions of the proposed uniform credit legislation under consideration by the Standing Committee of Consumer Affairs Ministers (SCOCAM); and

- the identification requirements of the cash transaction reporting system and the tax file number system.

9.51 Issues arising from SCOCAM's consideration of proposed uniform credit legislation are considered in Section V.

9.52 In regard to the identification requirements, the ABA and consumer organisations argued that the account opening procedures of the *Cash Transaction Reports Act 1988*, coupled with the tax file number requirements, make people more reluctant to disturb existing banking arrangements.[37] The cash transaction reporting system, which seeks to detect and inhibit tax evasion, money laundering and other financial fraud and crime, comprises two elements:

- reporting of suspicious and large cash transactions to the Cash Transaction Reports Agency (CTRA) by banks, other financial institutions, financial corporations and gambling institutions; and

- identification and verification requirements for new account holders, coupled with a prohibition on operating false name accounts.

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37 Evidence, pp. S60 and S1548.

9.53 The verification procedures require customers opening new accounts to satisfy a 100 point identification test. Consumer representatives suggested that such requirements, while well-intended, create an inertia which makes competition less effective.[38]

9.54 The Attorney-General's Department, however, advised that the verification procedures are only a minimum requirement. It indicated some cash dealers actually apply more rigorous verification standards to satisfy their own requirements.[39]

9.55 From a similar perspective, the CTRA noted that some banks have absorbed the verification procedures into their own systems, resulting in streamlined operations at the counter. Others, however, have added the procedures as an extra step to their existing methods. The CTRA indicated this has sometimes led to a feeling that the requirements are an imposition beyond what is necessary for the bank.[40] In regard to this issue, the CTRA noted:

> ... some financial institutions, such as the building societies in Queensland, have indicated to the CTRA that they are no longer having difficulties with the procedures and that indeed they have streamlined their provisions to the point where they may be gaining business from cash dealers who have in effect 'done it the hard way'.[41]

Conclusion

9.56 While the Committee accepts that the verification requirements of the cash transaction reporting system may contribute to a reluctance on behalf of customers to change the financial institution with which they conduct business, it does not regard those requirements as being either unreasonable or a significant barrier to competition. As all financial institutions have a minimum obligation in terms of the account opening procedures, the requirements of the system should be neutral in their effect.

9.57 The Committee notes with interest evidence from the CTRA that some financial institutions have streamlined their procedures to assist customers in satisfying the requirements of the cash transaction reporting system. The Committee encourages all financial institutions to adopt this approach. The liaison committee, which is chaired by the CTRA and which includes representatives of major cash dealers, should have a role in this regard.

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38 Evidence, p. S1548.
39 Evidence, p. 1907.
40 Evidence, p. S4356.
41 Evidence, p. S4358.

9.58 The Committee is aware that a review of the cash transaction reporting system is due within three years of its operation.[42] As part of that review, the verification and reporting requirements of the system should be assessed not only to ensure that the objectives of the system are being met, but also to ensure that the benefits of the system justify the costs for the financial services sector.

Recommendation

9.59 **The Committee recommends that:**

9. as part of a broader review of the cash transaction reporting system, due within three years of its operation, the verification and reporting requirements of the system, as they impact on financial institutions, be assessed to ensure that the benefits which are being achieved justify the costs which are involved.

42 Evidence, p. 1910.

CHAPTER TEN

FOREIGN BANKS

The new entrants

10.1 The first foreign banks to gain entry into Australia commenced operations prior to the introduction of the original Banking Act in 1945. Of these, three foreign banking groups, owned by the governments of China, New Zealand and France, established and maintained limited branch representation in Australia, gaining a relatively small share of Australian banking business.[1] The presence of the three foreign banks predated what was to become a longstanding policy prohibiting the establishment of new banks owned by non-residents, and restricting the participation of non-residents as substantial equity holders in Australian banks.

10.2 The policy on foreign bank entry was altered as part of the deregulation process. In September 1984, the then Treasurer called for applications from domestic and foreign interests wishing to operate as banks in Australia. This decision arose from a recommendation of the Campbell Committee that the existing embargo on non-resident participation in Australian banking should be removed.[2] The recommendation was supported in the main by the Martin Review Group, although it qualified this support by recommending that the maximum share to be held by foreign interests should be 50 per cent.[3] This restriction necessitated new banks with foreign equity being incorporated in Australia as subsidiaries rather than as branches.

10.3 Announcing the decision on new bank entry in September 1984, the Treasurer indicated that the establishment of new banks would bring substantial benefits to the Australian community through the development of a more innovative, efficient and competitive financial sector.[4]

10.4 Forty two applications for a banking authority were received. In February 1985, the Treasurer announced that 16 foreign banks (some with Australian partners) would be invited to develop their applications further. The first new foreign-owned bank commenced operations in Australia in September 1985. Of the 16 banks invited to develop their applications for a banking authority, only one has yet to take up its authority.

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1 The Bank of China ceased operations in Australia in 1972, but reopened its branch operation in Sydney in December 1985.

2 Campbell Committee, p. 439.

3 Martin Review Group, pp. 68-71.

4 Treasurer's press release no. 142, 10.9.84.

10.5 The expectations in relation to the new banks were that they would provide a wide range of banking services and would extend their activities to encompass Australia's different regions.[5] Reinforcing these expectations was the insistence of the Reserve Bank that new banks offer some form of retail operation.[6] It was acknowledged, though, that the new banks might wish to emphasise certain areas of business in which they have special expertise.[7]

10.6 The new entrants themselves had high expectations of their future impact on the Australian market. A survey conducted in late 1985 indicated that the new foreign banks expected to secure about 20 per cent of the Australian banking market within five years of their entry.[8]

10.7 It is evident that these expectations have not been met. The new foreign banks have focused their activities primarily in the wholesale or corporate sectors, providing vigorous competition in this area. However, very few have established a retail banking presence. Together, the new foreign banks have 89 branches between them. Only 21 of these branches are located outside the eastern seaboard. The foreign banks account for a small 3 per cent of outstanding housing loans, with 2 per cent accounted for by just one bank. Their total share of the national market for banking services is around 10 per cent. While some foreign bank subsidiaries raise a significant level of their deposits in Australia, others do not.

10.8 The limited impact made by foreign banks on the Australian market has been attributed to a variety of factors:

- the number of new banking authorities issued was much larger than originally anticipated, which meant that those entering the market faced more intense competition for market share than was expected when they initially applied for banking authorities;[9]

- the new foreign banks have been required to operate as subsidiaries rather than branches, which has increased the cost of raising funds for the new banks and has created an environment in which they have been unable to compete on an equal footing with the incumbent domestic banks;[10] and

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5 ibid.
6 Evidence, p. S1247.
7 Treasurer's press release no. 142, 10.9.84.
8 Evidence, p. S628.
9 Evidence, pp. S1246-S1247.
10 Evidence, p. S1247.

- the new foreign banks have faced high barriers to competition, particularly the vast branch and agency networks of the major banks, which have been crucial in protecting the market share of the major banks.[11]

10.9 Commenting on the experience of the new foreign banks entering the Australian market, one foreign bank executive likened the new banks to front line soldiers, suggesting that they have been the 'cannon fodder' of deregulation. The Managing Director of BT Australia stated:

> Like most front line troops, the foreign banks never really had a chance to succeed. The big 4 incumbent banks had plenty of warning about their arrival and thus had set about preparing for the onslaught. ... it is clear that by virtue of their entrenched positions, their preparedness via mergers and spending on raising entry barriers, the big 4 incumbent banks were very comfortably sitting behind remarkably high entry barriers by the time foreign banks came on the scene in 1985.[12]

10.10 In the aftermath of this initial battle for market share, the Committee identified two principal issues relevant to the continued presence of foreign banks in Australia:

- whether restrictions on further foreign bank entry should be removed; and
- the ongoing debate about whether foreign banks should be allowed to operate in Australia as branches of their parent bank, rather than just as subsidiaries.

Open entry

10.11 In evidence to the inquiry, both foreign and domestic banks called for existing restrictions on further foreign bank entry to be removed. Chase AMP and Citibank argued that facilitation of effective competition can be achieved through open entry for new banks, subject only to prudential requirements, and with no restrictions on strategy.[13] The four major domestic banks agreed with the principle of open entry.[14] Westpac indicated that removal of restrictions on further foreign bank entry would provide a significant incentive to maintain competitiveness, as it would give rise to the threat of further competition. Westpac also argued that the

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11 Evidence, pp. S353 and S1257.

12 Ferguson (1990), pp. 4-5.

13 Evidence, pp. S1778 and S2332.

14 Evidence, pp. 92, S261, S505 and S517.

removal of entry restrictions was important for the future international development of the Australian banking industry. It considered that existing restrictions posed obstacles to further offshore expansion by Australian banks, in that they created the perception in several countries, including the European Community, that significant discrimination existed against foreign banks in Australia. Westpac suggested that reciprocal access for Australian banks would not be possible unless the restrictions are removed.[15]

10.12 The importance of reciprocal access was confirmed during discussions which the Chairman held with representatives of the European Community.

10.13 While agreeing that a more open approach to foreign bank entry into Australia would make it easier for Australian banks trying to establish operations overseas, the Reserve Bank indicated that it was arguable whether more open entry would add significantly to competition in the banking sector, or whether it simply would add to surplus capacity. In its view, the entry of additional foreign banks would not enhance competition significantly, unless foreign banks were permitted to take over or merge with a significant domestic bank.[16]

10.14 From a competition policy perspective, the TPC commented that partial, limited or restricted deregulation tends to have counterproductive effects compared with a slightly more open situation.[17] It indicated that the idea of having 16 entrants mistakes numbers of competitors for competition. The TPC emphasised that competition is not about numbers of market participants, but rather about effective rivalry where market participants try to take customers from one another by offering better service delivery and better prices.[18] The TPC stated:

> ... it is pretty true of deregulation in a whole lot of economies and a whole lot of sectors that ... artificial forms of ongoing regulation often have ... undesirable, unexpected and counterproductive effects ... .[19]

10.15 Related to the issue of open entry is the question of whether foreign banks should be able to exit and re-enter the market whenever the economic or market conditions warrant such a move. As the banking authorities granted in 1985 were issued on a one off basis, existing arrangements preclude any foreign bank which decides or is forced to exit the market from re-entering at a later stage.

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15 Evidence, p. S261.
16 Evidence, p. S1143.
17 Evidence, p. 3500.
18 Evidence, p. 3503.
19 Evidence, p. 3500.

10.16 The Reserve Bank felt that, if the issue of exit was considered in isolation, it would be unfair to those applicants which missed out on entry in 1985 if the successful applicants were allowed to exit from the market in the knowledge that they could return at a later stage, whenever it suited them, without having to compete against other applicants for entry.[20] This concern about discrimination, though, would not be relevant if a policy of open entry was adopted, as favoured by representatives of the banking industry.

10.17 From a policy perspective, Treasury stated:

> ... the idea of having markets that are contestable where people can move in and do business whenever they see the opportunity to do business is really the one - whether you have got an oligopoly or whether you have got even a broader range of institutions. If there is somebody who can take advantage of technology, particular marketing nous or whatever it is and come in and put pressure on players in a market, the market usually performs better.[21]

Conclusion

10.18 There was widespread support for the removal of existing restrictions on further foreign bank entry into Australia. Amongst those in favour of such a move were the major domestic banks and the foreign banks which commenced operations in Australia from 1985 onwards.

10.19 Sound reasons were advanced for the removal of existing numerical restrictions on new foreign bank entry. No submissions raised objections to a policy of open entry based on the principle of reciprocal access for Australian banks in overseas markets. It is evident that a policy of reciprocal open entry may assist in providing an ongoing spur to competitiveness of existing banks, because of the competitive implications arising from the threat of new entry. At the very least, the removal of limits on the number of foreign bank licences will facilitate access to overseas markets by Australian banks, particularly in countries in which reciprocal treatment is part of official policy. Given that Australian banks are pursuing an increased international focus, and given that banks around the world are operating on a more global basis, a policy of reciprocal open entry for foreign banks is important in ensuring that Australia is able to participate fully in the worldwide financial system.

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20 Evidence, p. 2958.

21 Evidence, p. 3581.

10.20 The Committee notes that the Industry Commission came to a similar conclusion on foreign bank entry in its draft report on the availability of capital. In that report, the Industry Commission recommended that the restrictions on the number of foreign bank licences be lifted, subject to the maintenance of suitable prudential requirements for new entrants.[22] The Committee supports this recommendation, on the understanding that the new entrants provide a wide range of banking services, as was expected in 1985.

10.21 On the basis that a policy of reciprocal open entry is adopted, the Committee considers that foreign banks which choose to exit from the Australian market should be able to re-enter the market whenever economic or market conditions provide them with an opportunity to do so. This, however, should only be the case if such banks, in deciding to exit, follow appropriate procedures for an orderly exit.

Recommendation

10.22 **The Committee recommends that:**

10. the existing restrictions on the number of foreign bank licences be removed for new entrants from countries offering reciprocal access for Australian banks, subject to the maintenance of appropriate prudential requirements.

Branches versus subsidiaries

10.23 Foreign banks operating in Australia since 1985 (except for the three banking groups noted at paragraph 10.1) have been required to establish as locally incorporated subsidiaries rather than as branches of the parent bank. As noted at paragraph 10.2, this requirement arose from a recommendation of the Martin Review Group, which saw advantages in making the new businesses subject to Australian law and Australian prudential standards.[23]

10.24 In their evidence to the inquiry, some of the foreign banks in Australia indicated that the requirement to operate as subsidiaries adds to their costs and limits their ability to compete effectively. They advised the Committee that, because of their size and short operating history, their credit rating, which is based on their status as separate legal entities, is generally lower than that of their parent banks and the major domestic banks. In their view, this tends to:

. increase the price for borrowed funds;

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22 Industry Commission, *Availability of Capital*, Draft Report, 1991, p. 115.

23 Martin Review Group, p. 71.

- reduce the amount which can be sourced from individual, particularly wholesale, investors through lower credit limits; and

- reduce access to funds of longer maturity.[24]

10.25 In a joint submission, Barclays Bank, Deutsche Bank and NatWest Australia Bank argued that the funding mechanisms available to the foreign banks, in their capacity as subsidiaries, limit their ability to make certain types of loans. In particular, they indicated that foreign banks are unwilling to commit funds for longer maturities, such as home mortgage lending, whilst their own funding is predominantly short term. They also submitted that local incorporation, and the finite domestic capital which subsequently is available to them, place a limit on the amount which they are able to lend to individual borrowers, and the amount which they are able to lend in total.[25] This point was reiterated by the Australian Merchant Bankers' Association (AMBA), which indicated that the subsidiary structure imposes an artificial lending constraint on the Australian operation in circumstances where it would be prudent to lend if the operations were conducted through a branch.[26]

10.26 In terms of additional costs, a further point raised by the three banks was that the locally incorporated subsidiaries not only must satisfy the accounting and reporting requirements of the parent bank, but also must bear the costs of complete audits, preparation of annual reports, and filing of those reports with the appropriate regulatory bodies in Australia.[27]

10.27 Barclays, Deutsche, NatWest Australia and AMBA outlined a range of benefits which could be achieved if foreign banks were permitted to operate as branches. These include:

- enhanced depositor protection as a result of having direct recourse to the financial resources of the parent bank;

- improved competitiveness as a result of having access to cheaper funds and funds of greater maturity, which would permit consideration of longer term home mortgage products and would allow the funding requirements of the corporate sector to be more readily accommodated;

- reduced costs as a result of the bank not having to obtain a guarantee from its parent;

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24 Evidence, p. S1253.

25 Evidence, pp. S1254-S1255.

26 Evidence, p. S791.

27 Evidence, p. S1256.

- increased competition as foreign banks would be in a better position to tackle the domestic banks;

- improved liquidity in the local and foreign exchange markets as a result of greatly increased credit limits available to branches, and a streamlined credit approval process;

- improved organisational efficiency;

- a greater likelihood of foreign banks remaining in Australia;

- improved opportunities for Australia to develop as a financial centre in the region; and

- expansion of non-banking activities by foreign banks, as a result of having increased access to capital.[28]

10.28 The three banks also raised the question of reciprocal access. They argued that Australia is out of step with major world financial markets in insisting that foreign banks operate as subsidiaries. They stated:

> The maintenance of this barrier to competition could result in Australian domestic banks being denied free access to overseas markets. Insistence upon subsidiary status for foreign banks is not consistent with the free flow of financial services worldwide.[29]

10.29 AMBA took the same view in discussing Australia's ambition to be a major regional financial centre. It indicated that this aspiration is difficult to achieve when Australia's major competitors in the region allow banks to operate as branches. Referring to countries such as Hong Kong, Japan, Singapore and Thailand, AMBA stated:

> All of these countries have recognised that leaving the decision about the most appropriate structure to the individual bank is the most efficient approach, conferring benefits to the local economy which would otherwise not eventuate. At the same time they have adjusted their instruments of prudential supervision to accommodate the efficient conduct of business rather than, as in Australia, allowed the supervisory structure to stand in the way of efficiency and competition.[30]

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28 Evidence, pp. S789-791 and S1259-S1261.

29 Evidence, p. S1261.

30 Evidence, pp. S788-S789.

10.30 Clearly fearful of overseas access being restricted or denied, Australia's four major domestic banks supported the calls for foreign banks to be allowed to operate in Australia as branches.[31] They felt that entry by Australia banks to foreign markets is best pursued by the existence of an open banking environment in Australia. The general view of the major banks was summed up by ANZ when it stated:

> The only conditions for entry should be the appropriate level of professional skill, integrity and financial strength.[32]

10.31 As noted at paragraph 10.12, the question of reciprocal access was raised in discussions which the Chairman held with representatives of the European Community. In particular, the Vice-President of the Commission of European Communities, the Right Honourable Sir Leon Brittan, QC, indicated that the existing prohibition on foreign banks operating in Australia as branches was a major obstacle faced by the European Community in conducting business with Australia. Sir Leon emphasised that elimination of this obstacle is an important factor in the attempts to achieve a more liberal trading regime globally. He noted its significance in the context of the existing discussions on GATT.

10.32 The branch versus subsidiary question, though, raises a number of prudential supervision issues which need to be considered. These issues relate principally to the capacity of the Australian authorities to supervise a bank which is not established under or controlled by a board of directors subject to local legislation.

10.33 Under the provisions of the Banking Act, the Reserve Bank is responsible for protecting Australian depositors and for ensuring that banks operate in a sound and prudent way. The decision in 1984 to allow the new foreign banks to enter Australia only as subsidiaries was based primarily on concerns that the Reserve Bank would not have the capacity to fulfil its statutory responsibilities if the new foreign banks were established as branches. Those concerns are still evident today.

10.34 Allowing foreign banks to operate as branches would mean that the Reserve Bank would not be the primary supervisor for such banks. This raises questions about the extent to which the Reserve Bank could protect Australian depositors should a foreign bank with an Australian branch get into financial difficulties.

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31 Evidence, pp. 92, S261, S505 and S517.

32 Evidence, p. S547.

10.35 The Australian system for protecting depositors differs from that of many overseas countries in that it does not include a deposit insurance scheme, but rather relies on the supervision of the central bank and on statutory provisions which give priority to depositors in the circumstances of bank failure. Under section 14 of the Banking Act, the Reserve Bank is empowered to assume control of and carry on the business of a bank where it is advised by that bank, or forms its own view, that the bank is likely to become unable to meet its obligations, or is about to suspend payment. Section 16 of the Banking Act provides that, in the event of a bank being unable to meet its obligations or suspending payment, the assets of the bank in Australia shall be available to meet the bank's deposit liabilities in Australia in priority to all other liabilities of the bank.

10.36 While the above powers clearly offer suitable protection for depositors in situations involving foreign bank subsidiaries, there are doubts as to the extent to which the Reserve Bank could utilise these powers to protect depositors in situations involving foreign bank branches. It is arguable whether a foreign bank facing difficulties would signal its problems to the Reserve Bank, thereby providing an opportunity for early action by the Reserve Bank. Equally, it would be both difficult and expensive for the Reserve Bank to monitor the operations of a foreign bank with an Australian branch to assess for itself the risk of that bank being unable to meet its obligations.

10.37 Another difficulty which could arise is that the Australian requirement for depositors to be given priority in the circumstances of a bank failure may not correspond to the priority requirements of other countries. This could disadvantage Australian depositors by delaying access to their funds. Relevant also are the difficulties which could be faced if a bank which is collapsing withdraws assets from Australia in contravention of the requirement, also under section 16 of the Banking Act, that assets be held in Australia of a value not less than its deposit liabilities.

10.38 Commenting on the difficulties associated with supervising branches of foreign banks, the Reserve Bank stated:

> There are ... some provisions in the Banking Act which give us powers to actually take control of and manage a bank if we feel that depositors' interests might be at risk ... there could be some technical difficulties in carrying out our powers under those provisions in the case of a branch which did not have dedicated capital on the ground here ... .[33]

10.39 Concerns similar to these were expressed by representatives of the Canadian central bank during discussions which they held with the Committee. It is on the basis of such concerns that Canada continues to support the entry of foreign bank subsidiaries rather than branches.

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33 Evidence, p. 636.

10.40 The Reserve Bank, though, indicated that the concerns which existed in 1984, and which weighed heavily in the decision to opt for subsidiaries rather than branches, have been lessened by the development of the Basle guidelines harmonising capital requirements. While suggesting that the development of appropriate supervisory arrangements for the branches of foreign banks would depend on the adequacy of supervision in the banks' home countries, the Reserve Bank clearly stated:

> There is no reason that foreign banks cannot be established here as branches, and there are three already *established in that form.*[34]

Conclusion

10.41 There was widespread support for allowing foreign banks to operate in Australia as branches. The main evidence for this proposal was provided by foreign banks operating in Australia as subsidiaries. The major domestic banks also favoured this approach, while the Reserve Bank did not raise any substantive objections.

10.42 The Committee considers that there are a range of benefits which can be achieved by allowing foreign banks to operate in Australia as branches. First and foremost of these is the possibility of increased competition in the banking industry. By having a broader capital base and improved fund raising capabilities, it is evident that a branch of a foreign bank would be in a far better position than a foreign bank subsidiary to compete against the incumbent domestic banks.

10.43 In addition, it is evident that reciprocal access for Australian banks to overseas markets, as well as Australia's future trading position with the European Community, hinges to a significant degree on the conditions of entry into the Australian market for foreign banks. Allowing foreign banks to operate as branches will bring Australia into line with the practice of the major world and regional financial centres. It is an appropriate signal to the international community about Australia's desire to participate openly in the worldwide financial system. There is no doubt that it will improve opportunities for the international expansion of Australian banks, and will contribute towards Australia's efforts to achieve a more liberal trading regime globally.

10.44 The Committee, of course, is mindful of the difficulties associated with prudential supervision of foreign bank branches, and the concerns which exist in this regard. It is encouraged, though, by the confidence of the Reserve Bank that satisfactory arrangements for supervision can be worked out. The Committee is adamant that prudential standards must not be sacrificed in the pursuit of an improved competitive environment.

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34 Evidence, p. 2961.

10.45 On balance, the Committee supports the proposal to allow foreign banks to operate in Australia as branches, as long as appropriate supervisory arrangements can be established. The benefits to Australia, particularly in terms of competition and trade relations, outweigh the risks which may be involved.

Recommendation

10.46 **The Committee recommends that:**

11. foreign banks, from countries offering Australian banks reciprocal access, be permitted to operate in Australia as branches, subject to them satisfying the following conditions:

- **maintenance of appropriate prudential requirements specified by the Reserve Bank;**

- **provision to the Reserve Bank of information relevant to the foreign bank's Australian operations;**

- **allowing access by Australian bank examiners to the foreign bank's operations in Australia as part of the appropriate supervisory arrangements; and**

- **ensuring, to the satisfaction of the Reserve Bank, that Australian depositors with foreign banks are protected to the same level as Australian depositors with Australian banks.**

CHAPTER ELEVEN

DIVERSIFICATION OF BANKS' ACTIVITIES

11.1 Banks in Australia and worldwide are undergoing fundamental change. They have moved away from traditional deposit-taking and lending activities and into a role more akin to that of financial supermarkets. The structural and market boundaries between different types of financial institution are fading and 'financial conglomerates' are emerging. This chapter describes these developments and some of their implications. The question of the prudential supervision of these activities is examined in the following chapters.

11.2 Whilst banks first extended their activities beyond pure banking many years ago, it was mainly to enable them to conduct banking business outside the regulatory restraints applying to banks, through, for example, ownership of finance companies and money market corporations. It was not until the early 1980s that the banks set about diversifying their activities to include insurance, superannuation, funds management, investment advice, foreign exchange trading and stockbroking.

11.3 The differences between banking, funds management and other activities has given rise to misgivings about the capacity of managers to understand and coordinate such a wide range of activities in a complex conglomerate.

Background on funds management

11.4 Commonwealth Government policy initiatives have increased superannuation coverage from 40 per cent of employees in 1983 to 67 per cent now. Superannuation funds have grown from $35 billion in 1983 to around $125 billion at end-1990 and are predicted to grow to between $300 and $600 billion by 2000. About half of the $125 billion is controlled by life offices. It is estimated that superannuation funds hold around 20 per cent of the shares listed on Australian stock exchanges.

11.5 There are over 100,000 superannuation funds with fewer than 200 members but only 500 funds account for 99 per cent of the industry by value. Many observers suggest the number of funds will shrink rapidly.

11.6 There are two main types of funds:

(i) 'defined benefit' where the employer promises to pay a predetermined benefit and bears the investment risk. The main risk for a member is the fund performing so poorly that the employer cannot make up the difference; and

(ii) 'defined contribution' where the member bears the investment risk.

11.7 A superannuation fund is generally constituted as a trust fund with the trustee bound by the relevant trust law. While members of funds do not have a client relationship with trustees, case law has established that a trustee has an obligation to invest trust moneys prudently.[1]

11.8 Other funds management vehicles include unit trusts, approved deposit funds and trustee common funds. These types of investment are generally referred to as 'pooled' or 'collective' investments.

11.9 Many pooled or collective investments are 'prescribed interests' as defined in the *Corporations Act, 1989.* The definition excludes any interest arising in relation to a life insurance policy, shares, debentures, partnerships, retirement villages and trusts not promoted by professional promoters.

11.10 Although it is difficult to obtain precise figures, it has been estimated that about $65 billion (excluding superannuation funds) is invested in prescribed interests.[2]

11.11 There are some significant entry barriers to the funds management industry. It is widely held within the industry that a minimum size of $1 billion is needed to justify the cost of establishing a sophisticated financial management infrastructure. There are currently around ten funds managers of this size: three of the major banks, Bankers' Trust, the largest insurance companies and a few others.[3]

11.12 To build a synergistic funds management team is a lengthy process. To establish a favourable 'track record' in the market takes even longer. These factors will also make it hard for new entrants to establish a significant market share. Given these barriers to new entrants, measures that reduce competition between existing players are of concern.

Banks' diversification into funds management

11.13 Australian banks' diversification into insurance and superannuation is part of a global trend. In Europe it is known as 'allfinanz' or 'bancassurance' and is facilitated by moves towards the single financial market.[4] Regulations which have inhibited diversification in the United States are currently under review.

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1 ISC Evidence, p. S3967.

2 Australian Law Reform Commission (1991) p. 3.

3 Morgan (1991).

4 This has perhaps gone furthest in the United Kingdom with almost all the large banks being involved in insurance activities. In some cases insurance now provides over half the group profit.

11.14 Banks have diversified for two main reasons. First, modern communications and developments in electronic banking have reduced the role of branches in gathering funds and selling banking services. The excess branch capacity can profitably be directed towards selling other products. In the process it may enforce existing banking relationships. The bank networks form a lower cost distribution network than those used by rivals such as traditional life offices.

11.15 Second, bank deposits are increasingly challenged by superannuation as the preferred savings vehicle. Superannuation has been encouraged by the government, mindful of the aging of the population.[5] Figure 11.1 shows the recent trend and forecasts by Westpac Financial Services.

11.16 Assets under bank-owned funds managers increased from the equivalent of around 5 per cent of bank assets in 1980 to nearly 10 per cent in 1990. These bank-controlled assets represent about 20 per cent of total managed funds.[6]

11.17 It is not necessary for banks to own or form alliances with funds managers to tap savings placed with them. Banks have specialised skills in retail lending. Funds managers wishing to include retail loans in their portfolios can either purchase the loans or buy securities based on them. More simply, the funds can just place deposits with banks and gain the additional benefit of the protection applying to bank deposits. As the Commonwealth Bank put it:

> What banks have the comparative advantage in is obviously assessing and processing loans. They will be aiming to keep exercising that comparative advantage whether they are shifting the loans through or keeping it on the balance sheet through creative ways.[7]

11.18 An alternative way banks could compete with managed funds would be for interest on some bank deposit accounts to be tax exempt. One bank has mentioned the Tax Exempt Special Savings Accounts in the United Kingdom as an example.[8]

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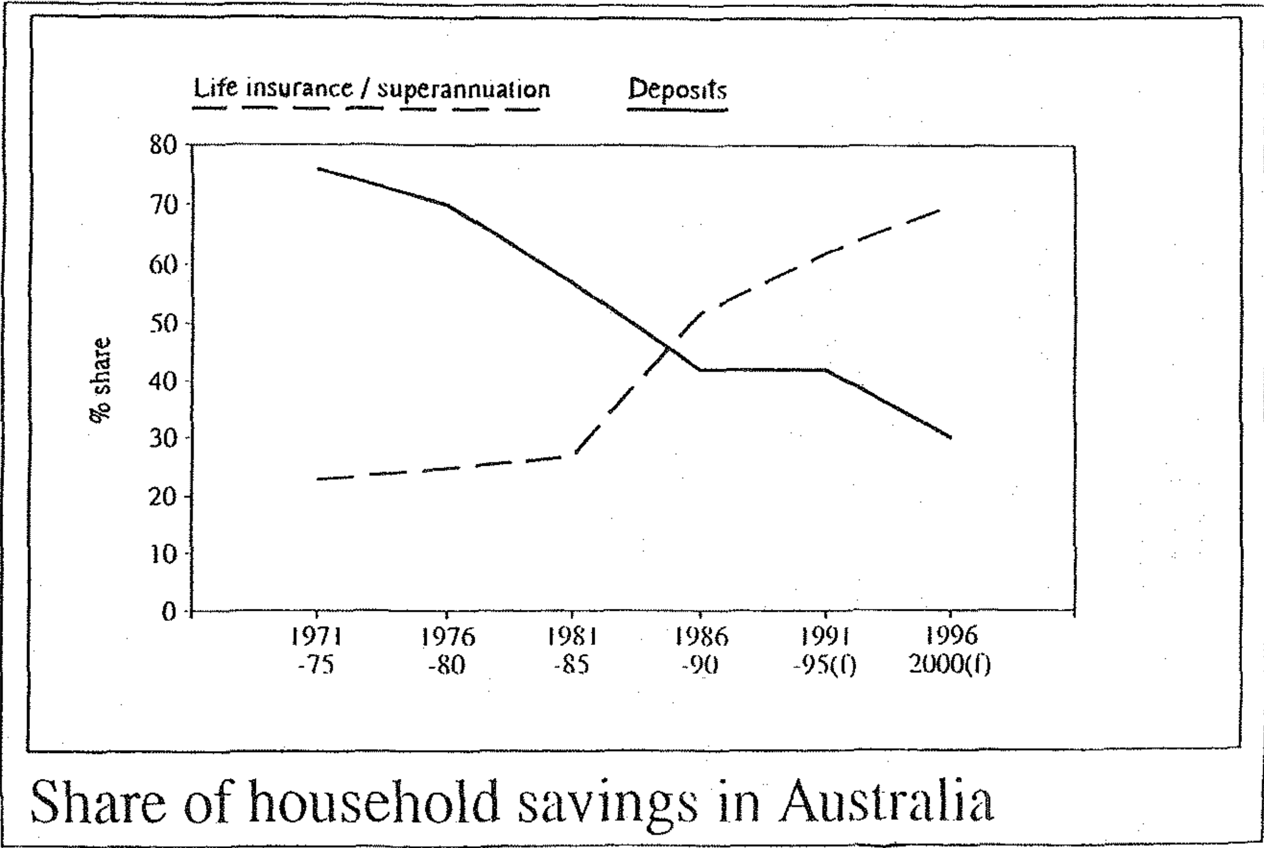
5 Morgan (1991) cites projections that over the next forty years Australia will go from having around six workers for each retiree to having only three. It will be hard to fund pensions out of current taxes once this stage has been reached and so private provision of retirement income needs to be encouraged.

6 Thompson (1991), pp. 10-11.

7 Evidence p. 3709.

8 ANZ (1991).

FIGURE 11.1



Share of household savings in Australia

Conflicts of interest in funds management

11.19 The control by banks of managed funds raises questions of conflicts of interest. For example, a bank may wish to sell some assets and a fund managed by it may be a potential purchaser. With a readily traded homogenous product such as government securities it is a relatively easy matter to determine a fair price. However, with an asset such as property it is more difficult to judge whether a fair price has been paid.

11.20 Another example would involve a bank with an unsecured loan to a company in parlous circumstances. If a fund managed by the bank took up equity in the company it would improve the bank's chances of recovering its debt.

11.21 These two examples are hypothetical. The Committee did not hear of any cases where contributors to a fund have suffered from a bank improperly managing its affairs. But the Committee does not regard this as grounds for complacency. It is desirable that measures to prevent or reduce such conflicts are in place before they become a problem.

11.22 The Australian Securities Commission (ASC) expressed concern about managers directing funds to related companies:

> the biggest worry is investment with associated entities, which is not presently banned or even regulated other than at the margin, but which in my opinion should be ... The classic example ... is the Estate Mortgage property trusts.[9]

11.23 The predecessor of the ASC, the National Companies and Securities Commission, had taken no action on this matter as:

> that role was put in the hands of a private trustee *largely, enforced by unit holders not the regulator.*[10]

11.24 The banks assured the Committee their procedures prevent such conflicts of interest from arising. NAB described their funds management arm as follows:

> It operates, in its day-to-day activities, quite separately from the bank and the bank has no influence over its funds management.[11]

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9 Evidence p. 3951-2.

10 ibid.

11 Evidence p. 3248.

Another bank referred to the 'strong Chinese walls' between these two aspects of their operations.[12]

11.25 Despite these assurances, the personal view of the ASC chairman was that there should be:

> very substantial iron walls - much more substantial iron walls - between the banking activity and the securities business than presently exist.[13]

Conclusion

11.26 There are grounds for concern about potential conflicts of interest when banks are involved in funds management activities.

Recommendation

11.27 **The Committee recommends that:**

12. regulators should satisfy themselves that appropriate systems are in place to ensure adequate separation of the banking and funds management activities of financial conglomerates.

Perceptions of customers

11.28 Another concern about banks' involvement in funds management is that consumers may form the impression the bank is standing behind the fund or guaranteeing it in some way. This is particularly the case where the product is sold to them by bank staff in a bank branch and the brochure has a bank's name and logo on it.

11.29 The banks claim they make it quite clear that they do not guarantee the performance of any fund managed by them. However, the Committee notes one bank's brochures where the only disclaimer appears on the inside back cover, underneath the information on the typesetting and printing. When it was put to another bank that the bank's logo appeared prominently on a brochure for a fund they managed, they replied that 'it is not the same colour'.[14] It was also pointed out that the ASC vets each prospectus for misleading statements and this should include inferences that the bank guarantees the fund.

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12 Evidence p. 3633.

13 Evidence p. 3955.

14 Evidence pp. 3248-9.

11.30 It was clear that banks gain a marketing advantage from associating funds with the bank's name. One banker said:

> We do not resile from acknowledging that [linkage] ... We believe that gives some comfort to the people who may be applying for units in it that it will be well managed.[15]

11.31 The Reserve Bank advised the Committee that guidelines are presently being developed, in consultation with banks, which will ensure adequate separation of subsidiaries (selling unlisted property trusts, life policies and the like) from banks. The Governor stated that:

> what [the Reserve Bank] is trying to do is work out some more effective arrangements with the banks so that clients who procure these particular products are in no doubt at all that they are quite separate.[16]

11.32 In the Committee's opinion, not only must the structural separation be there, it must be reflected in advertising and any other marketing to the public, so that consumers will understand the separation and will take it into account when exercising their choice.

11.33 If it was impossible to dissociate banks from their funds management activities, there would be a case for requiring banks to give an explicit guarantee of some minimum performance. This would then imply that the funds they manage would come under the capital requirements for the banks as an off-balance-sheet contingent exposure. A major problem with this approach is that it may price banks out of the funds management industry.

11.34 None of the regulators would go so far as to require the banks to divest themselves of funds management activities. It was recognised there were advantages to consumers, especially in remote areas, from being able to access insurance, superannuation and unit trusts through the branch networks of the banks. Bank operations are also some of the most healthy and competitive in the funds management area. The ASC commented that:

> I know where the management skills and the capital investment in systems have already been made and they have been made by the banks.[17]

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15 Evidence pp. 3248-9.

16 Evidence p. 2944.

17 Evidence p. 3966.

Conclusion

11.35 The Committee is concerned about the current situation where many customers may form the impression that the sponsoring bank is guaranteeing the performance of funds managed by it or its subsidiaries. However the Committee acknowledges some advantages to consumers in being able to invest in such funds through banks and would not want to prevent the involvement of banks in this area.

Recommendation

11.36 **The Committee recommends that:**

> **13. brochures or advertising by banks state clearly that the bank does not guarantee any fund it manages. This statement should be given as much prominence as the fact that the fund is managed by a bank or its subsidiary.**

Unlisted property trusts

11.37 An example which shows some of the difficulties of banks operating managed funds is the Commonwealth Government's decision to freeze Unlisted Property Trusts (UPTs) for a period. The Deputy Governor of the RBA described UPTs as a 'flawed product' because those organisations offering them failed to ensure 'that the redemption period for any of those units is not shorter than the revaluation periods of the portfolio'.[18] The ASC explained that it was flawed because of 'the government [in the form of the National Companies and Securities Commission] rule that required a short redemption period'.[19]

11.38 No action was taken about UPTs until after the property trusts were hit badly by the decline in commercial property markets in the late 1980s. In 1990 some UPTs not affiliated with banks faced runs. They fended off liquidation only by calling meetings of unit holders which agreed to a freeze on redemptions. At this time those UPTs managed by banks boldly declared they were not affected. Press reports suggested they would not be troubled by lack of liquidity because they had credit lines from the banks.

11.39 By mid-1991 the commercial property market was no better placed. Bank-managed UPTs were facing net redemptions. This was not surprising as given the lag in revaluations of the UPTs' portfolios, early withdrawers received more than their fair share. Some bank managed funds were rumoured to be finding it difficult to fund redemptions by borrowing from their affiliated banks. This may have been because the banks were nearing large exposure ceilings, bank management was worried about the prudence of such loans or UPT trust deeds limited borrowings.

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18 Evidence, p. 2965.

19 Evidence, p. 3961.

After representations from some of these banks the decision was taken by the Commonwealth Government to apply a freeze on redemptions.

11.40 This action was subject to criticism that the bank-managed UPTs were receiving favoured treatment. The Insurance and Superannuation Commission's view of the national interest argument was:

> there was a risk that unlisted property trust investors would form perceptions about the stability of the financial system overall because of their inability to redeem their property trusts. That could carry national interest implications.[20]

As presumably the confidence effect would be more alarming if was causing doubts about the stability of banks, this rationale suggests that, despite any disclaimers, bank UPTs were treated differently to others.

11.41 Treasury put the argument in different terms:

> If we had a large amount of property put onto the market for fire sale as a result of the failure of property trusts, that would have implications for the value of the loan books ... of the banks. It was through that route that it was a problem for the system.[21]

The problem with this argument is that it applies equally well to the situation in 1990, when it was the unaffiliated UPTs that were in difficulty, but the Government took no action then.

11.42 The Australian Securities Commission's response to this riposte is:

> the chances would be remote that unit holders in a major bank sponsored property trust would voluntarily vote to suspend redemptions, when they have the image of a bank parent standing behind.[22]

This explains why the Government needed to act in 1991 but not in 1990. It implies that unit holders did perceive that the bank stood behind its UPT.

Conclusion

11.43 The problems with UPTs highlight the concerns expressed above.

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20 Evidence, p. 3549.

21 Evidence, p. 3593.

22 Evidence, p. 3955. Treasury put a similar argument at Evidence, pp. 3593-4.

Life insurance

11.44 Australia has 58 life offices registered under the Life Insurance Act and various government-owned insurers. These institutions reported total written income of $14.8 billion in the year to 31 December 1990. Some 62 per cent of this was generated by the 5 largest life offices. More than 50 per cent of the life office statutory fund Australian assets relate to superannuation business written by life offices.[23]

11.45 Three of the four major banks, and three other banks, own life offices. Westpac Life is being sold to the AMP. The six bank-owned companies have a combined market share of around 5 per cent.

Finance companies

11.46 Finance companies arose in the 1920s as consumer financiers. They experienced a rapid growth in market share in the period from 1950 to 1980. Then, in the early 1980s, their market share began to fall and has continued to do so, albeit at a reducing pace, over the last three years.[24] As at July 1991, finance company assets were $35 billion, representing 7 per cent of the assets of financial intermediaries.

11.47 Finance companies, including those owned by banks, have gradually moved away from their consumer finance origins. Much of this business is now conducted by the banks. Consumer lending now constitutes only 19 per cent of finance companies' total lending. Their portfolios are now primarily commercial, with leasing forming around a quarter of their total lending. Factoring is another important activity.

11.48 Around three quarters of the consumer business of finance companies is generated through agent retailers, most agency arrangements being with motor dealers.[25]

11.49 Australian banks first entered the finance company market by buying shareholdings in existing companies. The move was made so that banks could share some of the growing profits from the less regulated consumer lending activities of the finance companies. Foreign banks joined the industry as a means of entering the Australian market when they were ineligible for banking licences. While the Boards of Directors are often substantially the same as those of the parent bank, in many cases these subsidiaries have developed a separate 'culture'.

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23 ISC Evidence, p. S3953.

24 Australian Finance Conference Evidence, p. 3395.

25 Ibid, p. S3407.

11.50 Until recently, all four major Australian banks had subsidiary finance companies; AGC (Westpac), Custom Credit (NAB), Esanda (ANZ) and CBFC (Commonwealth). The NAB has now absorbed Custom Credit. The finance companies of the four major banks have accounted on average for 43 per cent of the finance company industry in recent years, with the remaining bank-affiliated companies accounting for a further 8 per cent.[26] Some of their operations are being wound back into the parent banks.

11.51 As indicated above, the finance companies operate under distinct names from their parent banks. Their brochures state that they do not have a guarantee from the parent bank. However, concerns remain about the potential for customers to be confused about the difference between the bank and its finance company subsidiary, particularly as they often take debentures in the retail branches of the parent bank.

Money market corporations

11.52 Money market corporations (MMCs), commonly known as 'merchant banks', are the largest group of non-bank financial intermediaries. In the ten years since 1980, the number of MMCs has more than trebled to over 100. This reflected a relaxation of the rules covering overseas ownership.[27] Their share of financial intermediaries' assets is around 9 per cent.

11.53 MMCs not only lend to large corporates but are active traders in financial markets. Many are involved in corporate advisory work. They are major players in areas such as foreign exchange, swaps, futures, options and investment banking. They claim the credit for many innovations, including developing cash management trusts, the commercial bill market, the currency hedge market, the promissory note market, rebatable preference shares and the unofficial money market.

11.54 Most of Australia's larger MMCs are owned by local or foreign banks. Major companies owned by the Australian banks include; AEFC Ltd (CBA), ANZ McCaughan Ltd (ANZ), Macquarie Acceptances Ltd (Macquarie Bank) and National Australia Ltd (NAB).

11.55 The proportion of total MMC assets owned by subsidiaries of Australian-owned banks has fallen to below one tenth. This has happened because many of the operations they previously carried out are now undertaken by the banks themselves. In some cases, such as Westpac and Partnership Pacific, the MMCs have been totally absorbed into their parent banks.

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26 Ibid, p. S3404.

27 A more detailed description is given in Reserve Bank of Australia (1987b).

Other services

11.56 Most of the banks are now involved, to varying degrees, in other activities which are unrelated to traditional banking, such as corporate advice, travel services, stockbroking and investment advice.

Banks' holdings of equity in non-financial corporations

11.57 The small business sector has often been critical of the lack of venture capital and funding generally.[28] One reason for the lack of venture capital from banks is the guidelines issued by the Reserve Bank on banks' holdings of equity.[29] The Reserve Bank has made clear its view that:

> banks' equity investment in non-financial businesses should not be substantial ... because a bank's soundness, and public perceptions of that, should not be hostage to the fortunes of non-financial companies.[30]

However, the Reserve Bank has indicated that it may be prepared to consider equity involvement by banks on a case by case basis, where the bank's involvement will be for a short period only as part of a 'work-out' of a problem loan.

11.58 International practice on this matter varies considerably. While few countries seem as opposed to the concept as the RBA, only some, such as Switzerland, place no limits on it. Many countries restrict banks' holdings to 5-10 per cent of the company's equity. There are often restrictions on the proportion of the bank's capital or assets that can be invested in a given company or in aggregate. For example, the European Community's Second Banking Directive limits individual shareholdings to 15 per cent of capital and aggregate shareholdings to 60 per cent.

11.59 Banks may be more careful in their assessment of funding if it took the form of equity rather than loans. Equity funding would be more flexible as firms would not be faced with continuing (or even higher) interest payments during a recession.[31]

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28 See, for example, Industry Commission (1991).

29 Prudential Statement G1 in Reserve Bank of Australia (1990a).

30 Reserve Bank of Australia (1991) p. 38.

31 This may be a less radical departure from usual practice than it appears as during the 1980s banks often lent on a 'negative pledge' basis which meant they had little security.

11.60 Treasury described allowing banks to take equity stakes as:

> a departure from our normal system ... that is not unheard of in other parts of the world[32]

but expressed no view on its desirability.

11.61 An individual equity exposure is riskier for a bank than a loan to the same company. It is therefore reasonable that there should be tighter 'large exposure' limits on equity exposures than loans. However, a portfolio of small equity exposures to what may be regarded as 'speculative' projects may not be riskier than a portfolio of large loan exposures as there may be less correlation between the returns on the equity exposures. The loan exposures will all be affected by interest rates and economic conditions in a similar way whereas the returns from the equity positions will vary with a wider range of factors specific to the individual companies.

Conclusion

11.62 Australian banks may be unduly discouraged from providing equity capital to business by Reserve Bank guidelines. Some restrictions on banks' holding of equity are desirable on prudential grounds, however, reflecting the differing risk characteristics of equity rather than loans.

Recommendation

11.63 **The Committee recommends that:**

14. banks be permitted to take equity positions in non-financial companies but there should be strict limits on the size of individual exposures and some limit on the aggregate exposure.

Non-bank ownership of banks

11.64 A non-bank company can only acquire a controlling interest in a bank if it receives exemption under the Banks (Shareholdings) Act. Such exemptions would only be granted if it was judged to be in the national interest and if certain conditions were met.

11.65 The conditions are:

- the company has a corporate structure, as distinct from a mutual structure;

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32 Evidence, p. 3595.

- the company has a diverse share register consistent with the Banks (Shareholdings) Act;

- the company can demonstrate sufficient financial strength; and

- the company accepts the supervision of the RBA to the extent necessary to ensure the integrity of its banking subsidiary and the stability of the financial system as a whole.[33]

These provisions have not yet been incorporated into legislation.

11.66 Aspects of the ownership of banks are discussed in Chapter 8. Other developments which could be of concern to consumers and which might result from ownership of a bank by a non-bank would include any direct marketing of the owner's products to the bank's customers and any transfer of personal information from the bank's data base to the owner.

Diversification and competition

11.67 The issue of competition has been considered in detail in Part II of this Report. Diversification has the capacity to intensify competition and to improve efficiency and customer convenience. Banks are well placed to provide other financial services with maximum efficiency and economies of scale and scope. However, a bank in such circumstances will almost certainly only offer one brand of products. The structure will not promote shopping around by consumers.

11.68 Some banks have diversified by arrangements with non-bank financial institutions, such as life offices, rather than by establishing subsidiaries. In the case of ANZ Bank and National Mutual a full merger was proposed but was rejected by the then Treasurer on the grounds of substantial lessening of competition.

11.69 Westpac and AMP instead entered into an 'alliance'. This involved AMP's retail banking operations being transferred to Westpac and Westpac Life's activities being subsumed by AMP. In many ways the arrangement will have a similar effect to a merger. The TPC has expressed concerns about:

> certain covenants in the agreement that we do not like, like the non-competition covenants that Westpac is not to get back into insurance and AMP is not to get back into banking.[34]

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33 Thompson (1991), p. 11.

34 Evidence, p. 3509. In a Press Release issued on 9 October 1991, the TPC Chairman expressed concern that the covenant could contravene the Trade Practices Act by involving a lessening of competition sufficient to breach sections 45 and 47 of the Act.

11.70 State Bank of New South Wales has entered an arrangement with MLC. Further link-ups and mergers are expected. The insurance industry, like banking, consists of a handful of large firms and a lot of small ones. Some of these smaller firms are being taken over by the major life offices. There is therefore concern that the overall financial sector will become excessively concentrated if a close watch is not kept on mergers and arrangements between the large banks and insurance companies.

11.71 To assess the impact of diversification on competition levels, the market shares of the banks and other financial institutions, on the one hand, and bank cross-ownership and bank ownership of non-bank financial institutions, on the other hand, must be analysed.

11.72 The tied agency arrangements between finance companies and particular retailers mean consumers often lack choice as to the credit provider at the point of sale where the retailer arranges the finance. Competition would appear to be weak at such levels.

11.73 An example of a market lacking competition in this way is that for consumer credit insurance (CCI). A recent study by the Trade Practices Commission found:

> About 80 per cent of CCI policies are sold at the premises of a credit provider ... It is usually difficult or inconvenient for consumers to shop around for 'the best buy' among the alternative CCI products offered by different insurers ... [as] CCI is invariably sold as part of a package ... most retail agents for CCI have sole agency arrangements with a particular insurer ... [and] there is a dearth of published information about CCI.[35]

Conclusion

11.74 The trend towards increasing concentration in the broad financial sector is of concern. There are dangers that increased concentration could reduce the spur to efficiency or allow anti-competitive practices to develop. Competition levels in all areas of the diversified financial sector need to be closely monitored. Detailed information about market shares and cross-ownership needs to be regularly analysed and published.

11.75 The Committee considers any merger or arrangement which would lead to further concentration should be subject to careful scrutiny. Only those proposals that can be shown to generate substantial public benefits should be approved.

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35 Trade Practices Commission (1991), p. 3.

Recommendations

11.76 **The Committee recommends that:**

15. the Treasurer, in considering applications for mergers or *substantial increases in cross-ownership between banks and* other major financial institutions, should prohibit any which would result in a substantial lessening of competition, unless public benefit can be shown. In making this judgement, the Treasurer should seek the advice of the TPC.

Disclosure of information and consumer remedies

11.77 The importance of information to a well-functioning market is reiterated throughout this report and considered in detail in Chapter 21. Most of the points made in respect to banking in that chapter apply equally well to the other products offered by conglomerates. In addition it is important there be adequate disclosure of the relationship between the bank selling the product and the product itself. In particular it must be clear whether the bank is providing any guarantee.

11.78 Generally speaking, banks and their subsidiaries sell only one brand of financial products and services through their bank branches, either those created by their subsidiaries or those created by a life office with which the bank has a strategic alliance. Very little of investors' money is placed in products offered by unrelated companies.[36] This structure does not promote shopping around by consumers and reduces the effect of market pressures which result from the availability of information about comparative products. Recommendations are made in Chapter 21 of this Report on the production of comparative information.

11.79 However, when complex insurance products are being sold, issues relating to the quality of advice and the competence of the advisers also arise.

11.80 Some of the financial institutions which have established subsidiary life companies to sell their own retirement investment products employ sales staff who are paid by commission. Others employ only salaried sales staff, and some employ staff who receive both salaries and commissions.

11.81 Although the financial institutions provide training for the staff who sell their financial products, there is no minimum qualifications or standard of quality which applies to financial advisers and agents. To date, this has tended to be a concern more about sole agents of the major mutual life offices than the agents and advisers selling the bank subsidiaries' products and services. Nevertheless, many of the concerns relating to qualifications and the quality of advice apply in relation to both.

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36 ACA. Evidence, p. S1454.

11.82 Some self-regulatory initiatives are being developed. For example, although the details are yet a little sketchy, there are moves afoot by the Australian Lifewriters' Association, to which many of the life insurance agents belong, to introduce minimum standards and training for members, to develop self-regulatory codes as regards, for example, disclosure and to introduce a system of registration for life agents. These initiatives should be encouraged.

11.83 In 1986 the OECD recommended for consideration the following measures with regard to agents:

(a) licensing or regulation ... based on professional qualifications or other proofs of competence;

(b) professional training and education requirements;

(c) the creation of voluntary codes of conduct for selling practices;

(d) the enforcement of sanctions for unfair selling practices;

(e) the liability of insurance companies for the negligence, misrepresentation or fraudulent acts of their agents or employees;

(f) provisions concerning abusive twisting (advising the purchase of a replacement policy counter to the consumer's best interest);

(g) clear disclosure to the consumer of the ... [agent's] self interest in the transaction; and

(h) the provision to consumers periodically throughout the life of the policy of information concerning the current cash value of and the profits allocated to the policy.[37]

11.84 People with little or no financial sophistication are now investing in superannuation and life insurance policies, savings plans, approved deposit funds and unit trusts. The bargaining power between the sellers and their new buyers is increasingly unequal. In recognition of this, some who gave evidence before the Committee called for improved remedies and access to cheap, fair and speedy dispute resolution procedures.

11.85 The resolution of disputes is a matter which is considered in Chapter 20 of this Report. Many of the points made there concerning banks also apply more broadly to financial conglomerates and other financial intermediaries.

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37 OECD (1987), p. 73.

11.86 The Committee has noted the development of a number of industry-based dispute resolution procedures in the consumer financial services area.[38] Whilst these developments should be strongly encouraged, there may be a need for rationalisation. This is especially so in the light of the announcement by the Treasurer in his August 1991 Budget Speech that the Government is examining the development of a superannuation dispute resolution scheme.

Conclusion

11.87 Benefits to consumers as a result of diversification cannot be assured unless significant improvements are made in the areas of information and dispute resolution.

Recommendations

11.88 **The Committee recommends that:**

16. where applicable, the recommendations concerning disclosure made in Chapter 21 also apply to other activities of bank-led conglomerates, including companies with which they have close associations;

17. the Lifewriters' Association and other representatives of financial advisers and agents should be invited, along with government and consumer representatives, to participate in a general review of quality control of financial advisers and agents; and

18. the Commonwealth Government consult with industry and consumer groups in the development of a list of required features for industry-based dispute resolution procedures and establish a process through which the Government, the industry and consumer representatives can look at options for rationalising the various schemes and proposed schemes.

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38 There are currently four industry-based schemes, dealing with banking, life insurance, general insurance and credit union disputes.

SECTION III

PRUDENTIAL SUPERVISION

The following three chapters discuss prudential supervision. This emerged as a vital issue during the inquiry. While vigorous competition between banks and their rivals is desirable, to ensure that competition brings effective benefits it must not be allowed to damage the confidence of the community in the financial system.

There are eight generally recognised categories of financial intermediary. These are banks, building societies, credit unions, authorised money market dealers, money market corporations, pastoral financiers, finance companies and general financiers.[1] Authorised money market dealers operate only in the short term money market and are closely supervised by the RBA. They are not considered in this report. Pastoral finance companies are discussed in Chapter 16. Supervision of the other intermediaries is discussed in this part of the report.

Chapter 12 describes the existing supervisory structure and procedures. Chapter 13 concentrates on recommendations about the appropriate goals of supervision and the ways they can best be achieved within the existing broad distribution of supervisory responsibilities. Chapter 14 examines possible changes to the distribution of these supervisory responsibilities.

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1 Regulations under the Financial Corporations Act recognise these seven categories of NBFIs and a couple of minor categories ('inter-group financiers' and 'other'). In its statistics on credit and broad money, the RBA includes the eight categories of intermediary and cash management trusts.

CHAPTER TWELVE

CURRENT PRUDENTIAL SUPERVISION OF FINANCIAL INSTITUTIONS

Overview

12.1 Supervision of Australian financial institutions has been conducted on institutional lines. As institutions have diversified differences have emerged between a functional and institutional approach. For example, building societies now conduct many 'banking' activities and banks are involved in insurance.

12.2 The distribution of supervisory responsibilities is shown in Figure 12.1. Banks other than State banks are formally supervised, but not guaranteed, by the Reserve Bank of Australia. State banks are subject to voluntary supervision by the Reserve Bank. Building societies and credit unions are supervised by State government authorities. Insurance and superannuation funds are the province of the Insurance and Superannuation Commission (ISC). Institutions not directly covered by these supervisors account for around a third of the financial system. About half of this sector is represented by money market corporations and finance companies. The majority of these are subsidiaries of either domestic or foreign banks and so to some extent fall under the purview of either the Reserve Bank or overseas supervisors. Some aspects of this sector's activities, such as the issue of debentures and the operations of unit trusts, are regulated by the Australian Securities Commission (ASC).

12.3 The Campbell Committee made a number of recommendations on the supervision of financial intermediaries. These are summarised in Chapter 2. Many of them have only been partly implemented.[2]

Background to bank supervision

12.4 Prior to deregulation, prudential supervision was not a significant issue in banking. Banks were restricted in their lending, what they could pay on deposits and what they could charge on loans. As a former Reserve Bank Deputy Governor put it, during this period the authorities' attitude towards banks was 'if you did not let them do much, they would not get into much trouble'.[3]

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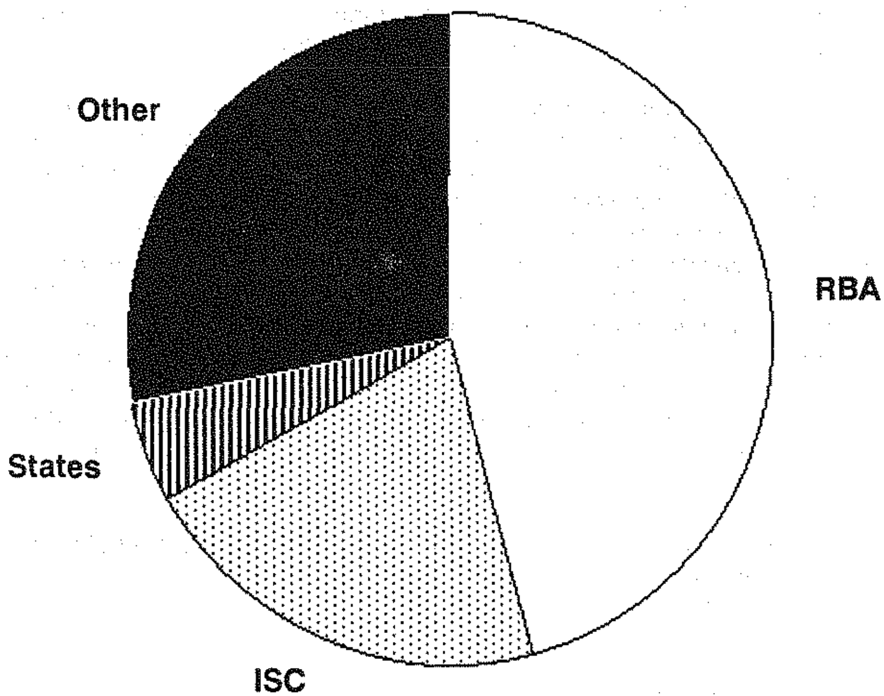
2 A summary of the Campbell recommendations and the responses to them are contained in Reserve Bank of Australia (1989).

3 Evidence, p. 73.

FIGURE 12. 1



Source: Data in *Reserve Bank Bulletin* December 1990.

12.5 While conducted in an informal way, the Reserve Bank's powers over banks derived from the Banking Act. This empowered the Reserve Bank to 'require a bank to supply it with such information relating to the financial stability of the bank as is specified' (section 13), 'determine the policy in relation to advances to be followed by banks' (section 36) and 'make provision for the control of rates of interest payable to or by banks' (section 50).

12.6 A more formal supervisory procedure was introduced following deregulation. The banking 'authorities' issued to the new banks explicitly required them to operate within prudential standards determined by the Reserve Bank.[4] Amendments to the Banking Act in 1989 render the Reserve Bank responsible for 'the collection and analysis of information in respect of prudential matters relating to banks' and the promotion of sound practices (section 11B) and empower it to require the banks to observe prudential regulations.

The goals of bank supervision

12.7 Banks have special characteristics that require them to be supervised in a way that is not regarded as necessary for greengrocers or book stores. One is that they rely on public confidence in their financial soundness for their survival. By definition, no financial intermediary is able to meet requests for the immediate withdrawal of all its deposits. It will never need to do so as long as its depositors are assured their funds will be there when they need them.

12.8 However, if there is a crisis of confidence, it is in the interests of each depositor to be at the head of the queue to withdraw their funds before the bank runs out of cash. In a 'run', customers understandably panic and rush to withdraw their funds even if they personally believe the bank is soundly managed.

12.9 Such episodes are disruptive. A bank subject to demand for withdrawals will have to stop lending and call in existing loans. The public's confidence in a bank is enhanced if they believe a credible supervisor is watching over it.

12.10 Another difference between banks and retail shops is the risk of contagion or 'guilt by association':

> If one greengrocer goes broke, this will not stop people buying their fruit from the grocer down the street. But if a bank experiences trouble, the public might justifiably wonder whether its problems are symptomatic of more general ills. If there is sufficient doubt a run might develop on otherwise sound organisations.[5]

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4 'Authority' is the term used in section 8 of the Banking Act for what are popularly termed banking 'licences'.

5 Fraser (1990), reprinted in Evidence, p. S110.

12.11 The above factors would be relevant to financial intermediaries in general. They are especially important in the case of banks as banks are expected to be the conduit for monetary policy, the key participants of the payments system, the source of liquidity for other intermediaries and a 'safe haven' for household savings.

12.12 The body charged with the supervision of banks is the Reserve Bank of Australia:

> It is the duty of the Reserve Bank to exercise its powers and functions under this Division for the protection of the depositors of the several banks.[6]

It is important to note that this does not mean that the Reserve Bank guarantees deposits in banks. It also does not mean that a bank cannot fail or its shareholders lose money. Since 1989 the Reserve Bank has been explicitly charged with 'the encouragement and promotion of the carrying out by banks of sound practices in relation to prudential matters'.[7]

12.13 The Bank also has a 'responsibility for ... the integrity of the payments system and overall stability of the financial system'.[8] This is not directly stated in the legislation although 'prudential matters' in the above clause is defined to include a bank not conducting its affairs in a way that would cause instability in the financial system. It would also come within the rubric of 'the economic prosperity and welfare of the people of Australia'.[9]

Current prudential requirements for protection for depositors

12.14 Some of the specific matters which the Reserve Bank examines in its supervision are:

- Banks are required at present to hold capital equivalent to 8 per cent of their 'risk-weighted' assets ie. a bank holding mainly government bonds and housing loans is required to hold less capital than one the same size with mostly corporate loans. At least half the required capital must now be 'core' or 'Tier I' capital: in broad terms paid-up capital and retained earnings. The remainder may be 'supplementary' or 'Tier II' capital which includes some reserves and some kinds of subordinated debt.

6 Banking Act section 12.

7 Banking Act section 11B.

8 Stated by the Reserve Bank in Evidence, p. S1121.

9 Reserve Bank Act section 10.

This measure is in line with an international agreement known as the Basle Concordant.[10] Further information on the capital requirements is contained in Appendix 8;

- Banks are currently required to hold 6 per cent of their assets as 'prime assets' ie. liquid and high quality assets such as cash and government securities;

- Banks must not be unduly exposed to any single borrower. They must now report exposures in excess of 10 per cent of capital and seek the approval of the Reserve Bank before entering into an exposure in excess of 30 per cent of capital; and

- Banks are required to have in place appropriate systems for monitoring and controlling risks.

The capital adequacy and large exposure guidelines are applied on a consolidated basis to the bank and its subsidiaries.

12.15 Additional protection for depositors is secured by the Banking Act which provides that, 'in the event of a bank being unable to meet its obligations or suspending payment, the assets of the bank in Australia shall be available to meet that bank's deposit liabilities in Australia in priority to all other liabilities of the bank' (section 16). The interpretation of 'deposit liabilities' has not been tested in the courts and the Committee believes it would be desirable for the Reserve Bank to clarify its meaning. The Banking Act also allows the Reserve Bank to take over the management of a bank if the Reserve Bank believes the bank may be unable to meet its obligations.

12.16 In Australia the central bank has responsibility for the supervision of banks and monetary policy. This is not always the case overseas. While the Bank of England is charged with both monetary policy and the supervision of British banks, in Canada supervision is undertaken by the Office of the Superintendent of Financial Institutions (OSFI) while monetary policy is the responsibility of the Bank of Canada. The same division holds in some European countries. In the United States the Federal Reserve Board conducts monetary policy and is one of a number of supervisors.

12.17 In part this appears to reflect history. In Canada the predecessor of OSFI was established before the Bank of Canada. In the United Kingdom both functions were accrued by the Bank of England over centuries. On the other hand, in the United States the division may be a more deliberate reflection of concerns about 'checks and balances'.

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10 The Bank for International Settlements' Committee on Banking Regulations and Supervisory Practices released its guidelines on 'International Convergence of Capital Measurement and Capital Standards' in July 1988.

The 'too big to fail' doctrine

12.18 Beyond the formal protection offered by the legislation, there is a belief in some quarters that deposits with the major banks have an additional degree of protection. This reflects a view that beyond a certain size a bank is 'too big to fail', by which is meant it is too large to be allowed to fail by the monetary authorities, the supervisors or the Government. It is argued that the failure of a large bank will cause damaging instability in the financial system and loss to many depositors. It may damage the payments system in a way that the failure of a small bank will not. This is partly because a much larger number of smaller banks will have significant exposures to it although the extent of these will depend on the nature of the payments system. It is argued that the failure of one of the major banks would be so disruptive that government could not allow it to occur and would, if necessary, use public funds to prop it up or pay out all depositors.

12.19 The 'too big to fail' doctrine is discussed widely overseas, particularly in the United States. There have been cases in recent years where banks have been supported on these grounds. The most discussed case has been Continental Illinois in the United States in 1984. In testimony after the rescue of this bank, senior supervisors hinted that the largest dozen banks were 'immune from failure'.[11]

12.20 More recent examples are the rescue packages implemented by Scandinavian governments in October 1991. The Norwegian Government injected $A 2.5 billion into a bank guarantee fund, bought equity in the second largest bank and reduced interest rates charged to banks borrowing from the authorities. The Swedish Government guaranteed a $A785 million loan for the country's largest savings bank and underwrote a share issue for another bank. The Bank of Finland recently took over the administration of a large savings bank. In Australian terms, the banks involved are larger than our state banks but smaller than the four majors. Relative to the population of these countries, these rescues have been larger than those of the State banks in Australia.

12.21 The Reserve Bank of Australia explicitly rejects the 'too big to fail' concept:

> the Reserve Bank does <u>not</u> subscribe to this doctrine. The Banking Act makes the [Reserve] Bank responsible for the protection of depositors of <u>all</u> banks authorised in terms of that Act ... in the event of any bank - large or small - getting into serious difficulty the [Reserve] Bank would use its powers to protect the interests of depositors and, in the interest of financial system stability, manage the orderly exit of the bank if there was no viable alternative.[12]

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11 Todd & Thomson (1990), p. 4.

12 Evidence, p. S2865.

The method of bank supervision

12.22 The Reserve Bank approach to supervision is similar to that used by the Bank of England.[13] It is often contrasted to the more intrusive style of supervision employed in North America and much of Asia which involves rigorous on-site examinations of banks. The approach in continental Europe is somewhere between the two. The Reserve Bank does not send teams to inspect banks, although it does now have regular formal meetings with banks' senior management and more frequent informal contact. It relies on statistical returns from banks, verified by their auditors, as the basis for checking that the banks are adhering to prudential standards.

12.23 The banks are not charged an explicit fee for supervision or a 'licence fee' for their banking authorities.[14] It is, of course, difficult to place a value on these. Given that forty two overseas banks applied for banking authorities in 1984 and a number of building societies have converted to bank status, they must have a significant value.

12.24 The most obvious source of value is that banks are able to raise funds more cheaply than non-banks because of the confidence in them arising from their supervision by the Reserve Bank. The Bank does not disclose the cost to it of supervising banks. Its latest annual accounts show total annual staff costs of around $100 million. Probably less than a quarter of this could be attributed to supervision of banks.

Restrictions on the ownership of banks

12.25 As mentioned in Chapter 8, the ownership of banks is restricted by the Banks (Shareholdings) Act. This limits the proportion of voting shares which an individual or associated persons may hold in a bank: the Treasurer's approval is required for a shareholding beyond 10 per cent and the Governor-General's approval is required for a shareholding above 15 per cent. Foreign interests must also comply with legislation on foreign investment. Approval was given for the foreign banks entering Australia from 1985 to exceed the 15 per cent limit. They are now all 100 per cent owned by their bank parents.

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13 Although the UK system has been described as 'a little more proactive' in that the Bank of England will 'call in for special reports from bank auditors and others on aspects of bank business'. Evidence, p. 3061.

14 Recent legislation requires superannuation funds to pay for their supervision. Building societies will contribute to the cost of their supervision under the new arrangements discussed below.

12.26 This legislation reflects the view that:

> depositors' interests are best protected if a small number of interests do not own and control a bank: with concentrated ownership there is a greater risk that conflicts of interest may arise and depositors' funds will be misused.[15]

Such misuse, often referred to as 'self dealing' is a significant problem in the United States financial system.

12.27 Furthermore, if a bank is majority-owned by one firm:

> any problems with the business of the non-bank parent might lead to a loss of confidence in the bank by depositors and other creditors.[16]

12.28 The Reserve Bank has also taken the view that 'it is desirable that control of a bank should be in the hands of a board of directors which is representative of the shareholders as a whole'.[17] Accordingly:

> as a general rule, the Reserve Bank would expect that a shareholder (or group) which had an interest in up to 15 per cent of the voting shares in a bank would be represented by no more than one person associated with the shareholder (or group) on a board consisting of up to six directors, and by no more than two such persons on a board consisting of seven or more directors. In cases where a shareholder (or group) has been permitted to have an interest in more than 15 per cent of the voting shares of a bank, a greater representation, though one still broadly proportionate to the shareholding concerned, would be allowed.[18]

Government owned banks

12.29 Section 51(xiii) of the Constitution enables the Commonwealth to make laws governing 'banking, other than State banking; also State banking extending beyond the limits of the State concerned'. The Reserve Bank has taken a narrow view of this and claimed it does not have formal power over the operations of State banks. State banks operate under State legislation rather than the Banking Act.

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15 Thompson (1989), p. 6.

16 Evidence, p. S2864.

17 Prudential Statement B1 reprinted in Reserve Bank of Australia (1990).

18 ibid.

The State governments guarantee the liabilities of the state banks. As noted in Chapter 2, this did not protect the Government Savings Bank of New South Wales from having to close its doors during the depression.

12.30 The State banks were established to provide a savings vehicle for the industrious poor and provide banking services outside the central business districts. These roles are now adequately fulfilled by the range of other banks and NBFIs. The State banks are becoming increasingly 'corporatised'. For example, the State Bank of New South Wales describes itself as 'primarily a profit motivated organisation'.[19]

12.31 The State banks had entered into 'voluntary agreements' to meet Reserve Bank prudential requirements. Under the voluntary agreements, they were not required to place non-callable deposits with the Reserve Bank and the Reserve was not empowered to take over their operations if they are in extreme difficulties.

12.32 The recent experiences of the State Banks highlight some of the difficulties in their operations and the voluntary nature of their supervision by the Reserve Bank. It has been apparent that the State banks have been excessively optimistic about their loan books, which may reflect serious deficiencies in their internal controls.

12.33 The State Bank of South Australia's annual results in 1990 showed a loss on a pre-tax basis. Despite this poor result, and signs that other banks were finding conditions harder, in January 1991 SBSA said they expected 'to return to strong profitability through the early 1990s'.[20] By February they were requiring $500 million in support from the State Government and in August a further $1700 million was required.

12.34 The R&I Bank were expecting 'a significant and consistent improvement' in their profits in May 1991. An increase of 25 per cent for the nine months to September 1991 was mentioned.[21] By August 1991 they announced a loss of approximately $100 million. This was attributed to:

> the continuing economic recession and, in particular, a deterioration in the commercial property market [which] has caused difficulty for a number of our business customers and a need to revise property security values to an extent which could not have been envisaged.[22]

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19 Evidence, p. S1801.

20 Evidence, p. S1073.

21 Evidence, p. 1656.

22 Letter from Mr W Kent, Managing Director, R&I Bank of Western Australia, 19 August 1991.

Concurrent with the announcement of the loss was the provision of an additional $70 million in capital by the State Government to maintain capital in excess of Reserve Bank requirements.

12.35 The State Bank of New South Wales has not faced the same problems. It regards recent media reports of a $1 billion increase in problem loans as misleading.[23]

12.36 The State governments claimed that they acted from a sense of propriety and placed the bank's operations 'at arm's length'. They indicated that the Cabinet and the Treasury in each state quite properly took no part in the lending decisions of the bank. It was submitted this was totally the responsibility of the bank's board.

12.37 However, insufficient attention appears to have been paid by State government authorities to the prudent operation of the bank:

> The [South Australian] Government certainly did not decide to establish any particular regulatory agency to monitor and advise on the State Bank. There was an assumption at that time, shared by, I would say, all involved including the Parliament itself, that it should suffice to have a board of responsible people making the decisions about the nature of the bank's activity in an appropriate way.[24]

12.38 It was naive and grievously in error of State governments and their advisers not to appreciate the need for an independent external supervisor. Sadly the trust the Governments maintained in the boards and management of the banks was misplaced. The South Australian Government has injected $2.2 billion into SBSA this year, equivalent to around $1,500 for each person in the State.

12.39 An additional factor in the difficulties was an apparent misunderstanding by the Governments of the role of supervision by the Reserve Bank. They appeared to believe the Reserve Bank could be relied upon to protect the capital of the bank. However, in its normal supervisory procedures the Reserve is charged with protecting the depositors, not the shareholders.

12.40 The Government of South Australia told the Committee that it was not informed by the Reserve Bank 'about possible difficulties in our State Bank' until late in 1990.[25] It may have been misinformed by the State Bank before then or it may have been the case that the State Bank was itself unaware of its difficulties.

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23 The report was in the 31 October issue of the *Australian Financial Review*. A reply by the bank was contained in the 1 November issue.

24 Evidence, p. 3733.

25 Evidence, p. 3745.

12.41 The Reserve Bank appears to have been unaware of the degree to which the governments were relying on them. Asked whether they had informed the Victorian Government of their concerns on some matter, the Bank replied:

> I don't think we were of the view that the Government was not aware of this matter.[26]

12.42 There was the additional factor of the government guarantee. This meant that the depositors were protected in any case. It has been put that this reassurance meant that the Reserve Bank may have been less probing than it would have been with a private bank.

12.43 The voluntary nature of the supervisory arrangement may also have inhibited the Reserve Bank. There have been suggestions that the SBSA disregarded warnings by the Bank in a manner that would not have been tolerated in the case of a private bank. The Reserve Bank conceded:

> We attempted to treat the State Banks on the same basis as we treated the other banks, but I think at the back of the minds of those in the position at the time was the knowledge that the arrangement with the State bank was a voluntary one.[27]

The South Australian Government is now arranging for supervision to be conducted on a 'contractual' basis.

12.44 However, on the evidence presented to the Committee, it appears that due to the voluntary nature of the supervision the Reserve Bank has adopted a different role with respect to State banking than it applies to private banks. The Committee is not satisfied with the vigilance of the Reserve Bank in regard to State banks.

12.45 The attribution of blame is more properly the role of the Royal Commissions presently inquiring into these matters. The Committee believes much of the problem reflects a misinterpretation by State governments of the extent to which the task of protecting the interests of their taxpayers could be left to the Reserve Bank. The Committee is concerned with preventing a repetition. Recommendations are contained in the next chapter.

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26 Royal Commission into the Tricontinental Group of Companies. 28 May 1991, Transcript, p. 7631.

27 Royal Commission into the Tricontinental Group of Companies. 28 May 1981, Transcript, p. 7630.

Supervision of finance companies

12.46 The activities of finance companies are described in Chapter 11. There are no specialised supervisory organisations covering finance company activities. This has sometimes been regarded as a gap in the supervisory structure. These companies submit statistics to the Reserve Bank for the compilation of financial aggregates but are not supervised by it. The Corporations Act sets out the primary regulatory framework applying to finance companies, including the issuing of prospectuses, conditions for borrowing from the public and the regulation of securities activities. More than 40 per cent of the funds of finance companies are raised through debentures, which brings the companies squarely within the prospectus requirements of the Act. It also means that in a sense trustees act as 'private supervisors'.

12.47 In addition, the consumer lending and some other activities of finance companies are regulated by the Credit Acts in many states and territories. Those Acts cover the provision of information to borrowers and provide remedies for aggrieved parties to credit contracts.

12.48 As noted in Chapter 11, the major companies in this sector are subsidiaries of the major banks. Some of their operations are being wound back into the parent bank.

12.49 The Reserve Bank keeps informed of some aspects of the activities of banks' finance company subsidiaries. The capital adequacy and large exposure guidelines relate not just to banks but to the consolidated group of intermediaries.

12.50 The Reserve Bank has issued a Prudential Statement on banks' associations with non-banks. Through the statement, the Reserve Bank has sought to satisfy itself that banks' subsidiaries and associates are not a danger to the good health of the parent bank. To this end, each bank is required to ensure that:

> . the size of its subsidiaries does not become unduly large relative to the bank itself ...;
>
> . it does not give guarantees regarding the repayment of liabilities issued by its subsidiaries and associates; and
>
> . its subsidiaries and associates are prudently managed and adequately capitalised to handle the range and size of operations intended.[28]

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28 Prudential Statement G1 in Reserve Bank of Australia (1990).

12.51 The Committee asked the banks why, in a deregulated system, they retained separate finance companies. Few reasons were forthcoming. One bank mentioned that the finance company operation allowed the group to offer secured debentures.[29] Were banks able to offer secured deposits, this justification would vanish. In some cases the finance company had established its own goodwill and reputation and attracted customers who would not deal with the parent bank.

12.52 Finance companies offer investors the chance for a higher risk, higher return investment. Other reasons mentioned for their existence are that keeping some specialised 'niche' operations within a separate entity allows it to operate more flexibly than if these activities were conducted as a department of a larger, more bureaucratic organisation.

Supervision of money market corporations

12.53 Money Market Corporations (MMCs) are mostly owned by domestic or foreign banks. They have virtually no involvement with the household sector, borrowing from and lending to the corporate sector. Their activities are described in Chapter 11.

12.54 There is no general supervisor for MMCs. A degree of self-regulation is imposed by the Australian Merchant Bankers' Association. Those MMCs licensed to trade in foreign exchange are subject to regulation by the Reserve Bank concerning this part of their operations. The Corporations Act sets out the primary regulatory framework applying to MMCs, including the issuing of prospectuses, conditions for borrowing and the regulation of securities activities.

12.55 If the recommendations in Chapter 10 about allowing more liberal entry of foreign banks are adopted it is likely that most of the larger MMCs will obtain banking authorities.

The supervision of building societies and credit unions

12.56 Building societies and credit unions are important competitors for banks in taking deposits from and lending to the household sector. The former specialise in housing loans and the latter in consumer loans. They are generally organised as co-operatives and their activities are concentrated in their home states. The largest building society, St George, is one of the ten largest financial

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29 Evidence, p. 3087.

intermediaries in Australia. The credit unions are much smaller organisations. There are currently around 40 building societies and over 350 credit unions operating in Australia with combined assets of around $22 billion and $9 billion respectively.[30]

12.57 When regulation restricted the amounts the banks could lend, building societies and credit unions were able to meet the unsatisfied demand for finance. They grew very rapidly over the 1970s but much more modestly since the banks were deregulated. During the 1980s a number of building societies converted into banks and so the size of the industry was reduced.

12.58 Building societies and credit unions are supervised by State government authorities, often titled 'registrars'. The applicable legislation, while broadly similar, varies from state to state. There has been even more variation in the strictness of the supervision by the State authorities and the amount of resources allocated to it. The result has been marked differences in the incidence of difficulties faced by the institutions in the various States.

12.59 Building societies are required to insure housing loans above a certain size or where the loan exceeds a certain proportion of the valuation.[31] As a result societies are unlikely to incur significant losses from bad debts while they remain with their traditional lending activities.

12.60 Under the Financial Corporations Act the Commonwealth Government could have assumed the power to control asset ratios, lending policies and interest rates of building societies and credit unions. However, the relevant part of the Act has never been proclaimed and so its scope is limited to requiring them to provide statistics to the Reserve Bank. Even if fully proclaimed, the Reserve Bank believe the powers of the Act would be insufficient for prudential supervision of the NBFI sector.[32]

12.61 A process of reform of the supervisory system for building societies and credit unions was established following the Special Premiers' Conference in 1990. This involves the establishment of the Australian Financial Institutions Commission (AFIC) which will act as a co-ordinating group setting guidelines for uniform prudential standards for the State registrars. It will be up to the various states to adopt these guidelines as AFIC will have no coercive powers. The November 1991 Special Premiers Conference is expected to finalise the arrangements for AFIC.

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30 There are over 200 credit unions with assets over $5 million and almost 70 with assets of between $1 million and $5 million. These are registered under the Financial Corporations Act. There are also around a hundred smaller credit unions.

31 Evidence, p. 775.

32 Evidence, p. S2888.

12.62 The Reserve Bank may have a seat on the AFIC board but will have no direct supervisory involvement. AFIC will be jointly funded by the industry and the government.[33] It is argued that it should facilitate interstate mergers of building societies and credit unions.

12.63 There are to be no explicit guarantees by the State governments and any liquidity support is to come from industry bodies. Many of the prudential guidelines are likely to follow those applied by the Reserve Bank to banks but the State authorities will continue to use on-site inspections. There are likely to be restrictions on the composition of assets to keep the intermediaries' focus on the household sector.

Supervision of funds management activities

12.64 The insurance and funds management industry, and the involvement of banks in it, is described in Chapter 11. It is a rapidly growing area of the financial system and one in which banks are becoming increasingly involved. There is a clear need for appropriate supervision but it needs to be different to that applying to banks. Managed funds cannot be consolidated into banks' balance sheets in the same way as finance companies or MMCs. The assets of a fund are not owned by the bank.

12.65 The principal regulators of funds managers are the Insurance and Superannuation Commission (ISC) and the Australian Securities Commission (ASC).

12.66 The ISC's responsibilities are 'to provide and continually develop adequate prudential safeguards to ensure the continued stability of, and community confidence in, the insurance and superannuation industries and to reduce the likelihood of loss to policyholders and superannuation beneficiaries' in a way which avoids unnecessary intervention in the business activities of the industries; to provide policy advice to the Treasurer and Government on insurance and superannuation matters; and to provide actuarial advice to the Commonwealth as required.[34]

12.67 The ISC is responsible for the administration of the principal statutes which regulate these industries. These include:

- *Life Insurance Act 1945* which provides for the registration of life insurance companies and collection of statistics from them;

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33 The likely cost of operating AFIC was not known when the Committee took evidence on it in July. Some concerns have been expressed that it could be an expensive operation.

34 Evidence, p. S3952 and ISC *Annual Report* 1989/90, p. 2.

- *Insurance Contracts Act 1984* which 'seeks to lay down a uniform and fair set of rules which govern the relationship between the parties to an insurance contract', and allows for a 14 day 'free look' period within which a life policyholder has the right to cancel the contract and receive full refund of premium;[35]

- *Insurance (Agents and Brokers) Act 1984* which provides for the registration of insurance brokers and makes insurers responsible for the conduct of their agents; and

- *Occupational Superannuation Standards Act 1987* which places certain prudential restrictions on super funds seeking eligibility for taxation concessions (in practice all funds). For example, they are limited in their ability to borrow, restricted on investments in employer sponsors and required to obtain an annual independent audit. There are requirements for providing information to members and minimum standards for vesting, preservation and portability of benefits.

12.68 The ASC is responsible for the regulation of 'any collective investment except a superannuation fund', although the ASC do not see the inherent difference.[36] Many collective managed funds are 'prescribed interests' as defined in the Corporations Act which brings them under the scope of that Act.

12.69 There are a number of reviews presently under way of the managed funds sector. The Senate Select Committee on Superannuation is inquiring into that part of the industry. Regulation of prescribed interests and other collective investments is currently under review by the Australian Law Reform Commission. The Commission has recently released an Issues Paper on the subject and is expected to present its final report in 1992.

12.70 A review of the prudential controls on superannuation is being conducted by Treasury and the ISC in consultation with the Reserve Bank, ASC, the Attorney-General's Department and the superannuation industry. One issue to emerge is that current legislation relies on withdrawal of taxation benefits as a sanction against breaches of the guidelines and this may be seen as punishing the members rather than the trustees.

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35 Evidence, p. S3955.

36 Evidence, p. 3951.

CHAPTER THIRTEEN

IMPROVING THE CURRENT APPROACH TO SUPERVISION

Introduction

13.1 The Committee is aware of a number of issues concerning the current approach to supervision which are relevant regardless of whether changes are proposed to the present supervisory regime. They include discussions of the appropriate focus of supervision and the methods used to examine them. In particular, this chapter reviews evidence on the Reserve Bank's use of auditors rather than on-site examiners. Additional methods of protecting depositors, such as by insurance or offering security over assets, are examined. The treatment of government owned organisations is also considered.

The focus of prudential requirements

13.2 It is important, but difficult, to assess on which aspects of banks' operations the supervisor should place most emphasis. In Australia bank failures have been so rare that it is difficult to draw many lessons from them. Merrett (1989) conducted a study of the bank failures of the 1890s which concluded that the failing banks were characterised by low capital and liquidity, large and non-diversified exposures to property developers and generally poor managerial control.

13.3 Most studies of the 'causes' (or 'predictors') of bank failures have been done in the United States as they have a very large number of banks and, especially in the 1980s, a significant number of failures. A number of these studies are summarised in Table 13.1.

13.4 Low capital and profitability were the variables most often found to be significant causes of bank failure. Profitability may have been important as an indicator of future capital levels. Empirical evidence also suggested the mix of loans was important; the likelihood of failure increased with greater exposure to commercial (especially property development) loans. Bad debts, measured by both write-offs and provisions and the incidence of non-performing loans, were also useful predictors of subsequent failure. Holdings of liquid assets also improved chances of survival. Perhaps surprisingly, growth in assets was rarely found to be significant.[1]

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1 An examination of estimated parameter values from some of the studies suggested that, across plausible variations, capital and asset composition are more important than liquidity and profitability.

TABLE 13.1: PREDICTORS OF FAILURE

STUDY	PERIOD	C	M	D	P	L	G
Meyer & Pifer (1970)	1948 - 65				*		
Korobow et al (1977)	1971 - 75	*	*	*	*	*	
Martin (1977)	1970 - 76	*	*		*		
Sinkey (1977)	1960 - 76	*			*		
Sinkey (1978)	1974	*		*			
Pettway & Sinkey (1980)	1970 - 75				*	*	
Bovenzi et al (1983)	1980 - 83			*	*	*	
Avery & Handwick (1984)	1987 - 83						
West (1985)	1980 - 82	*	*	*	*	*	
Lane et al (1986)	1979 - 84	*	*		*	*	
Pantalone & Pratt (1987)	1983 - 84			*		*	*
Chessen (1987)	1983 - 84	*		*			*
Whalen & Thomson (1988)	1983 - 86			*			
Gajewski (1988)	1984 - 86	*	*		*		
Whalen (1991)	1987 - 90	*		*			

An * denotes a variable which was a significant predictor. The variables are:

C: Capital M: Mix of Loans (Retail v Corporate, Property) D: Bad Debts P: Profits L: Liquidity
G: Growth Rate of Assets

13.5 Capital requirements are the linchpin of prudential regulation. Capital provides a buffer against losses. It allows for some fall in the value of banks' assets before depositors' funds are at risk. It also provides 'hurt money'; making shareholders bear the brunt of imprudent management. For these reasons it is vital that adequate capital levels are maintained. In the United States the Committee was made aware of 'drop dead' provisions which involve closing a bank once capital falls below a certain threshold. It is important that such provisions be used promptly as a bank with a low level of capital has little to lose from adopting a very risky strategy.

13.6 Liquidity requirements are regarded as important in engendering confidence and as a first line of defence against a run. There is a paradox here in that once a bank is required to hold liquid assets they are no longer available to meet demands for funds. One solution to this paradox is to adopt the recommendation of the Campbell Committee that the liquidity ratio be met on an average basis over a period of time.

13.7 Another perspective on the rationale for requiring banks to hold 'prime' assets is that it provides security against which the Reserve Bank can make a 'lender of last resort' loan. These loans are no longer available to banks as a right but can be made by the Reserve at its discretion. To maximise the incentive for banks to conduct their affairs in a prudent manner, it is not desirable for the Reserve Bank to spell out the conditions under which it is willing to make such loans.[2] It should, however, re-affirm that the power exists.

Conclusion

13.8 The Committee supports the current emphasis on capital as the integral part of the supervisory framework. Strong steps should be taken to prevent banks' capital being eroded because experience has shown that tardiness will increase the chances that depositors' funds will be lost.

Recommendation

13.9 **The Committee recommends that:**

> **19. the Reserve Bank should use its legislative power to supervise actively the operations of any bank whose capital ratio falls significantly below the minimum standard.**

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2 Bannock (1990) refers to this as 'creative ambiguity'.

Prudential aspects of the payments system

13.10 An important issue in preventing a 'domino effect' among banks is limiting inter-bank exposures. Otherwise, when one bank fails, other banks to which it owed large amounts will also fail and then still further banks.

13.11 One important source of these exposures is the payments system where there has been rapid growth in high-value electronic transactions. The Australian Payments System Council notes:

> In some countries these transactions now account for more than 90 per cent of the value of transactions between banks, although they make up only a small proportion of the volume of payments. This means that in most systems large interbank exposures can accumulate very quickly.[3]

13.12 These dangers are currently exercising the minds of the relevant authorities around the world.[4] In Switzerland they have introduced a system where such exposures cannot arise. A bank cannot make a payment unless funds are available in its reserve account at the central bank. Similar schemes may soon be operating in Canada and France.

13.13 In Australia such risks are currently limited because direct access to the high-value payments system is restricted to the five largest banks. The Reserve Bank is 'encouraging tighter risk control' as part of the reform of the clearing system currently under way.[5]

13.14 The size of exposures is much less if they are restricted to net rather than gross obligations. For example, if bank A owes bank B $100m and bank B owes bank A $80m, then the net exposure is only $20m. A failure of bank A would therefore cost bank B much less if obligations are expressed on a net basis. The main impediments to more use of netting are legal problems. The Australian Payments System Council notes:

> There has recently been considerable examination of how to allow the continuing replacement of contracts with one overriding contract to allow the legal settlement

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3 Australian Payments System Council (1990), p. 34.

4 Corrigan (1988), in what is known as the 'Williamsburg address' outlines the desirable features of a high-value payments system.

5 Evidence, p. S2881.

obligation of each participant to be defined solely in terms of bilateral net positions as these are continually updated during the trading day.[6]

Conclusion

13.15 The banking system would have greater safety and soundness if inter-bank exposures were limited. Accordingly it would be desirable if the current reform of the payments system were to result in a high-value electronic payments system which operated on similar principles to the Swiss system. For similar reasons the Committee supports measures to facilitate effective 'netting' of exposures.

Recommendation

13.16 **The Committee recommends that:**

> **20. the Reserve Bank encourage the formation of a high-value electronic payments system which strictly limits the exposures of banks to each other.**

Exposure to speculative assets

13.17 Australia has experienced a number of 'property booms' where excessive amounts were lent to developers of speculative commercial property projects. Notable examples were the early 1890s and the middle of the 1970s. In both of these periods some lenders became caught up in the speculative mentality which infected the community. Lenders became overexposed to these speculators and themselves failed.[7]

13.18 There have also been other kinds of speculative mania. The gold rush of the 1850s and the 'Poseidon' nickel boom of 1969-70 were two examples.[8]

13.19 The lessons from these experiences appeared not to have been learnt by banks when, armed with the freedom to lend, they were faced with similar circumstances in the 1980s. This issue has been raised not only on prudential grounds but as a concern that banks have been too willing to support 'speculative' rather than 'productive' investment activity.

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6 Australian Payments System Council (1990). International issues involving netting are discussed in Basle Committee on Interbank Netting (1990).

7 Sykes (1990) discusses this in more detail.

8 Sykes (1988) and Blainey (1978) provide accounts of many 'booms'.

13.20 The Campbell Committee recommended that consideration be given to limiting:

> investments in, or aggregate lending on the security of, certain classes of property such as low or non-income-producing property of a developmental or speculative nature.[9]

13.21 Treasury, when asked whether banks should be limited in the exposure they are allowed to the property market, replied:

> A bank that is properly run will run for itself an exposure limit on particular lines of activity, including property and property related activity like tourism ... That is something that banks should do ... rather than necessarily something that should be imposed by somebody else.[10]

13.22 The Reserve Bank also remarked on the special aspects of property lending. In its discussion of property trusts the Bank remarked:

> it is the type of asset which does tend to go through rather severe fluctuations over time. We can both think of how many times we have had property booms and busts in Australia.[11]

Surprisingly, the Reserve Bank offered no view on whether banks should be limited in their involvement.

13.23 On the question of the allocation of resources, Professor Harper defended the role of the market:

> the best judge ... is ... the private sector. If they choose to invest in the property market at this time, that is well and good. If they make a mistake, they will pay the price. In the meantime it will serve to depress prices in the property sector, which will artificially raise relative prices in the traded goods sector and encourage new investment into export oriented industries.[12]

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9 Australian Financial System Inquiry (1981), p. 305.

10 Evidence, p. 3614.

11 Evidence, p. 2967.

12 Evidence, pp. 3406-7.

However, there are many who would argue that more than the borrowers have paid a price for poor property investment decisions.

Conclusion

13.24 Banks have shown a tendency to become excessively exposed to speculative commercial property involvement and other asset-price speculation to the detriment both of their prudential standing and national development.

Recommendation

13.25 **The Committee recommends that:**

> **21. banks enhance internal monitoring systems to limit their exposure to particular classes of business such as speculative property developments. The Reserve Bank should satisfy itself that such systems are adequate, and if necessary impose limits on banks' exposure.**

The approach to bank supervision

13.26 The Reserve Bank's current approach to the supervision of banks was described in the previous chapter. It has the general support of the banks. For example, Challenge Bank declared:

> I believe the process of supervision has worked extremely well. It is a good working and person to person relationship which I think is a key in the process rather than there being a whole set of more detailed regulations.[13]

13.27 However, some outside the banking industry are less sanguine. A former bank auditor of a bank's subsidiary and trainer expressed her concern that:

> you cannot rely on prudential supervision whereby the Reserve Bank collects information and assesses it because if you have bad internal controls within the bank, if you had fraud perpetrated from within the bank, or if you just simply have some mismanagement, that information may be unreliable.[14]

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13 Evidence, p. 1703.

14 Evidence, pp. 313-4.

13.28 A similar concern was expressed by the consumer movement:

> senior management of a bank and the auditors often do not know what is happening in their own bank. The Reserve Bank depends on this information for prudential supervision. It is a worrying thing.[15]

13.29 The Governor of the Reserve Bank acknowledged that this had been a problem:

> I think the banks are providing the information in good faith ... [however] the banks themselves, in the early stages, did not have good information systems. They did not have good risk assessment and credit monitoring arrangements.[16]

13.30 The Reserve Bank's reliance on banks' external auditors has been questioned. Concerns have been expressed about conflicts of interest, the effectiveness of auditors and the adequacy of communication between auditors and the Reserve Bank.

13.31 It may be thought the auditors may be reluctant to offend those who appoint them, although the auditors themselves reject this view. This would be a particular concern if it is believed that securing an auditing relationship with a bank gives the inside running on more profitable consultancy and training work. This does not seem to be a particular problem in Australia as banks use a variety of accounting firms for different types of work.

13.32 In Australia it is uncommon for banks to change their auditors.[17] This may lead to auditors becoming too close to the banks they audit and complacent in their performance. This has led to suggestions that there be limits placed on how long the one firm can audit a given bank. The Australian National Audit Office saw merit in a change of auditors every five years.[18] On the other hand, as the private sector auditors pointed out, such a change would be 'disruptive' and costly.

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15 Evidence, pp. 998-9.

16 Evidence, p. 453.

17 A senior partner in an auditing firm said 'I cannot recollect there being more than one or two changes in the last decade'. Evidence, p. 3042.

18 Evidence, p. 3566.

13.33 In the United States there is concern about 'opinion shopping'.[19] Banks are said to look for auditors who are known to be lax in their standards. No evidence was presented that this has occurred in Australia. The Institute of Chartered Accountants released a statement in March 1991 setting out rules on how auditors should deal with such a situation, were it to arise, to minimise any adverse consequences.

13.34 A related concern was tendering for auditing. In order to win the tender, a firm might cut costs by devoting insufficient resources to the audit. The major banks have not used tenders in recent times although some of the foreign banks did so when they entered the market. The auditors replied that professional ethics determine the amount of time they need to spend on an audit before they can give an unqualified opinion on it and they would not submit a tender less than the cost of this amount of time, even if it meant losing the client. This had occurred with some clients outside the finance sector. The auditors also believed that bank directors, unlike some of the 'entrepreneurial' directors, are persons of integrity who would not seek to skimp on auditing.

13.35 In Australia it has been extremely rare for banks' accounts to be qualified. The auditors said this is not because auditors are superficial in their analysis:

> There have been a number of occasions ... where we have said to financial institutions that if a particular process or act or a matter of recording profit or assets or liabilities is recorded in accounts, then we would qualify those accounts. We have gone right up to board level ... In all the cases that come to mind ... the bank has acknowledged that and has changed the accounts.[20]

13.36 Other concerns raised about auditing included the fact that banks' subsidiaries are often audited by a different firm to the bank's auditor. The latter still has to present a view on the overall accounts. Auditing standards set out how this should be handled.[21] The treatment of subsidiaries is more difficult when the subsidiaries operate overseas as the accounts will then have been prepared to different accounting standards. Work is under way to more closely align international accounting standards but progress is slow.

13.37 Three auditors, who between them audit the four major banks and the majority of the others, appeared before the Committee. They generally felt that there was inadequate communication between the Reserve Bank and the auditing profession.

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19 See, for example, U.S. Treasury (*1991*); the 'Brady Report'.

20 Evidence, p. 3048.

21 The relevant standard, AUP 11, is described in Evidence, pp. 3331-2.

13.38 At present, auditors only report to the Reserve Bank once a year, within four months of the release of the bank's annual accounts. This means that a problem could have been around for almost sixteen months before it is drawn to the attention of the Reserve Bank. The auditing profession believes contact, in both directions, should be more frequent as is the case with the Bank of England.

13.39 One major firm suggested that the Reserve Bank should convene an annual meeting with all bank auditors to discuss general concerns and explain its requirements. Allowing auditors some input into the development of prudential standards may prevent any ambiguities arising.

13.40 Another problem is that auditors only report to the Reserve Bank indirectly through their client banks. This means that if a bank altered an adverse report before sending it to the Reserve Bank, the auditors and the Reserve Bank would not know this. It is not being suggested this has ever happened but the procedures should be designed to cope with the rare times when a bank is in serious difficulties and management may resort to unorthodox behaviour.

13.41 Auditors' assessments of the adequacy of provisions for doubtful debts depend on assumptions about future trends in the economy.[22] One auditing firm suggested that the Reserve Bank could advise the auditors of its assessment of the likely course of the economy. There are two reasons why this might be desirable. First, the Reserve Bank has greater expertise in economic forecasting than do auditors and devotes more resources to it. The Reserve Bank forecasts are likely to be more accurate. Second, even though the forecast outcomes may not eventuate, if auditors are adopting the same forecasts there will be greater consistency in the treatment of different banks.

13.42 The suggestion of auditors receiving forecasts from the Reserve Bank does raise some problems. Auditors under pressure over the quality of their reports may seek to blame the Reserve Bank for providing inaccurate forecasts. A possible solution would be to encourage auditors to reach a consensus among themselves or to base their assumptions on the forecasts published in the Budget papers.

13.43 Although banks are now required to forward returns to the Reserve Bank on non-performing loans, this is not subject to review by the auditors. There is also no industry standard on what constitutes a non-performing loan. The auditors argued that this is because there is a lot of judgement required to form an opinion on whether a loan is recoverable. The Committee believes this confuses a non-performing and a doubtful loan. A non-performing loan should be defined in terms of repayments being overdue by more than a certain period, or only being met from further advances.

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22 An assessment of the variation in, and accuracy of, economic forecasts is given in Macfarlane and Hawkins (1983).

13.44 The Reserve Bank have acknowledged there are doubts about the reliance on external auditors. The Governor concedes 'when the arrangements were *put in place ... auditors were held in rather higher esteem*'.[23] As a consequence, the Bank:

> will have to think about developing some limited in-house capacity that will help us to get an independent feel for the seriousness of potential problems and for the inadequacies of systems that might exist in particular institutions where we are a bit suspicious or a bit concerned about what might be developing.[24]

13.45 The Committee supports this review by the Bank of its procedures. The Committee was interested to hear about the role of examiners appointed by OSFI in Canada. OSFI send in a different team of examiners on each inspection of a bank. The team is a mixture of experienced supervisors, new recruits and some senior ex-bankers hired on a consultancy basis.[25] The teams examine procedures and check the valuation of assets. Senior bankers in Canada approved of the approach.

13.46 The Committee felt that, as well as making routine inspections, teams of examiners could be sent to investigate banks about which the Reserve Bank had specific concerns. In order to avoid the arrival of inspectors being taken as a signal by the market that a bank is in difficulty, the routine inspections should occur strictly randomly, even if this means the same bank is visited twice in succession. This is a policy that will need to be carefully explained. In this way outsiders would not know whether an inspection had any special significance.

13.47 A number of witnesses have suggested in stronger terms that the Reserve Bank should engage in vigorous on-site inspections to verify information and assess systems. Critics of this idea, including the Reserve Bank itself, generally raise three objections. The first is that:

> having an army of Reserve Bank examiners looking over the shoulders of commercial banks and second-guessing their decisions ... [would have a] numbing effect ... it would not stop banks from writing bad loans and from making losses.[26]

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23 Evidence, p. 615.

24 Evidence, p. 432.

25 These are not sent to their former banks.

26 Evidence, p. 431.

13.48 The Committee views this as a 'straw man'. No witness was suggesting that a supervisor should approve every individual loan made by a bank. It therefore follows that banks will make some bad loans. What is being proposed by some witnesses is that the supervisor takes more rigorous steps to ensure that the bank has appropriate systems to limit risks and that bad debts are recognised in a prompt and consistent manner. The aim is not to replace the emphasis on capital adequacy. It is to reinforce it by ensuring that the reported capital is not overstated due to inflated values being placed on assets.

13.49 The second common argument is that:

> You only have to look at the situation in the US, where there is an extensive system of on-site examinations. That does not stop a large number of banks going bust in the US every year.[27]

13.50 Again, it is never claimed by proponents that on-site inspection provides a guarantee that the banking system will be stable. Nor does it follow that the high number of bank failures in the USA is due to flaws in on-site inspection. A major reason is the extremely large number of banks operating there. Other institutional factors, such as restrictions on the ability of banks to diversify their loan portfolio and the extent to which the best companies raise funds directly rather than through intermediaries, are also important. The multiplicity of supervisors in the USA is probably not conducive to effectiveness.

13.51 The third argument is that additional supervision would be expensive. The Committee's view is that, having seen the size of losses made by banks and the real or potential costs to taxpayers or depositors in recent times, the additional cost of better quality supervision would be very small in relation to the possible gains.

13.52 An area where the Committee believes the Reserve Bank needs to be more vigilant is in bankers moving outside their area of expertise. The Committee is particularly mindful of the State Bank of South Australia's expansion into commercial lending in Northern America. The Bank should not go so far as to prohibit such expansion or innovation, but if warnings about the need for caution are not heeded, greater provisions for losses or higher capital ratios should be required.

13.53 A practice of the United States supervisors which the Committee found attractive was the 'shared national credits' scheme. This involved the supervisors assessing the state of some major borrowers and then comparing the treatment of them by various banks. Concerns were raised if one bank regarded a borrower as at risk while another thought it was sound. This applies particularly in the case of syndicated loans where the exposure of the various banks would be the same. In

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27 Evidence p. 431.

other cases the supervisor would need to assure itself that one bank had better security than another lending to the same company. This exercise cannot be undertaken by the banks' external auditors or the banks themselves due to customer confidentiality requirements. The so-called 'Chinese walls' within auditors' offices prevent information from one bank's audit being used in another. Similarly, the Reserve Bank could check whether banks who believe they are the sole lenders to a company have been misled.

Conclusion

13.54 The current arrangements between the Reserve Bank and the banks' external auditors are inadequate. Information is not provided to the Reserve Bank in a sufficiently timely or secure manner. The Bank's requirements are not clearly explained. There is a need to tighten up the relationship.

13.55 The lack of consistent standards in some aspects of banks' reporting to the Reserve Bank has made the supervisory task more difficult.

13.56 There is a need for a 'hands-on' supervisory capacity within the Reserve Bank to allow it to monitor banks more closely and to assess the adequacy and consistency of banks' treatment of doubtful debts and non-performing loans.

Recommendations

13.57 **The Committee recommends that:**

22. the Reserve Bank hold an annual meeting with banks' auditors to discuss aspects of the auditors' role in prudential supervision;

23. the Reserve Bank put in place appropriate mechanisms to assist auditors in understanding the views each has on prospective economic conditions;

24. auditors send their reports directly to the Reserve Bank at the same time as they are sent to the client bank. The auditors should be free to raise issues of concern with the Reserve Bank at any time and should be protected from action being taken against them for doing so;

25. the Reserve Bank develop consistent standards for the reporting of banks' non-performing loans and that the banks' auditors be required to certify these returns; and

26. the Reserve Bank should develop a capacity to inspect banks' systems and assess their valuation of assets, particularly the adequacy of provisions for doubtful debts and non-performing loans. It is suggested that senior ex-bankers be hired as examiners on a consultancy basis and included among the

inspection teams. These inspections should occur on both a random, but frequent, basis and when there are particular concerns. The inspection teams should monitor the assessment of the credit worthiness of large borrowers to whom loans have been made by more than one bank to achieve consistency of prudential approach.

Charging for Supervision

13.58 It has been suggested that banks should pay for the cost of their supervision. The banks do not accept this. Their view is that:

> banks are supervised by governments for the benefit of the community and not for the benefit of the banks.[28]

13.59 The Reserve Bank's view is that:

> We apply a very heavy cost to banks for the services we provide to the banking and financial system, and those costs come through the requirement that banks have to hold a minimum amount of non-callable deposits with the Reserve Bank, and they get a well below market interest rate on those deposits. We are certain that those costs cover the general costs that we incur in providing a service to the financial system through the banks.[29]

13.60 The banks currently hold $2.5 billion in non-callable deposits on which they are paid five per cent below the prevailing Treasury note rate. This results in an annual cost to the banks of $125 million.

Protection of Depositors

13.61 It was noted in Chapter 12 that the Reserve Bank is charged with the protection of depositors. This is an appropriate goal but the discharge of this duty becomes increasingly onerous as more bank assets are involved in greater levels of risk (as banks have moved from being credit rationers to lenders to a wider range of riskier borrowers). Accordingly recommendations have been made to enhance the current methods the Reserve Bank employs to protect depositors.

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28 Evidence, pp. S2779-80.

29 Evidence, p.613.

13.62 There are supplementary methods by which depositors can be protected. Some of these emerged during discussions the Committee had in the United States and Canada and were raised on a few occasions during the final hearings. They include deposit insurance and priority and secured deposits. It has not been possible to assess reaction in Australia to such a significant change in the banking framework. The need for further consultation was highlighted by the views expressed in North America that once changes were made to depositor protection, such as by introducing or extending deposit insurance, they are all but impossible to reverse.

Deposit insurance

13.63 A common feature of the banking system overseas is deposit insurance. A majority of OECD countries have it including the United Kingdom, Canada, the United States, Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Spain, Switzerland and Turkey. Characteristics of some of these schemes are given in Tables 13.2 and 13.3. It should be noted however, that there are a number of OECD countries that do not have deposit insurance.

13.64 Administration of deposit insurance varies from country to country. In some countries, it is administered by governments, in others by the banking industry, and in yet others jointly by the banks and the authorities.

13.65 Three main arguments for deposit insurance were drawn to the Committee's attention.[30] First there is a need for types of saving vehicles which provide safe havens for transaction/working balances and the modest savings of individuals and their households. Some argue that these safe havens are needed in their own right, to underpin the effective working of a market economy, others argue for them because not everyone can assess the riskiness of banks or carry out an effective policy of diversification.

13.66 Second, there are those who argue these schemes can prevent runs by reducing the incentives for sudden withdrawals of funds from banks perceived to be in difficulty. These runs are prevented today by a number of factors that enhance public confidence in Australian banks. These include government guarantees, the absence of bank failures this century, the supervision of banks by the Reserve Bank and the perception that some banks are 'too big to fail'.

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30 The arguments for and against deposit insurance are elaborated on in the OECD study by Pecchioli (1987), p. 134; American Bankers' Association (1990) and Woodward (1990).

TABLE 13. 2

Insurance Coverage and Pricing Schemes for Foreign Deposit Insurance Systems

Country	Insurance coverage limit (domestic currency)	U.S. dollar equivalent (as of July 6, 1990)	Premium pricing scheme
Argentina	100% of deposits up to A$ 100,000,000, 90% above that amount.	(1)	0.03% of total deposits.
Austria	$ 200,000	17,185	Unfunded Arrangement.
Belgium	BF 500,000	14,706	0.02% of specified liabilities.
Brazil	N/A	N/A	N/A
Canada	C$ 60,000	51,582	0.1% of insured deposits.
Chile	100% of demand deposits, 90% other deposits up to 120 UF.	(1)	Unfunded Arrangement.
Colombia	75% of Col$ 200,000 (*i.e.*, Col$ 150,000	309	0.5% of required reserves on deposits.
Denmark	kr. 250,000	39,708	Max. 0.2% of total deposits; starting in 1989, total annual contributions of all members is kr. 700 mil. until fund reaches kr. 3 billion.
Finland	FM 500,000	128,966	Between 0.1% and 0.05% of total assets.
France	FF 400,000	72,033	Collected as needed, assessments based on deposits.
Germany (DSF)	30% of the "liable capital of bank concerned per depositor".	(1)	0.03% of total deposits.
(SBSF)	100% of deposits and credits	(1)	0.03% of "claims on customers".
(CCSS)	100% of deposits and credits	(1)	complex premiums and mutual guarantees.
India	Rs30,000	1,722	0.04% of total deposits.
Ireland	80% of first IRP 5,000, 70% of next IRP 5,000, 50% of next IRP 5,000.	16,206	0.2% of deposits.
Italy	100% of first L 200 mil., 75% of next L 800 mil	659,385	Unfunded Arrangement.
Japan	Y 10,000,000	66,212	0.012% of covered deposit balance.
Kenya	Kshs 100,000	5,519	0.1% of deposits.
Netherlands	G 35,000	18,800	Unfunded Arrangement.
Nigeria	N. 50,000	11,765	0.93% of deposits.
Norway	Unlimited	(1)	0.015% of total assets.
Paraguay	G 5,000,000	4,803	.25% of deposits
Philippines	P 15,000	662	0.0667% of total deposits
Spain	Pts 1,500,000	14,789	.2% of deposits.
Sweden	N/A	(1)	Fund at such a level that in recent years annual contributions considered to be necessary.
Switzerland	SF 30,000	21,406	Unfunded Arrangement.
Trinidad & Tobago.	TT$ 50,000	12,225	N/A
Turkey	TL 3,000,000	1,142	0.3% of insured deposits.
United Kingdom	75% of deposit balance up to L 20,000	35,730	progressive levy with the effective rate not to exceed 0.3% of domestic sterling deposits.
United States	$100,000	100,000	0.195% of domestic deposits as of January 1, 1991.
Venezuela	B 250,000	5,296	0.25% of deposits.
Yugoslavia	Unlimited	(1)	N/A.

[1] Information unavailable.

Source : U.S. Department of the Treasury (1991) [The 'Brady Report']

TABLE 13.3

Selected Characteristics of Deposit Protection

Country	Coverage of interbank deposits	Coverage of deposits held by nonresidents	Coverage of deposits in foreign currency	Coverage of deposits in domestic branches of foreign banks	Coverage of deposits in foreign branches of domestic banks
Argentina	N	Y	N	—	—
Austria	N	Y	Y	N	N
Belgium	N	Y	N	N	N
Brazil	N	—	—	—	—
Canada	Y	Y	N	—	N
Chile	N	Y	N	Y	N
Colombia	Y	Y	—	—	—
Denmark	—	—	—	—	—
Finland	—	—	—	—	—
France	N	Y	N	Y	N
Germany (DSF)	N	Y	Y	Y	Y
(SBSF)	—	—	—	—	—
(CCSS)	—	—	—	—	—
India	N	Y	N	N	N
Ireland	—	—	P	—	—
Italy	N	Y	Y	*	Y
Japan	N	Y	N	N	Y
Kenya	Y	Y	—	—	—
Netherlands	N	Y	Y	Y	N
Nigeria	Y	Y	Y	Y	N
Norway	Y	Y	Y	Y	Y
Paraguay	N	Y	N	N	—
Philippines	N	—	Y	—	—
Spain	N	Y	N	—	N
Sweden	—	—	—	—	—
Switzerland	N	Y	N	Y	N
Trinidad & Tabago	Y	Y	Y	Y	N
Turkey	N	Y	Y	N	N
United Kingdom	N	Y	N	Y	N
United States	Y	Y	Y	Y	N
Venezuela	—	—	—	—	—
Yugoslavia	Y	Y	Y	—	—

* Permissible, but none have yet elected, coverage.

Note: N=No, Y=Yes, P=Provisionally, —=Information Unavailable.

Source : U.S. Department of the Treasury (1991) [The 'Brady Report']

13.67 Third, in the absence of comprehensive deposit protection schemes, small banks may find it harder to compete with larger banks. Smaller and new banks may find it hard to establish a public reputation. It is notable here that the United States, with its extraordinarily large number of small banks, was one of the first countries to introduce deposit insurance and has one of the most generous schemes.

13.68 Serious problems have emerged with deposit insurance schemes overseas. It is debatable whether these problems reflect inherent conceptual flaws in deposit insurance or defective implementation.

13.69 The main criticism of deposit insurance is that, with their deposits insured in all banks, customers have no incentive to take care over to which bank they entrust their savings. It is rational for them to place their funds in the bank paying the highest rate of interest, which is likely to be the bank with the riskiest portfolio of assets.

13.70 Deposit insurance is likely to make bank management feel less accountable. Banks have an incentive to engage in risky lending as the bank's shareholders receive all the profit if the high risk strategy succeeds while the insurance fund has to cover the loss if it fails.

13.71 The cost of deposit insurance will be passed on to depositors. This raises a problem with deposit insurance schemes which require all deposits to be insured. Some depositors, who would be willing to accept more risk for a higher return, are paying an implicit insurance premium, in the form of lower interest on their deposits, for insurance they do not want.

13.72 The manner in which deposit insurance has been implemented has been criticised. Ceilings on the extent of insurance in some countries have been set too high, or set in relation to each account or each bank at which accounts are held, rather than providing a fixed single amount for each individual. In some countries the government has also required the insurance fund to pay out uninsured as well as insured deposits, even when this is not commercially necessary to limit the call on the deposit insurance fund.

13.73 Furthermore, in practice the insurance premia have often been set too low. This has meant that the insurance fund has then been unable to afford to meet its commitments without an injection of funds from government.

13.74 The potential size of such injections is almost unlimited. In the United States the cost to the taxpayers of insuring the deposits of the savings and loan associations has been \$100 to \$200 billion and may go higher.[31] Congress is presently debating proposals to inject massive funds into the bank deposit insurance

31 Woodward (1990) puts the cost at \$100-\$200 billion. Thomas (1991) puts the cost at \$150 billion but expects it to reach \$500 billion.

body, the FDIC, to prevent it becoming insolvent. There are a wide range of factors responsible for the problems of banks in the United States and the government may have found itself supporting them to some extent even in the absence of deposit insurance. The Canadian Deposit Insurance Corporation had to borrow from the government when two banks there failed in the mid-1980s.

13.75 These concerns have led many countries to stop short of full insurance. Most countries impose a ceiling on the extent of insurance, arguing that wealthier investors should be able to look after themselves. In the United States the limit is US$100,000; in Canada C$60,000 and in the United Kingdom 20,000 pounds.[32] These amounts are quite high in relation to the size of most household accounts. It would be better if coverage was restricted to a smaller amount which would reasonably covers transactions balances and modest savings of individuals and households. Persons wanting absolute safety for larger amounts could invest in government securities.

13.76 Conceptually these limits should probably apply to a single depositor or household. For practical reasons this has proved hard to enforce and so they generally apply to accounts with each bank. This has resulted in many customers spreading their money around so that no one account has more than the ceiling. In the United States this has been taken further with 'brokers' who take large amounts of money from clients and allocate this among banks paying the highest interest, to keep the whole amount fully insured.

13.77 In Australia the '100 point check list' requirement for opening a bank account, the obligation to provide a bank with a tax file number for any interest bearing account, and the existence of the tax file number itself, would make the effective administration of a deposit insurance ceiling applicable to individuals somewhat easier although it would still be an extensive process.

13.78 Another option is to limit the insurance to less than 100 per cent of the deposits insured, often known as 'co-insurance'. For example, in the United Kingdom, the insurance scheme covers only 75 per cent of the deposits.

13.79 Either of these alternatives does inject some discipline into the market. However, as the coverage of deposit insurance is reduced the greater is the need for adequate prudential supervision to maintain confidence in banks if the likelihood of runs on banks is to be minimised.

13.80 Another possibility for preventing deposit insurance encouraging riskier behaviour by banks is for the insurer to charge a risk-related premium. This could be based on the (simple or risk-weighted) capital ratio, or the grade assigned to a bank by ratings agencies or a much more complex analysis of both quantitative and qualitative factors. There are also problems with this approach. It would provide an

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32 In $A terms these would be equivalent to around $125 000, $65 000 and $45 000 respectively.

incentive for the insured bank to mislead the insurer about its condition, or at least to gild the lily. If it became public knowledge that the premium being charged to a bank was being increased, this could trigger a withdrawal of funds by uninsured depositors. In the case of a bank near collapse the higher premium may push it over the edge. Although the matter has been discussed in a number of countries none have moved to implement a risk-related premium.

Priority and secured deposits

13.81 There are other approaches to depositor protection than insurance. A possible change is to replace the priority presently given by the Banking Act to all 'deposit liabilities in Australia' with a priority applying only to deposits up to a certain amount by Australian individuals and households. This would give increased protection to these deposits at the expense of other deposits.

13.82 Some banks indicated they were retaining their wholly owned finance company subsidiaries because people like lending money with the security of debentures. The current provisions of the Banking Act inhibit banks giving security over their assets to a particular class of depositors. If banks could offer a higher degree of security for certain classes of deposits on which lower rates of interest would be paid, the risk spectrum available to depositors would be expanded.

13.83 By way of first response to suggestions such as these the Commonwealth Bank said that it would be:

> hard to manage under the present dispensation, but if you wanted to change the law so there would be a tiering, perhaps some way could be found, but I think it would be very awkward.

However, they did not make clear whether this concern was with regard to the manner in which deposits might be legally secured or with regard to whether depositors would easily understand deposits with different levels of security.

Conclusion

13.84 The issues of supplementary forms of depositor protection were only canvassed in the latter stages of the inquiry as there were no calls for their introduction in the major submissions. In view of its proposed continuing role in reviewing banking issues, the Committee will assess whether there is a need to examine supplementary forms of deposit protection and if so determine who should carry out such an examination.

State banks

13.85 The extent to which State banks now operate on a commercial basis, and some problems that have arisen with two of them, was discussed in the previous chapter. None of the State governments concerned would be likely to regard the returns they have been receiving from their banks over recent years as satisfactory. This section discusses possible remedies.

13.86 One option is for the State banks to be sold. They would then be regulated in exactly the same way as any private bank. Call deposits would no longer have a government guarantee. There would be a case for maintaining a transitional guarantee on existing term deposits until maturity as depositors could claim they put their funds with the bank at a given rate on the understanding that there was a guarantee.

13.87 The Premier of New South Wales indicated his government was:

> committed to withdrawal from the field of State banking ... by the privatisation of the State Bank of New South Wales ... over the next two years or so. We see absolutely no public good justification for owning a bank.[33]

13.88 The State banks could be sold through an open float. Some foreign banks are believed to be interested in buying the State banks.[34] The Reserve Bank suggested this was probably the only way foreign banks could add significantly to competition in retail markets.[35] Either of these options would enable the sale of the banks without any significant increase in market concentration.

13.89 The State Bank of New South Wales has suggested it could become 'licensed under the Banking Act upon a referral of powers by the NSW Government to the Federal Government'.[36]

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33 Evidence, p. 2902.

34 For example, Citibank hinted they would be interested. Evidence, p. 1358.

35 Evidence, p. S1143.

36 Evidence, p S1834.

13.90 Appearing before the inquiry, the New South Wales government told the Committee it was:

> proceeding with the approach of a constitutional referral of powers over prudential supervision of the State Bank to the Commonwealth. To this end, draft legislation has been prepared and will shortly be provided to the Commonwealth for their consideration.[37]

13.91 The Attorney-General's Department confirmed that this procedure would enable the Reserve Bank 'to impose standards rather than relying on voluntary compliance'.[38]

13.92 The only disadvantage for the State banks is that they would then be obliged to hold non-callable deposits with the Reserve Bank (at a below market interest rate). The Committee views this as desirable to ensure fair competition. In any case, the State Bank of South Australia has recently agreed to do this and the R & I Bank of Western Australia is apparently also agreeable.[39]

Conclusion

13.93 The Committee sees no purpose in state banks remaining under government ownership when they are operating in the same manner as commercial banks. The options are to float them, either singly or as a group, or sell them to a foreign or domestic bank or other financial institution. The Committee would prefer they be floated and brought fully under the Banking Act and the Banks (Shareholdings) Act. Any sale to another bank should be referred to the Trade Practices Commission for review of whether it would substantially lessen competition and, if so, whether there were sufficient public benefits to justify approval of such a purchase.

13.94 If the banks are not sold, or until they are, the Committee believes steps need to be taken to address weaknesses in the existing 'voluntary' arrangements for the supervision of State banks.

13.95 The State governments need to recognise that Reserve Bank supervision is for the protection of depositors not shareholders, and therefore ensure that they closely monitor the operations of their banks to protect taxpayers' interests.

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37 Evidence, p. 2903.

38 Evidence, p. 1276.

39 'The board of the bank has considered this point and would be quite happy to come completely within the prudential requirements or controls of the Reserve Bank.' Evidence, p. 1672.

Recommendations

13.96 **The Committee recommends that:**

27. State governments formally refer powers over State banking to the Commonwealth Government so that state banks can be regulated and supervised in the same manner as private banks. If the State governments choose not to do so, the Reserve Bank should exercise its power to supervise their activities outside their home state;

28. where governments own banks, they ensure that they have appropriate mechanisms in place to monitor closely the operations of the bank with a view to protecting the interests of the shareholders.

The Commonwealth Bank

13.97 The other government bank is the Commonwealth Bank of Australia. Its history is discussed in Chapter 2. The CBA is treated by the Reserve Bank in the same manner as the private banks. Its liabilities are guaranteed by the Commonwealth Government. Thirty per cent of the CBA is now owned by private shareholders.

13.98 The concerns expressed about the supervision of the State banks may lead some to be concerned about the CBA. The Committee has been told, and has no reason to doubt, that despite its government ownership the CBA is supervised in the same manner as the major private banks. Unlike the State banks the CBA is authorised under the Banking Act.

13.99 The Secretary of the Treasury is an ex officio member of the CBA Board. This dual role has been criticised as involving a potential conflict of interest.[40] Commenting on this matter, a former Treasury Secretary said the problem was no different to a private board member who is on a number of boards and was rarely an issue.[41] The incumbent believes:

> there are difficulties in having somebody on the boards of both those institutions ... the idea of having somebody from a portfolio other than the Treasury on the Board of the Commonwealth Bank is an idea that I entertain.[42]

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40 Evidence, p. S255.

41 Evidence, p. 471.

42 Evidence, p. 3596.

Conclusion

13.100 The Committee recognises the potential for an apparent conflict of interest in the Secretary of the Treasury being on the boards of both the Reserve and Commonwealth Banks. It remains appropriate, however, that the Commonwealth Government be directly represented on the Commonwealth Bank board.

Recommendations

13.101 **The Committee recommends that:**

29. **the Secretary of the Department of Finance replace the Secretary of the Treasury on the board of the Commonwealth Bank of Australia. The Department should receive copies of all documents prepared for the Board and senior policy committees of the bank;**

30. **in order to reinforce public confidence, the Reserve Bank publicly confirm that it adopts no less strict supervision for government-owned banks under the Banking Act than it does for banks without a government guarantee.**

Miscellaneous 'Quasi-Banks'

13.102 There are some government-owned organisations which undertake activities like banks but which do not come under the supervisory net of the Reserve Bank or any other supervisor. One example to whom the Committee spoke was the Queensland Industry Development Corporation. They explained they:

> are not subject to prudential supervision as, for example, a normal bank would be under the Reserve Bank of Australia ... the Auditor-General of Queensland audits our accounts every year and secondly, we have sitting on our Board the Under Treasurer of the State of Queensland and we are in almost daily contact ... with the Queensland Treasury.[43]

Given the experiences of some State banks, the Committee is concerned about the adequacy of this 'supervision'.

43 Evidence, pp. 2466-7.

Recommendation

13.103 **The Committee recommends that:**

31. the Reserve Bank undertake a comprehensive review of quasi-bank organisations such as the Queensland Industries Development Corporation to ascertain whether they should be subject to similar prudential supervision as banks.

Money market corporations

13.104 MMCs have an exemption from section 66 of the Banking Act allowing them to style themselves 'merchant banks', although they cannot use 'bank' in their name.[44] This has led to some confusion as the media have often incorrectly referred to disreputable institutions such as Rothwells, and in earlier times Nugan Hand, as a 'bank'. This both misleads potential depositors and damages the standing of genuine banks.

13.105 If restraints on the entry of foreign banks are relaxed, then the subsidiaries of foreign banks, which constitute the majority of MMCs, are likely to obtain banking authorities. There would then be even less reason to allow the remaining MMCs to describe themselves as 'banks'.

Recommendation

13.106 **The Committee recommends that:**

32. the exemptions from section 66 of the Banking Act given to money market corporations be revoked and money market corporations should be prohibited from describing themselves as 'banks'.

Supervision of managed funds

13.107 Information on the structure of the funds management industry, and the role played by banks in it, is included in Chapter 11. It would be inappropriate to supervise managed funds such as unit trusts in a similar manner to banks. Unlike building society deposits, funds with unit trusts are not seen as a close substitute for bank deposits. Funds in them are generally not accessible for transactions. They are regarded as a longer term investment and generally involve larger amounts of

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44 This section governs use of the term 'bank'.

money. There is not the same commitment to maintain the nominal value of the sum placed with them. Funds with unit trusts are more akin to a portfolio of equity investments than a deposit.

13.108 This does not mean, of course, that investors in unit trusts should not be protected from anti-competitive behaviour, misleading conduct, inadequate disclosure or fraud by funds managers. These are appropriate areas for the ISC, ASC and other bodies to police. There is also an important role in public education so that investors do not mistakenly believe their funds with these organisations are in some way guaranteed.

13.109 Much of the preceding argument applies to superannuation as much as to other types of funds management. However, there are some features of superannuation which distinguish it from other kinds of funds management. First, it is more commonly the province of lower income earners. Many of these people are less financially sophisticated. They are also more likely to have a very large proportion of their life's savings with the one fund.

13.110 Second, much of the money in superannuation is 'captive savings'. It is there because of terms in an award and the choice of the manager has been made by an employer or union rather than the individual. Furthermore, superannuation has been actively encouraged as a preferred savings vehicle by the Government. This brings with it a moral and political obligation to ensure a degree of security for these savings. The Treasurer released some position papers in August 1991 which stated 'official encouragement of superannuation savings brings with it an obligation on Government to provide an appropriate prudential framework ... [but the Government] does not believe it can or should attempt to guarantee such funds'.

13.111 The Committee noted the concerns expressed by some groups about the adequacy of supervision in this area. One witness put the view that:

> if we were to look in 10 years' time, the committee like yours will be one to look at the excesses and the problems in the superannuation industry.[45]

Conclusions

13.112 The Committee is aware that managed funds are the subject of examination by a number of organisations. While a number of concerns were drawn to the Committee's attention, detailed conclusions about the supervision of the funds management industry are outside the scope of this report. The Committee does, however, believe that the following issues need to be included in current investigations:

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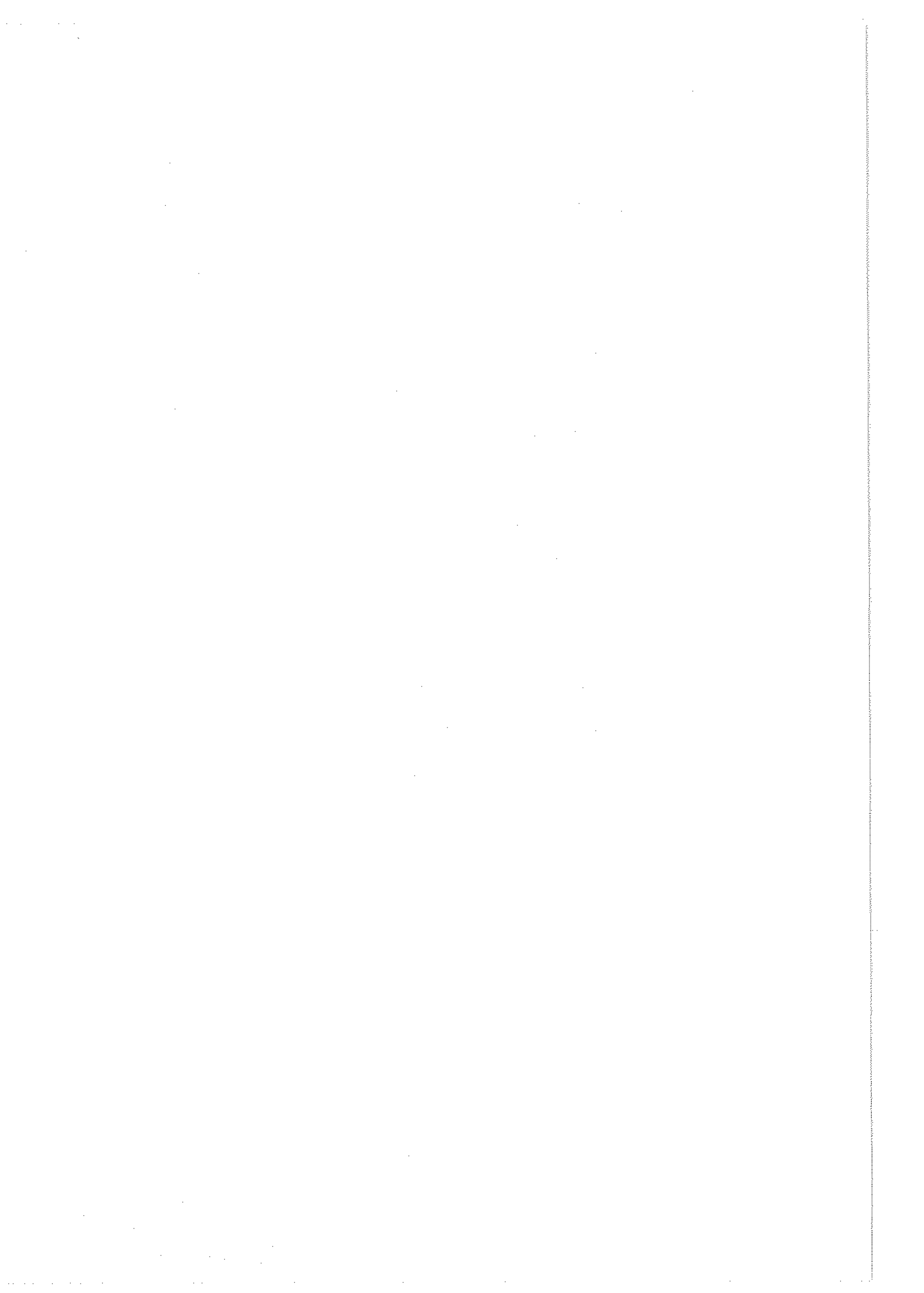
45 Evidence, p. 3063.

- market concentration;
- scope for rationalisation of the roles of the ISC, ASC and RBA;
- need for supervision to cover State government owned operations;
- need for liquidity guidelines and restrictions on borrowing;
- need for superannuation funds to diversify portfolios;
- marketing practices;
- conflicts of interest in investment decisions by funds managers;
- adequate disclosure of fees;
- provision of comparable and meaningful information on fund performance;
- training of staff; and
- the need to preserve a spectrum of risk.

Recommendation

13.113 **The Committee recommends that:**

33. the present reviews being undertaken into aspects of the financial services industry take into consideration the issues listed above with a view to ensuring that comparable institutions and products are subject to the same high regulatory standards and requirements.



CHAPTER FOURTEEN

ALTERNATIVE ARRANGEMENTS FOR SUPERVISION

Introduction

14.1 The increasing diversification of banks was described in Chapter 11. The following chapter identified some of the tensions this caused for the present supervisory structure with its mix of supervision by function and by structure. Subsidiary operations may have important implications for the parent bank but are subject to supervision by different regulators.

14.2 The Committee identified four basic ways of configuring the responsibilities for the supervision of the financial system as a whole. These are:

(i) retaining the existing division of responsibilities but with greater co-ordination between supervisors;

(ii) moving some intermediaries from one supervisor to another to reinforce the functional basis of supervision;

(iii) introducing a system of 'lead regulators'; and

(iv) creating a 'mega supervisor'.

14.3 This chapter assesses the case for each of these options. It starts by assessing whether the current arrangement whereby the Reserve Bank is responsible for both monetary policy and the supervision of banks is appropriate. It then asks whether the Reserve Bank's supervisory net should extend across to building societies. The issue of banks' NBFI operations is examined next. The Committee is concerned that the Reserve Bank may not be sufficiently well informed about banks' funds management activities, which are becoming so important. It therefore evaluates alternative approaches of introducing a 'lead regulator' or a 'mega supervisor'.

Should the central bank also be the supervisor of banks?

14.4 The main advantage of the separation of responsibilities for monetary policy and the prudential supervision of banks is that it may allow greater specialisation. It can also be argued that conflicts of interest may arise between the

supervisory and monetary policy objectives. For example, the authorities may be tempted to ease monetary policy to reduce pressure on banks at a time when marcoeconomic policy considerations suggested it should remain tight.

14.5 The Reserve Bank denies this happens in practice:

> Decisions about monetary policy do not give any credence to the profitability of banks at the time.[1]

14.6 Canadian authorities with whom the Committee consulted appeared quite content with the separation of responsibilities, but did not see great advantages in it for a financial system that historically had not had such separation. They did stress that there was a need for close liaison between the Bank of Canada and OSFI. This has occurred on an informal basis. Both bodies will soon be part of a co-ordinating council.

14.7 Under the German system the ultimate responsibility for supervision lies with an independent body. However, returns from banks are initially submitted to the central bank, which makes comments on them and then forwards them to the supervisory body.[2] This has been held to involve considerable 'overlap and duplication'.[3]

14.8 In the United States a senior official expressed the view that 'too much power in a central bank is not healthy'. However, the monetary authorities there are still involved in supervising a large proportion of banks. Few commentators outside the United States saw value in emulating their system of multiple bank supervisors. It was also heavily criticised by US banks who complained about the amount of duplication in reporting and inspection.

14.9 An expert in global supervisory issues believes that the trend will be towards greater rather than lesser involvement by central banks in the supervisory process. He opines:

> An increasingly integrated approach to international financial regulation will be needed which the central banks look to be best equipped to provide.[4]

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1 Evidence, p. 603.
2 Deustche Bundesbank (1991) p. 10.
3 Evidence, p. 3598.
4 Peter Cooke, the former Chairman of The Basle Committee on Banking Supervision, in Cooke (1990).

14.10 The Campbell Committee recorded that it had 'not received any submissions proposing that prudential and monetary policy responsibilities be handled by separate authorities'. It formed the view that:

> the interaction between the overall monetary environment and the stability of the financial system is such that it is vital that the two policy responsibilities be closely co-ordinated. This could be achieved by maintaining a close dialogue between two independent authorities, but this is not likely to work as effectively as a single institutional framework.[5]

14.11 The Treasury, Reserve Bank and senior bankers[6] told the Committee that separating the monetary policy and supervisory roles would lead to duplication and/or reduced effectiveness:

> if you were ... to separate those responsibilities, the central bank would need to go out and re-establish close relationships with the banks as well as with the formal supervisor ... monetary policy is not something that is conducted in isolation ... Monetary policy really requires close involvement with the banks. It requires an intimate knowledge of the banks because they are the instruments through which monetary policy is pursued ... I think the notion of separating out the two responsibilities would be a backward step.[7]

14.12 Difficulties could arise if liquidity support for a particular bank is required through a direct 'lender of last resort' loan by the Reserve Bank. The Reserve Bank would need to do this quickly and be in a position to make a judgment about the solvency of the distressed bank. This would be much more difficult if the Reserve Bank were not the supervisor.[8]

Conclusion

14.13 The Committee believes there are arguments which support both the view that the Reserve Bank should continue to be the supervisor of banks as well as having responsibility for the implementation of monetary policy and for the

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5 Australian Financial System Inquiry (1981) p. 23.

6 Including Don Sanders, who has a unique perspective as both the managing director of a major commercial bank and a former Deputy Governor of the Reserve Bank.

7 Governor of the RBA Evidence pp. 2932-3.

8 Phillips (1991) believes the separation of supervisory responsibilities between the Bank of Canada and the bank supervisor there caused serious problems when some banks were in difficulties in the early 1980s.

separation of these functions. On balance, the disadvantages in terms of duplication or the need to establish extensive co-ordination arrangements tend to outweigh the advantages from specialisation.

14.14 Accordingly the Committee concludes that the prudential supervision of banks remain with the Reserve Bank of Australia. However, the Committee concluded that the Reserve Bank's ability to conduct prudential supervision needs to be enhanced. Recommendations to this end are contained in the previous chapter and the following sections.

Recommendation

14.15 **The Committee recommends that:**

> **34. the Reserve Bank appoint a second Deputy Governor with specific responsibility for prudential supervision. The occupant should be titled the Supervisor of Banks.**

Should the Reserve Bank supervise building societies and credit unions?

14.16 The new arrangements being developed for the supervision of building societies and credit unions were described in Chapter 12. Some critics believe that the AFIC scheme is misguided as it increases the likelihood that building societies will be seen as having an implicit guarantee from the State governments. Professor Harper believes the building societies':

> attempt to achieve bank status by seeking equivalent regulation from the Government is a mistake ... It is an attempt by that industry to secure protection and public support in order to guarantee its own existence against dictates of market forces.[9]

14.17 The Committee recognises that it is a very hard task to educate the community about the nature of different retail financial institutions. This is one reason for wanting to improve their supervision. Alternative methods to make the situation clearer would be to require non-banks' advertising to state that they were not supervised by the Reserve Bank or for them to disclose a 'rating' from a ratings agency.

14.18 Professor Harper also expressed concern about what he viewed as excessively onerous liquidity and capital requirements which will make it hard for societies to compete with banks.[10] He is also opposed to what he sees as anti-competitive aspects of the proposed framework:

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9 Evidence, p. 2227.

10 Evidence p. 3421. Carew (1991b) reports others with similar concerns.

> the existing firms are cementing themselves in by providing their own regulatory network which gives them the imprimatur from the public at public expense by preventing any other corporation that can operate, except a mutual, to stop takeovers, to allow the directors currently there to continue.[11]

14.19 Some commentators, including St George Building Society[12] and the consumer movement[13], regard AFIC as a 'second best' to the Reserve Bank supervising these institutions. There is a case that as the activities of the larger co-operatives are almost indistinguishable from that of banks, they should be subject to the same rights and obligations and have the same supervision.

14.20 When the Committee questioned State officials on this, the reply was:

> The Commonwealth Government made it quite clear that *it was not prepared to be involved in the supervision of* these institutions, that they were a State responsibility and under no circumstances would it legislate to supervise these institutions.[14]

14.21 There are three main reasons why the Reserve Bank is reluctant to become involved with supervising building societies and credit unions and opposes giving them banking authorities. First, the sheer number of them would overwhelm the supervisory resources of the Reserve Bank. If an Reserve Bank-supervised credit union, with or without a banking authority, were then to collapse it could reduce confidence in the prudential supervision of banks. This is a significant problem in the short term but beyond that could be met by increasing the resources of the Reserve Bank.

14.22 This short term concern could be addressed in the interim by having a cut-off minimum size. The smallest licensed banks[15] have around $0.7 billion in assets. A cut-off of $1 billion would allow around three to five building societies, but no credit unions, to apply for banking authorities.

14.23 Second, there is a concern about retaining a risk spectrum. One problem with this argument is that it appears to be rejected by the general public.

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11 Evidence, p. 2232.

12 Evidence, p. 858.

13 Evidence, p. S1470.

14 Evidence, p. 2431.

15 Excluding the special cases of the moribund Australian Bank, the branch of the Bank of China, the savings bank arms of two small banks, and the Australian Resources Development Bank, now part of NAB.

There seems to be a generally held view that household deposits in building societies should be as safe as those in banks. On a more theoretical level, modern finance theory says that any efficient risk/return combination can be constructed with the appropriate combination of a riskfree asset (such as government securities, although bank deposits would come close) and a market portfolio (such as a broad based unit trust). There is no need for individual institutions to be placed all along the risk spectrum.[16]

14.24 The third impediment to their becoming banks is their co-operative status. The Reserve Bank has expressed its opposition to co-operatives receiving banking authorities because of perceived:

> problems in establishing and maintaining a strong sense of ownership among members; the potential lack of effective discipline on management and limited access to new capital.[17]

14.25 The Committee finds the first two points of this third objection curious as the Banks (Shareholdings) Act, which the Reserve Bank supports, and their own rules on the composition of bank boards, aim to reduce the influence on management of strong shareholders. The third point, that co-operatives have limited access to new capital, was rejected by St George. In any case, if they did have such difficulty, this would mean they would have to slow down the growth of their balance sheet.

14.26 Professor Harper, a specialist in the area, believes that while co-operative or mutual organisations are not as efficient as joint stock companies, they should not be precluded from receiving a banking authority on these grounds.[18]

14.27 Building societies, along with other NBFIs, are exempted from requiring a banking authority due to a blanket exemption given to organisations registered under the Financial Corporations Act. It has never been tested in the courts as to whether they conduct the 'general business of banking' and so would otherwise be required to seek such an authority. This raises the possibility that if it was desired to bring large building societies under the Banking Act, and they were reluctant, they could be compelled to seek an authority by revoking their exemption.

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16 Unless it is assumed the public wishes to deal with only one institution. St George said that 87 per cent of its customers also have a bank account (Evidence p. 843.) so this is unlikely to be a problem.

17 Evidence, p. S1143.

18 Evidence, p. 2233 and Carmichael and Harper (1991).

Conclusion

14.28 The Committee believes that the current process of harmonising the supervisory requirements of the States is a valuable first step in ensuring a more uniform supervisory regime for smaller NBFIs. The process should be completed as a matter of urgency. However, the Committee believes that, in the longer term, the supervision of these intermediaries would be more efficiently achieved by a national supervisor. The Committee would not favour governments guaranteeing deposits with co-operatives and any arrangements adopted should be careful not to create this impression.

14.29 Those large organisations which engage in essentially banking business and which the general community expects to be as safe as banks should be supervised by the Reserve Bank in the same manner as banks.

14.30 Co-operative status is not a sufficient reason for denying the issue of a banking authority. However, there are limits to the number of organisations which the Reserve Bank has the capacity to supervise without diminishing the quality of that supervision.

Recommendation

14.31 **The Committee recommends that:**

35. co-operative organisations with assets in excess of $1 billion which undertake banking business be required to obtain a banking authority and hence be supervised by the Reserve Bank.

Supervision of banks' subsidiaries

14.32 The supervision of finance companies and MMCs was described in Chapter 12. Subsidiaries of banks comprise a significant proportion of these sectors.

14.33 The banks claim that their subsidiaries are separate operations and there is no risk of problems in their operations jeopardising the parent bank. The Reserve Bank's large exposure guidelines and limits on the size of subsidiaries provide some controls. Nevertheless, problems with subsidiaries were major causes of the problems faced by the Bank of Adelaide (and its subsidiary Finance Corporation of Australia), the State Bank of Victoria (and Tricontinental) and the State Bank of South Australia (and Beneficial Finance).

14.34 When a subsidiary is in difficulty, it is very hard for the parent bank to walk away. SBSA was asked by the Committee why it did not cut adrift Beneficial Finance. It replied:

> We are ... supporting the business of the bank's liability base. It is seen as a group and as an overall responsibility ... if any Australian financial institution walked away from the wholesale funding obligations of a 100 per cent owned subsidiary, the likelihood is that access to international funding markets would be denied for any entity of that group, including the parent. For any financial entity which has a significant portion of its moneys raised in wholesale markets ... that would probably be the end of that institution[19].

14.35 The Reserve Bank acknowledges this problem:

> If one segment of a financial conglomerate gets into trouble it will be difficult, if not impossible, for other elements in the group to be unaffected. This is because those parts can feel obliged, for moral or commercial reasons, to provide support to the ailing segment, thereby weakening their own capital position. As a related effect, because the public perceives such connections among components of a group, emerging problems in one element can weaken confidence in other parts. In turn, this risk of damage to confidence is, of course, a major reason that other parts of a group might feel a `commercial' obligation to support a weak member.[20]

14.36 Given the impact that subsidiaries can have on the operations of the parent bank, it is sometimes suggested that their operations should be supervised in the same manner as banks. National Australia Bank suggested not only finance companies and MMC subsidiaries but superannuation funds managed by banks should be supervised by the Reserve Bank.[21]

14.37 This would reinforce the impression that funds placed with the subsidiaries had the same protection as bank deposits. This could give the bank subsidiaries an unfair advantage over other finance companies and MMCs.

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19 Evidence, pp. 3823-4.

20 Thompson (1991), pp. 9-10.

21 Evidence, p. 241.

14.38 The fact that banks do not provide formal guarantees to their subsidiaries is not sufficient to prevent these subsidiaries having the potential to damage the standing of the banks. As a consequence banks will be under pressure to prop up subsidiaries which will weaken the position of banks.

Recommendations

14.39 **The Committee recommends that:**

36. banks with Australian subsidiaries whose principal business is raising deposits and making loans be required to wind them back into the parent bank within three years;

37. in the interim there be prominent disclosures on prospectuses that subsidiaries are in no way guaranteed by the parent bank.

Greater co-ordination between supervisors

14.40 Given the involvement of banks and other intermediaries in the funds management area, there is a clear case for close liaison between the groups of regulators. Until recently, it seems, the Reserve Bank and the ISC have not had frequent contact. However, senior Reserve Bank staff now meet with senior ISC staff every six months and formal arrangements to exchange information are now in place. There is now considerable informal contact between the staff of the two bodies and the Bank is in the process of establishing similar links with the Australian Securities Commission.[22]

14.41 Some overseas countries have formal co-ordination arrangements in place. In the United States the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, Office of Thrift Supervision and the National Credit Union Administration are members of the Federal Financial Institutions Examination Council. In Canada a Financial Institutions Supervisory Group is being established including the Bank of Canada, OSFI and the Canadian Deposit Insurance Corporation.

Conclusion

14.42 The continuing trend within the financial system for the creation of financial conglomerates creates a need for closer co-ordination between the various supervisory organisations. This could be achieved by the creation of a formal council bringing together very senior representatives of the various supervisors for regular meetings. The secretariat for such a council could either reside within the Reserve Bank (as with the Australian Payment System Council) or in a government

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22 Evidence, pp. 2941, 3545 and 3950 discuss liaison from the perspective of the RBA, ISC and ASC respectively.

department.

Recommendation

14.43 **The Committee recommends that:**

38. a Council of Financial Supervisors be established to facilitate closer co-ordination between the supervisors of the Australian financial system. The Council should include the Reserve Bank, AFIC, the ISC and the ASC and be chaired by the Supervisor of Banks.

Lead regulators

14.44 An alternative approach to the supervision of financial conglomerates is to designate one supervisor, the 'lead regulator', with overall responsibility for each conglomerate but leave the various arms under the supervision of the appropriate supervisor. For bank-owned conglomerates the lead regulator would be the Reserve Bank.

14.45 A system along these lines operates in the United Kingdom. It was described to the Committee as follows:

> The Bank of England is the industry regulator for the banking system and the Securities Industry Board is the industries regulator for those organisations involved in securities, et cetera. Then a system was established involving what were called lead regulators ... Who was at the top of the pole in the conglomerate determined who the lead regulator was and, therefore, who had the overall responsibility even though the other regulators had some responsibility for particular parts of the organisation. So if we took a case of a bank in Australia that had these subsidiaries, then the Reserve Bank ... would become the lead regulator ... [with] the overall responsibility to make sure the total conglomerate was in order from a prudential point of view. But the insurance commissioner would still have his particular responsibilities and the ASC would have its particular responsibilities ... But there may be another organisation which would work in a different way in which perhaps the ISC would be the lead regulator.[23]

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23 Reserve Bank of Australia Evidence, p. 2956.

14.46 The Reserve Bank was asked its view on the system. It replied:

> The indications are yes, it is a workable system and in the circumstances may well be the best system ... But I think it is just a bit early to give it a total tick yet.[24]

14.47 The ABA also favoured the idea:

> there is a lot of merit in the idea of lead regulator ... Of all the alternatives, that is the one which seems to give the most consistency and rules for a particular industry, yet allows for the advantages for the community of having institutions like the banks come in with stronger prudential standards and better delivery systems.[25]

Conclusion

14.48 There is merit in achieving greater co-ordination of supervision by designating one supervisor the 'lead regulator' for each financial conglomerate.

Recommendation

14.49 **The Committee recommends that:**

39. the Council of Financial Supervisors designates one supervisor as the 'lead regulator' with overall responsibility for each financial conglomerate but that supervision of the individual arms of the conglomerate remain with the individual supervisors.

A Mega-Supervisor

14.50 There are some who see merit in the combination of the existing supervisors into the one mega-supervisor now that many conglomerates have divisions operating across more than one of these areas. This would be similar to OSFI in Canada, although it would also have responsibility for central banking functions. An alternative is to keep the existing distinctions but improve liaison and designate one of the groups as the lead regulator for each conglomerate. The latter approach is employed in the UK.

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24 Evidence p.2956

25 Evidence, pp. 3204-5.

14.51 There was considerable argument about the merits of establishing a mega-supervisor. The Reserve Bank expressed the opinion that creating a single regulator would be a retrograde step:

> The overlaps ... referred to are real and they are likely to increase, but I think that is an argument for each of the regulators sharpening his (sic) particular responsibilities and the instruments that he has available to him and at the same time for strengthening the consultation and co-ordination arrangements.[26]

14.52 The Australian Securities Commission:

> have a view that one regulator will lead to a lower prudential standard over all. A series of regulators based on function is sensible.[27]

14.53 It was further argued by the Reserve Bank that:

> It is not necessarily inappropriate to have different supervisors for different segments in the group. The nature of activities in one segment (eg insurance) may differ sufficiently from those in another (eg banking) to require supervisors with quite different expertise. In addition, the 'non-banking' activities are likely to be conducted also by independent financial institutions (eg stand-alone insurance companies) which require supervision but for which the banking supervisor has no responsibility.[28]

14.54 These views are consistent with those of an inter-departmental committee which concluded:

> rationalisation of regulators by way of amalgamation would be an excessive measure because of the significantly different responsibilities of the various supervisors.[29]

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26 Evidence, p. 2936.

27 Evidence, p. 3956.

28 Thompson (1991), p. 10.

29 The committee included representatives of Treasury, the Reserve Bank, Prime Minister and Cabinet, the Department of Industry Technology and Commerce and the National Companies Securities Commission. The report was published by Department of the Treasury (1988).

14.55 It was claimed that having the one regulator extending across the risk spectrum from banks to trusts (and in the light of the recommendations in this chapter also being responsible for monetary policy and ancillary central banking functions) would risk confusion. It is argued that one mega-regulator would have the effect of:

> eliminating, or at least narrowing the risk-reward spectrum in the financial system. Such a spectrum is important for the efficient working of a market-based economy. It would be difficult to preserve this in practice if all institutions had the support or protection of the one supervisory agency.[30]

14.56 The argument about preserving a risk spectrum is much more compelling when the question is about banks and unit trusts rather than banks and building societies. If trusts were regulated into being close substitutes for deposits with financial intermediaries, it would mean small investors seeking higher returns would be forced into buying less diversified, and so riskier, portfolios of equities in their own right. They would be shut out of the commercial property market.

14.57 The ISC also doubted whether there were any cost savings likely from the creation of a mega-regulator:

> the supervision of banking and the supervision of life insurance and general insurance are quite different indeed. The expertise that is required is quite different ... there are no economies of scale by combining supervision.[31]

Conclusion

14.58 The Committee is not convinced the establishment of one mega-supervisor is necessary at this time to ensure adequate protection of the savings of the public. In particular, it is mindful of the difficulties this would cause in maintaining both the reality and the perception of a clear range of risk/return options for investors.

14.59 The Committee recognises the financial system is evolving rapidly. There may be a need for re-examining the case for a mega-supervisor at a later date, especially if the trend towards the formation of conglomerates by merger or alliance continues. In the event that a mega-supervisor was found to be desirable the Council of Financial Supervisors could form the basis for it. The Committee will continue to monitor this issue closely.

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30 Reserve Bank of Australia. Evidence, p. S2887. Similar points were made by the ISC at Evidence, p.3542.

31 Evidence, p. 3542.

SECTION IV

BANKS AND SECTORAL FINANCE

In this section the Committee examines the relationship between a number of individual sectors and the banking industry. The focus is on those sectors which were perceived to have the greatest problems and as a result have received the greatest public prominence. The Committee was interested in the effects that deregulation has had on these sectors and whether any benefits have been derived from the deregulated environment.

In Chapter 15 the Committee examines the relationship between business and banking. In particular, emphasis is placed on the concerns of small business. The view has been expressed that the cost of debt finance was significantly higher for small business than for larger ones and that the higher margins could not be justified. Small business was also critical of the inability to assess the overall cost of borrowing and the difficulty of making comparisons between financial products of different lenders as a result of non interest add-on costs.

The Committee was also interested in the relationship between banks and the rural sector. Attention was directed at farm debt and the impact banking practices has had on the financial position of farmers. The concerns of the rural sector included the excessive charging of margins, failure to notify changes in loan agreements and forced foreclosures.

In Chapter 17 the Committee examined the issue of foreign currency loans. This issue was given public prominence with the publication of extracts from the 'Westpac letters' and the Committee's publication of a submission from Mr John McLennan, a consultant to the Foreign Currency Borrowers' Association. Submissions were also received from individual borrowers and from people who claimed to have expertise in foreign currency transactions. As a result the Committee undertook to investigate the issue in some detail.

The final chapter in this section examines allegations of fraud and corruption within the banking industry. In particular the allegations raised by former Senator Paul McLean and former NAB employee John Salmon are discussed. The conclusion is reached that fraud in the banking industry is of a minor nature only.

CHAPTER FIFTEEN

BANKING AND BUSINESS

15.1 Banks provide key services to businesses of all sizes. Virtually every business needs the banking system to operate. Sophisticated financial management is not possible without the use of banks. Banks provide services for these businesses for the receipt of, and making payments, and the secure custody of cash. In addition most businesses have recourse to the banks for working capital requirements. Working capital, particularly for small business can be subject to fluctuation over a monthly cycle, from being in debit at one point to being in surplus at another. Banks also provide for long term financial requirements and in the form of property finance, equipment finance and project finance. In order to conduct business outside Australia the banking connection is essential.

15.2 Banks provide a full range of corporate financial services ranging through the spectrum of depositing, credit and risk management facilities. Corporate banking in Australia has been transformed in recent years by the deregulation of the financial system, by the globalisation of financial markets, and by the rapid changes in financial services technology. Banks are one of the major suppliers in the highly competitive market of corporate financial service. They therefore have to ensure products are closely tailored to the needs of customers and are provided at competitive prices. The range of corporate products offered by banks has increased considerably.

15.3 Small business also relies heavily on banks. It is a very important element in Australia. Small firms have a vital role in Australia's economic development. There are an estimated 750,000 small businesses accounting for 96 per cent of all firms, half of all private sector employment, and approximately 30 per cent of Gross Domestic Product (GDP). The small business sector is a dynamic source of employment generation, an important supplier to the production processes of larger businesses and a breeding ground for innovation.

15.4 The Campbell Committee expected deregulation to make finance more readily available to the business sector generally, including to small business. However, the finance would be at a rate that reflected the risk of the lending proposal.

15.5 In this chapter, the Committee looks briefly at large and small business and then examines the issues affecting business generally with particular attention to the concerns of small business.

Corporate, or large business banking

15.6 Substantial development took place in corporate banking following deregulation. The Business Council of Australia stated that the deregulatory changes had meant significant improvements for business. While the price of finance fluctuated, 'funds were always available to credit-worthy customers at the going price'.[1] It noted that competition between banks at the wholesale end of the market (that applicable to corporate business) was intense. Many innovative financial instruments and products were developed.[2] In summary, the Business Council considered that:

> ... the net benefits to the economy of financial deregulation - both through the specific benefits to borrowers and through the impetus to change and reform - are positive and that their value will increase over time.[3]

15.7 However, the intense competition for the corporate market created difficulties for banks and other financial institutions such as merchant banks and finance companies. In the corporate lending area, the target customers were those seeking relatively large loans. The client base of this sector can be divided between the solid, blue-chip Australian companies and the like and a group which typically have become known as 'unproductive entrepreneurs'.

15.8 The economic environment in which this competition took place is a significant factor in the events that occurred. Until the 1987 share market correction, there was a steady growth in asset prices generally, coupled with a strong growth in domestic product. Monetary policy was eased deliberately following the share market correction, leading to an extraordinary growth in credit which was skewed to the business sector. This was reflected in substantial growth in lending assets held by financial institutions. Figure 15.1 illustrates the growth in credit, including credit to business in the 1980s.

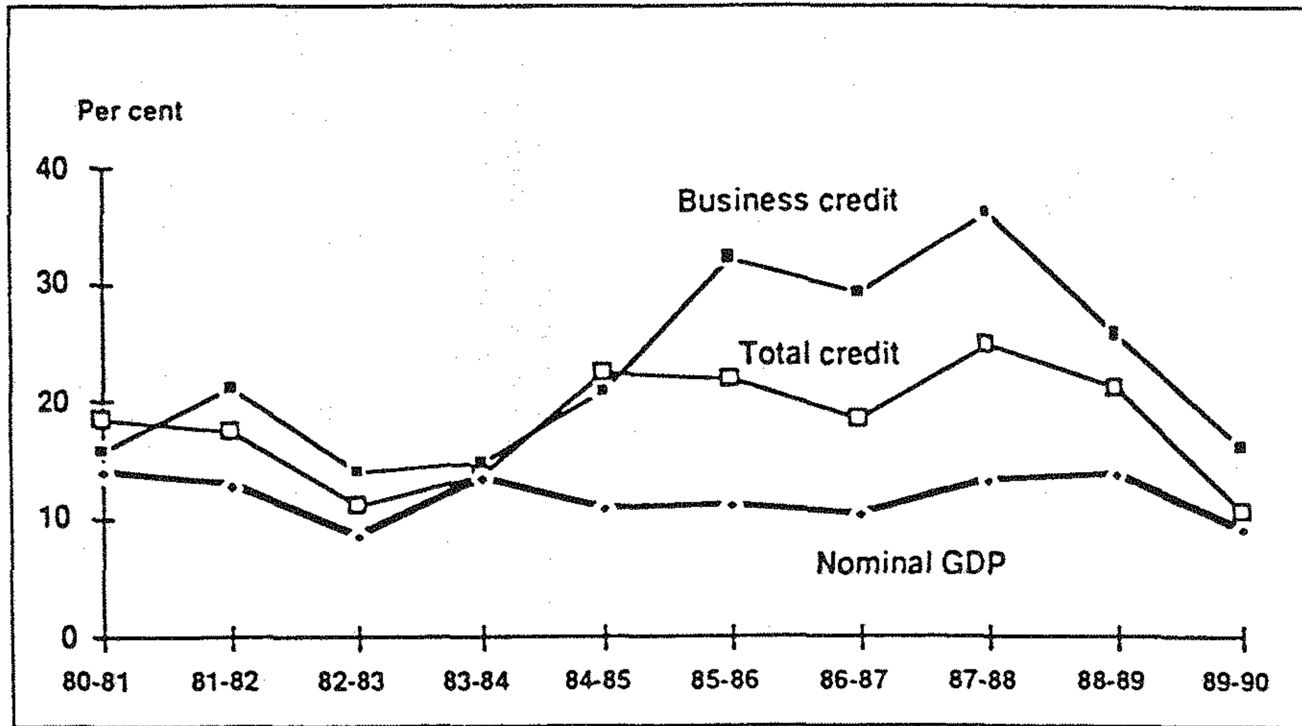
15.9 Following the share market correction, the property market was fuelled by an initial belief that it offered a safe haven for investment funds and this was encouraged by the re-introduction of negative gearing.

15.10 The competitive environment created by these changes led to intense competition for market share amongst all financial institutions. Without an infrastructure to handle high volume business, the new banks and the merchant banks targeted relatively large transactions with medium to large corporate

1 Evidence, p. S1879.
2 Evidence, p. S1870.
3 Evidence, p. S1872.

FIGURE 15.1

GROWTH IN CREDIT AND NOMINAL GDP (ANNUAL RATE OF GROWTH)



Source: Bureau of Industry Economics, submission to the Industry Commission's Inquiry into the Availability of Capital, p. 24.

borrowers. Throughout the decade most State governments embarked on a strategy to transform their State banks from primarily household savings institutions to commercial financial institutions providing the full range of banking services and this introduced a very strong further competitive element into the corporate lending market. In some cases these factors led to a concentration of risk.

15.11 In the face of financial institutions willing to lend, corporate borrowers were able to improve the terms through slimmer margins and lower security requirements. Evidence suggests that this has been reversed recently and that margins are now more normal for lending to corporate borrowers.

15.12 A further important factor was that traditional banking relationships were replaced with multiple banking relationships for corporate borrowers, with the result that the lending officers did not always remain as close to the business affairs of borrowers as had been the case in the past.

15.13 New techniques in lending were introduced, for example:

- 'name' lending where the perceived credibility of the borrower as the principal factor in the decision to advance credit;
- negative pledge borrowing arrangements;
- share scrip security; and
- front-end fees in response to fine margins at which the business was transacted.

15.14 The funding demands of the commercial real estate market led to a significant increase in the volume and quantity of property development loans where interest was capitalised and the exit strategy based on sale on completion or re-financing. This type of lending was justified at the time against the backdrop of a property market that had demonstrated sustained growth.

15.15 In the mid 1980s the focus was on 'entrepreneurs'. They were courted by governments, the press and the brokers and financiers (both domestic and overseas). These financiers were willing to lend on a name basis and indeed they were competing fiercely for the business. The local banks responded to this thrust by overseas lenders.

15.16 The business community was attracted to the aggregation of companies to achieve perceived economies of scale and the ability to compete better in global markets. The entrepreneurs were at the forefront of takeover activity, and tended to finance growth through debt, given the tax advantages and retention of control.

15.17 The recent extended period of high interest rates has had a dramatic impact on businesses and banks that engaged in the financial arrangements referred to earlier. The severity and depth of the resulting recession was not anticipated by most commentators. Further, in the late 1980s specific sectors of the economy came under intense pressure, for example in 1989 the pilots' strike had a crippling effect on the tourism industry and the other businesses, which included the activities of many developers. Many major entrepreneurs have encountered financial difficulty as have other businesses. Particularly hard hit by high interest rates have been the property developers and other corporate borrowers that relied on asset growth rather than access to cash flow. The strategies for exit on which financial institutions predicated the loans generally appears to have been unable to cope with the economic fundamentals that have changed so dramatically.

15.18 The levels of bad debts, provisions and unproductive accounts within the banking sector that have resulted have reached unprecedented levels. The results for the major banks, the State banks and many of the new entrants has seen an abrupt reversal in the fortunes of those organisations which can be illustrated by the significant leap in unproductive accounts, bad debts and the impact on profits. Chapter 6 referred to the extent of these bad debts and the impact they have had on bank profitability.

15.19 Banks told the Committee they have been on a 'learning curve' since deregulation and have corrected the practices that characterised the early days. They stated that the substantive benefits of deregulation to business that often are lost sight of can now be built on.

Conclusion

15.20 The problems of the 1980s in the corporate area can lead to a conclusion that deregulation caused many of the excesses. However, the Committee has outlined the broad range of factors that gave rise to the events of the 1980s, only one of which (albeit an important one) was financial deregulation. In particular, the anticipated and actual entry of new players was a spur to the vigorous competition that occurred in the corporate business area.

15.21 Banks should have been better prepared for the changes that deregulation brought about and have been able to respond in a more mature way. The experiences of deregulation in other countries would have provided a guide to banks of what to expect. A number of banks had branches in some of the countries which had experienced a deregulated system. Instead banks engaged in what one witness described as a 'collective madness' of lending without sufficient attention being paid to a prudent approach.[4]

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4 Evidence, p. 319.

15.22 The Committee is keen to see banks develop a sound approach to the financing of business that allows the freedom available as a result of deregulation to be utilised to its best advantage. The Committee would see banks making a significant contribution to the development of business in Australia.

Small business

15.23 Small business can be defined as a business which is independently owned and managed and which is closely controlled by the owner/managers who also contribute most of the operating capital. Typically, small businesses in the non manufacturing sector employ fewer than 20 people and in the manufacturing sector, less than 100 people, though this is not necessarily a strict definition.

15.24 Like large business, small business also has seen benefits from deregulation. In the regulated era finance was relatively cheap for small business as the ceiling on the small overdraft rate was generally below the large overdraft rate. However, finance was rationed to low risk customers. As a result of deregulation, finance was available to many more small businesses following deregulation, but they have had to bear the market cost of the funds.

15.25 Small business had concerns about a number of aspects of its relationship with banks. In general terms it had the view that the cost of debt finance was significantly higher for small business than for larger ones and that the higher margins could not be justified. In addition, many were critical of the number of non interest add-on costs which made it difficult for small businesses to assess the overall cost of borrowing and made comparisons between financial products of different lenders almost impossible. Small business also considered that the banks had made little effort to explain clearly their products and the costs associated with them to enable a comparison to be made.

15.26 The economic circumstances of the 1980s not only attracted the large innovators, but also appealed to small business. Many small business owners and professional people joined the rush to acquire property and to take advantage of the negative gearing arrangements available. Many of these businesses were affected adversely and suffered the same fate as the large entrepreneurs who over-borrowed against the potential of property. This departure from the traditional activities by small business owners was unfortunate and has led to the demise of many businesses.

15.27 More recently there have been small business failures as a consequence of the high interest rate environment coupled with the current recession. Generally the survival rate for new small business is relatively low. A study quoted in the

report of the House of Representatives Standing Committee on Industry, Science and Technology on small business showed that a new small business has an 82 per cent chance of surviving for 6 months; 52 per cent for two years; 39 per cent for three years; 32 per cent for four years; and 27 per cent for five years.[5]

15.28 The Committee now examines those aspects of the relationship between banks and business that received most attention in the inquiry. The Committee particularly looks at the concerns of small business.

Business product innovation

15.29 One of the major benefits to business from deregulation has been product innovation. Banks again became the major suppliers in the competitive market for business and made considerable effort to ensure that products were closely tailored to the needs of customers. The range of products offered by banks has increased considerably.

15.30 Funding arrangements can be matched to individual customer needs to take into account the various factors including liquidity, expected cash flows, the relative riskiness of those cash flows and tax and legal positions. Funds can be obtained for particular maturities or currencies on fixed or floating rate terms. In addition to changes in traditional sources such as overdrafts, mortgages, debentures, bills and unsecured notes, the capital market particularly has seen the introduction of convertible notes, promissory notes, Eurobonds, money market funds and a variety of leasing arrangements. Facilities comprising a mix of domestic and offshore funding are common. These exploit differences between domestic and offshore economic conditions. These funding facilities are often coupled with capital market products such as currency and interest rate swaps in order to achieve a desired cost\risk balance.

15.31 Additionally, banks arrange, lead and participate in large consortium loans both offshore and onshore, associated with for example, project financing. Banks have also introduced networks of decentralised offices to serve businesses close to their centre of operation and frequently this extends overseas.

15.32 The above products generally have been more significant to medium and larger sized businesses.

15.33 For the small business sector, banks indicated considerable efforts were being made to provide quality advisory services and training staff to ensure that their lending activities and advice to customers improved. As poor planning and poor financial management are considered to be significant factors in small business

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5 Report of the House of Representatives Standing Committee on Industry, Science and Technology, *Small Business in Australia: Challenges, Problems and Opportunities*, January 1990, p. 50.

failure, this is an important area of attention for the banks.[6] The Committee is aware that banks and the Australian Bankers' Association have developed packages to assist small business customers with financial management and planning.

15.34 Banks have introduced measures to improve the efficiency of business by saving on business time and costs. Banks have allowed direct access from customer premises to accounts, given value transfers between accounts on a 24 hour basis, to simplify the payroll processing, accounting and reports, and ensured there is a worldwide payment method which offers improved cash flow and reduces cash float costs.

15.35 Typical of these products were:

- bulk electronic processing of volume transactions;
- electronic financial management services with direct customer access via computer to financial information and services;
- personal computer software for complete employee payroll management for small\medium sized businesses; and
- voucher and EFT processing of sales transactions by retail customers.

Conclusion

15.36 Product innovation has been one of the major benefits to all business from deregulation. However, much of the innovation has been of particular benefit to large business. An area where small business requires assistance is in financial management and planning. Banks should develop more materials and advisory services to assist small business in this area. Such assistance will be to the benefit of both small business and banks.

Recommendations

15.37 **The Committee recommends that:**

40. banks further develop packages and advisory services that will assist small businesses to improve their financial management and planning;

41. small business representative organisations and relevant Commonwealth and State government departments, provide advice to small business about the products and services available from banks; and

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6 Evidence, pp. 1750 and S1864.

42. **banks look at further product development for business, particularly small business, to provide for the payment of interest on working capital accounts when the accounts are in credit.**

Credit availability

15.38 Clearly deregulation resulted in a greater availability of finance, at a price, for all business. In the scramble for market share, banks and other financial institutions were competing keenly to provide funds to business. An earlier figure demonstrated the growth in credit to business during the 1980s.

15.39 More recently concerns have been expressed that banks have been 'conducting their own monetary policy' thereby exacerbating the extent of the recession by slowing the rate of lending to below that which is dictated by economic fundamentals and failing to pass on cuts in market interest rates. It is further suggested that viable small businesses in particular are denied bank finance.

15.40 Proponents of this view suggest credit standards have been unnecessarily tightened, bank managers have been panicked by the experience of the 1980s and risk, particularly for smaller and medium businesses, is being over-priced. More recently the term 'credit squeeze' has been employed to describe the banks' actions. The Committee received anecdotal evidence that banks were imposing their own credit squeeze and restricting existing and future finance to small business.

15.41 In September 1991, the Bureau of Industry Economics (BIE), in its paper entitled 'Small Business Finance' indicated its research suggested tighter lending by banks was impeding much needed investment in the manufacturing sector.

15.42 The banks responded vigorously to this assertion, stating through the Executive Director of the Australian Bankers' Association, that 'the BIE has no factual data to back up these claims but has relied on perceptions of manufacturers rather than facts.' The banks submitted the existence of limits on the availability of credit is normal in a market economy. To an important extent, borrowers are rationed by price; those appearing more likely to default are charged higher interest rates, with the premium over market rates covering expected risk.

15.43 The Australian Bankers' Association stated that banks' lending has not been held below the level which would be dictated by economic fundamentals. Trends in lending are shown in Figures 15.2 to 15.5. They show:

- the growth in total credit has slowed markedly over the past two years. This slowing appears coincident with the slowdown in GDP rather than preceding it. The relationship in GDP and credit now appears to be closer to long run trends. In the second half of the 1980s credit growth had been exceptionally strong (Figure 15.2);

- the slowdown in lending has been more marked for NBFIs than banks (Figure 15.3);

- banks' new lending to commercial firms has been below the levels of 1989 but not by as much as some reports would suggest (Figure 15.4);

- banks' lending for housing, subdued in 1990, picked up around the middle of 1991 (Figure 15.5).

15.44 The main cause of slower credit growth was the significant tightening of monetary policy between 1988 and early 1990. The Reserve Bank argued in its recent annual report that while financial intermediaries had tightened their assessment procedures for loan applications:

> This, however, should be counted as a positive response to the earlier decline in standards, and does not necessarily imply a wide spread shortage of credit for worthy borrowers. Anecdotal reports suggest that some lenders have treated some of their customers harshly, but there is no hard evidence to suggest that such treatment has been widespread.[7]

15.45 The Reserve Bank also noted the overall credit figures implied a similar relationship with past trends in activity. A widespread credit squeeze could be expected to produce slower growth than had occurred. The Bank concluded 'the information available does not point to any widespread, bank-imposed "credit crunch"'.[8]

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7 Reserve Bank of Australia, Annual Report and Annual Statements, 30 June 1991, p. 15.

8 Ibid., p. 16.

FIGURE 15. 2

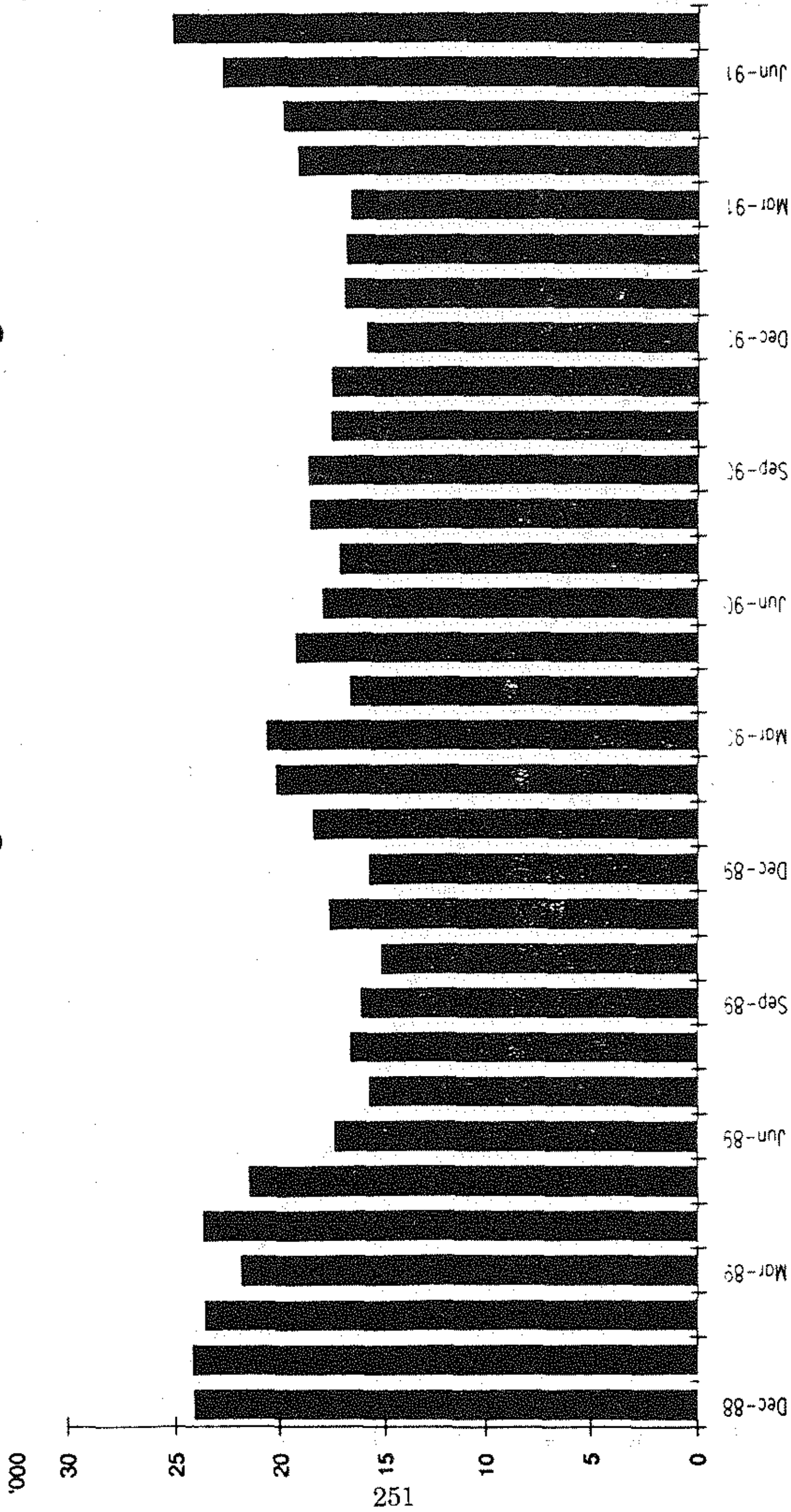


FIGURE 15. 3

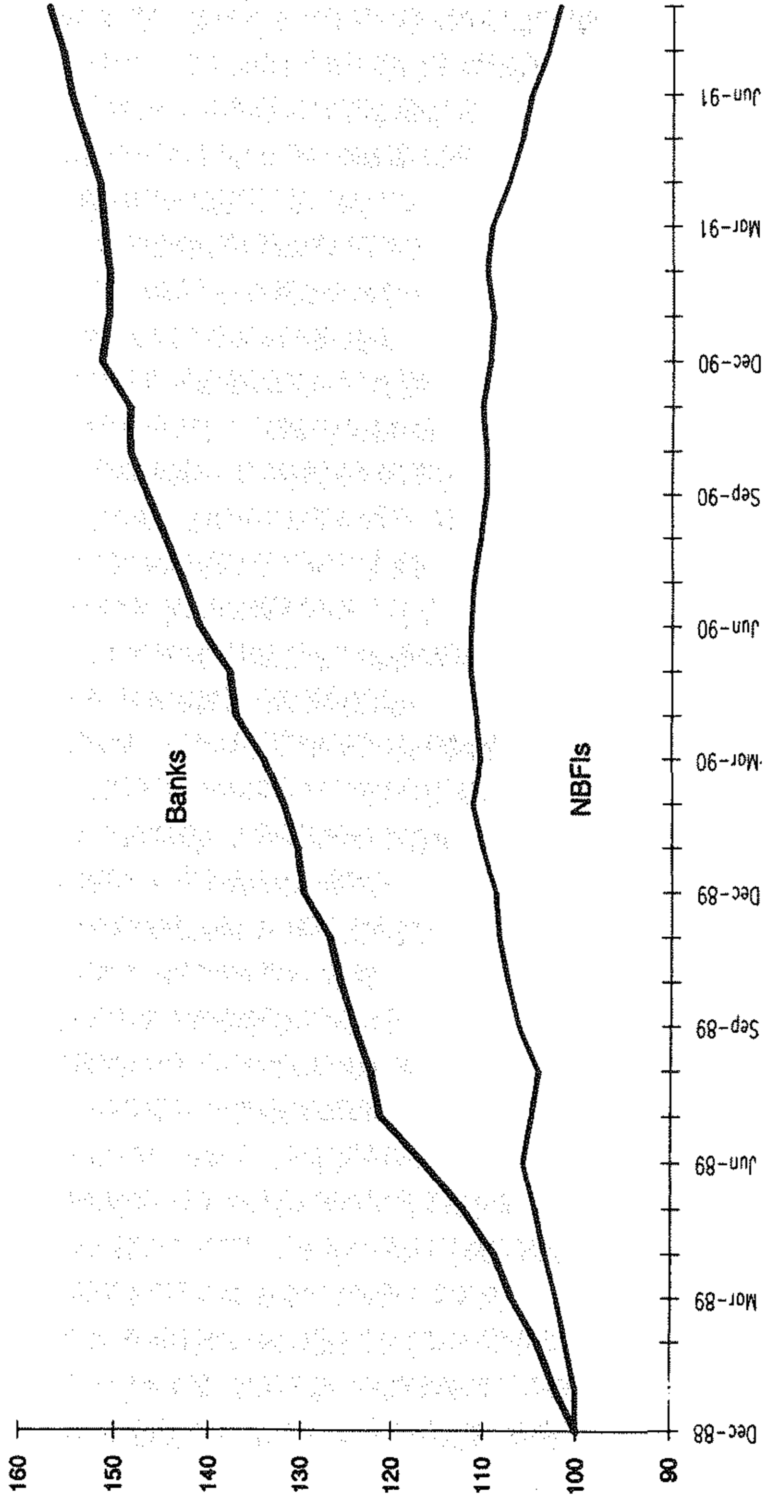


FIGURE 15. 4

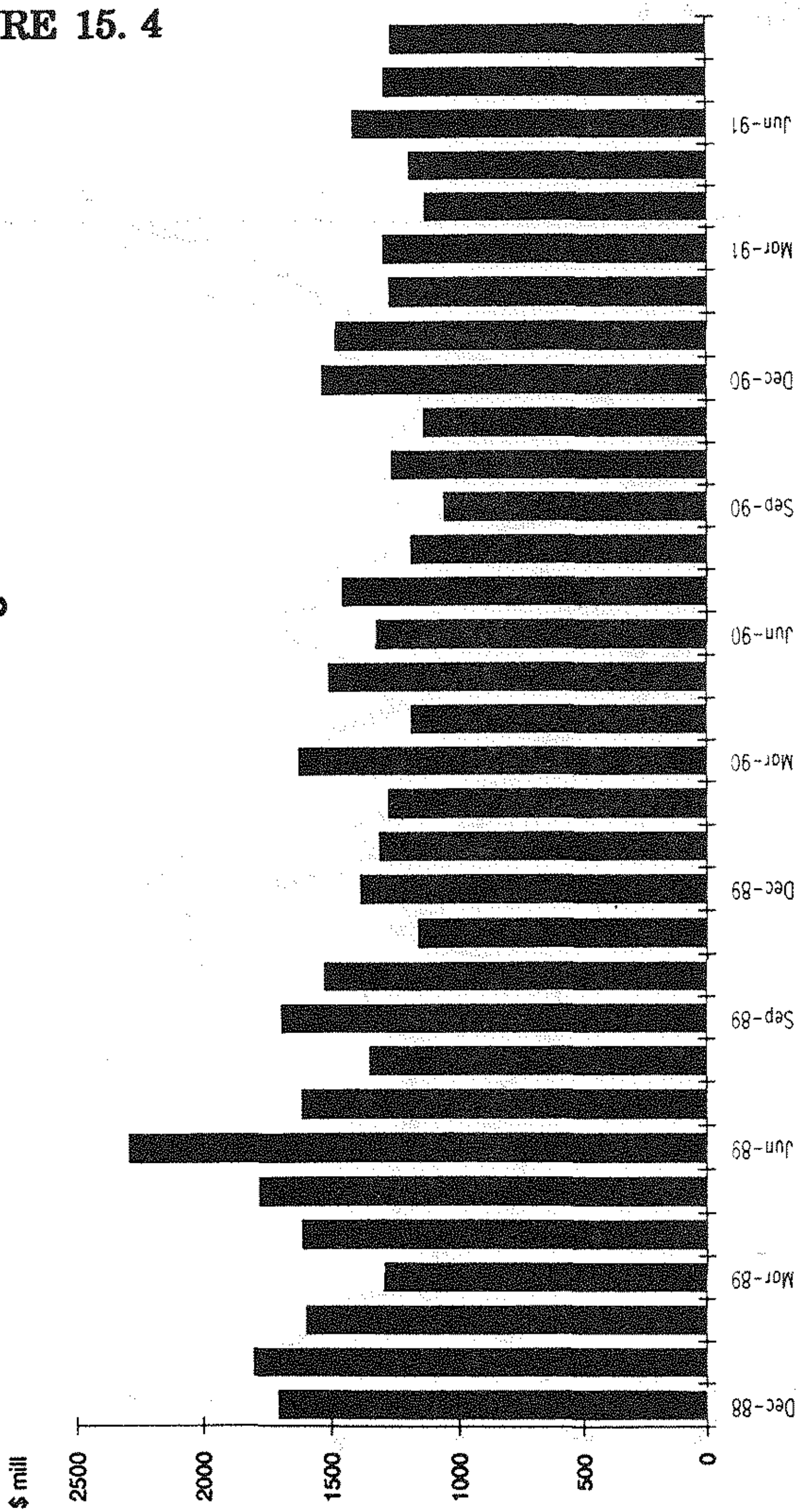
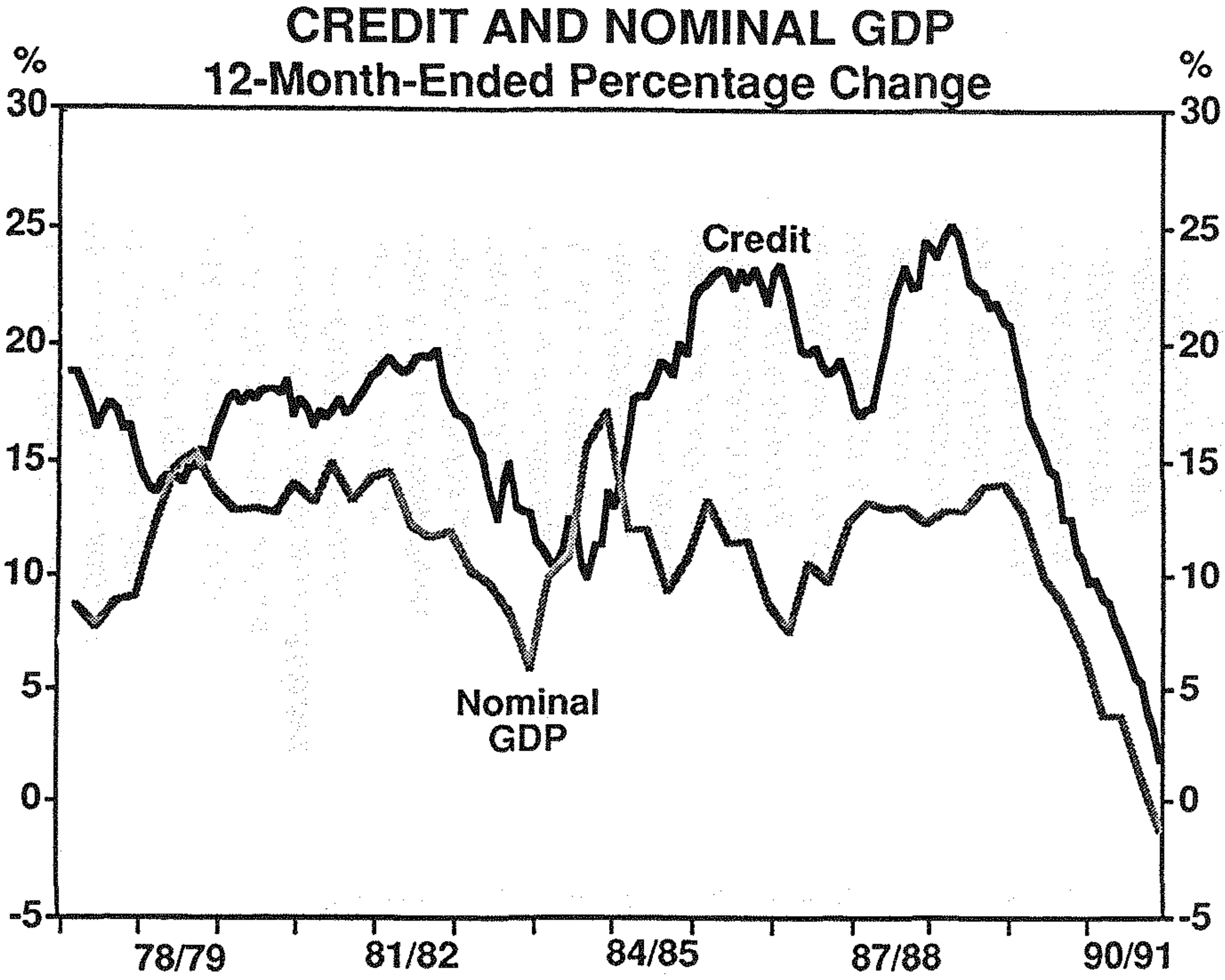


FIGURE 15. 5



Credit assessment

15.46 The major criteria which banks use in assessing loan proposals from business, particularly small business, are:

- capacity to repay;
- borrower's financial position;
- managerial competence;
- industry conditions;
- amount and purpose of loan; and
- security.[9]

15.47 However, banks noted that during the second half of the 1980s these criteria were not always adhered to. One managing director of a major bank said 'there was some sloppiness there in the boom times'.[10] Another noted there was a period when his bank forgot 'the risks that it was taking on'.[11]

15.48 The reaction to the experiences of the 1980s has had an effect on the approach to loan approvals and to the pricing. The issue of pricing is considered in the next section.

15.49 Banks indicated, although they have tightened their lending procedures, the essential criteria have remained much the same. As well as tightening procedures, the experiences of the 1980s may have induced a more cautious frame of mind amongst bank staff. One bank referred to a natural human reaction to bad debts as being for bankers to return to 'very, very careful banking'.[12] To overcome this problem, the bank separated those responsible for the administration of problem loans from those responsible for finding new business.

15.50 Banks emphasised that their business was lending and they had a strong interest in funding sound business propositions that met the usual criteria.

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9 Commonwealth Bank submission to the Industry Commission inquiry into the availability of capital, p. 1.

10 Evidence, p. 115.

11 Evidence, p. 233.

12 Evidence, p. 186.

According to the ABA, a number of banks have issued explicit guidance to managers to encourage them to lend on viable propositions. The managing director of one bank has written to credit administrators and regional managers emphasising that without lending the bank disappears, and that there is a need to manage risk, not eliminate it.[13]

15.51 However, it was suggested to the Committee that much of the problem was on the demand side. The managing director of one bank said:

> There is very little demand for borrowing ... There is great uncertainty in the community and we are not seeing the sort of borrowing requests that we would normally see in a healthy environment.[14]

The Governor of the Reserve Bank also considered the problem was more on the demand side with the volume of credit worthy loans not being there.[15]

15.52 Small business had some concerns with the effect of the credit assessment criteria used by banks. There was particular concern about the emphasis given by banks to property, including personal property, as security for small business loans.[16] For example, an Australian Chamber of Manufactures' survey of members showed that the average level of security required by banks was 99 per cent. Only 31 per cent of firms were able to satisfy their bank with security over business assets.[17] It was claimed this disadvantaged asset poor, but cash flow rich, firms.

15.53 Banks defended this approach stating it ensured a commitment of the borrower to repayment and provided a safety net to the bank's depositors and shareholders in the event of the borrower being unable to repay the loan.[18]

15.54 Small business was also concerned that the tightening of credit assessment in recent times had led to banks and other intermediaries 're-visiting' customers and altering existing arrangements often without consultation.[19] The Australian Chamber of Manufactures' survey of members revealed a number of firms (10 per cent of those surveyed) that had overdrafts decreased without consultation.[20]

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13 ABA additional information dated 14 October 1991, p. 3.

14 Evidence, p. 116.

15 Evidence, p. 435.

16 Evidence, pp. 1755 and S1863.

17 Evidence, p. S2830.

18 Commonwealth Bank submission to the Industry Commission inquiry into the availability of capital, p. 10.

19 Evidence, p. S2978.

20 Evidence, p. S2390.

15.55 In its submission to the Industry Commission's inquiry into the availability of capital, the Commonwealth Bank said it reviewed small business facilities at least annually and more frequently if the financial position of the customer deteriorated. One sign of deterioration was overdraft facilities operating outside previously agreed limits.[21] The reduction of overdrafts back to previously agreed levels could explain some of the instances of decrease in overdrafts without warning reported in the Australian Chamber of Manufactures' survey.

15.56 The Council of Small Business Organisations argued that small businesses should be properly consulted prior to any alterations to established credit arrangements with customers. It considered the following were necessary as absolute rights of small businesses:

- due warning (of change);
- personal contact; and
- rights of redress (preferably before change occurs).[22]

Conclusion

15.57 The Committee recognises that a tightening of bank credit assessment procedures was necessary following the excesses of the 1980s. However, it is important that banks do not overreact but continue to lend to sound business that meet normal credit criteria.

15.58 The Committee views with concern the issues raised by small business about the process of 're-visitation', especially in the current economic environment where sudden and unannounced changes to small business financial arrangements could have a dramatic effect on the viability of a business.

15.59 In the process of reassessment of lending facilities to small business, banks should deal fairly with customers by contacting them to discuss the review, providing written notification prior to any changes and offering an appeal mechanism. These requirements are especially important in the current environment where banks are re-assessing all their outstanding loans.

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21 Commonwealth Bank submission to the Industry Commission inquiry into the availability of capital, p. 11.

22 Evidence, p. S2977.

Recommendations

15.60 **The Committee recommends that:**

43. **banks reassess their lending procedures affecting small business to ensure that sound proposals that meet usual credit criteria are funded; and**

44. **in reassessing small business loans banks should:**

- **consult with the customer;**
- **advise in writing any changes prior to them being made;**
- **provide an appeal mechanism against any decision; and**
- **give added emphasis, in the current economic climate, to assisting businesses to manage themselves out of difficulty where some prospects for improvement exist rather than taking precipitate action.**

Business interest margins

15.61 The general issue of interest margins was dealt with extensively in Chapter 6. The additional comments in this chapter relate specifically to interest margins charged to business.

15.62 It was suggested by small business that deregulation resulted in greater competition for corporate business than for small business.[23] One of the indicators of the greater competition at the corporate level was that interest margins were lower for large than for small business.[24]

15.63 There is evidence that small business has been charged greater margins than large business since deregulation. Reserve Bank data provides clear evidence of a differential in the interest rates charged on small as opposed to large overdrafts. (see Table 15.1).

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23 Evidence, p. 1862.

24 Evidence, pp. S1006-10.

TABLE 15.1

RANGE OF INDICATOR RATES ON OVERDRAFT

Year ended June	Less than $100 000	$100 000 and over
1982	13.00 - 14.50	17.00 - 17.50
1983	13.50 - 14.00	14.00 - 16.00
1984	12.00 - 14.50	14.50 - 15.00
1985	15.00 - 15.50	16.75 - 17.75
1986	16.75 - 19.50	16.75 - 18.00
1987	16.25 - 20.50	16.00 - 16.25
1988	15.00 - 18.50	15.00
1989	19.75 - 22.00	19.75
1990	19.00 - 21.75	18.50 - 19.00

Source: Bureau of Industry Economics, submission to Industry Commission's Inquiry into the Availability of Capital, p. 15.

15.64 The Bureau of Industry Economics noted in relation to the data in the Table:

> Following the removal of the interest rate ceiling on loans below $100,000 in 1985, the indicator rate for overdrafts of less than $100,000 has been in its upper limit between 1.5 per cent and 4.25 per cent higher than the upper limit for over drafts of more than $100,000 ... There may be additional loadings for risk premiums and administrative charges that could further widen the average finance gap.[25]

15.65 Further evidence of interest differentials is referred to by the BIE. A study by Holmes and Kent of firms operating in the metal industry showed the average interest rates for small companies were consistently higher than for large companies with differences ranging from 0.3 to 2.9 per cent.[26] On the basis of the studies it examined, the BIE concluded 'an interest gap does exist, that is small business does pay a higher rate of interest'.[27]

15.66 It should not be considered unusual that large business would pay lower interest rate margins than small business. The banks have three broad factors that affect their setting of the margin for businesses:

- industry - risk associated with the industry in which the business operates;
- business - the position of the business within the industry; and
- financial - the financial stability, structure and profitability of the business.

15.67 The banks submitted that within each of these categories a variety of measures were covered in order to obtain a balanced appraisal of the business's risk. Each case was considered on its merits and, when considering a margin, the bank undertook a detailed analysis of factors influencing a business' ability to service its debt obligations and made a risk assessment. Small business generally was considered to be more risky than larger business. One small business representative conceded that banks were not:

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25 Bureau of Industry Economics submission to the Industry Commission's inquiry into the Availability of capital, p. 16.

26 ibid.

27 ibid.

> ... deliberately discriminating against small business, but by the same token I believe that the end result means that small businesses do pay more in the way of interest rates than large businesses.[28]

15.68 The Australian Chamber of Manufactures questioned that higher margins charged to small business could be justified on the basis of higher risk. It referred to a study of manufacturing industry that showed small manufactures were more stable than other small businesses and manufacturing industry generally was more stable than other industries. It considered this evidence proved that higher margins paid by small manufacturers could not be justified on the basis of the inherent riskiness of this sector.[29] It further questioned the need for higher risk margins for small business in the context that most small business loans were secured against property or other assets, while many loans to larger business were unsecured.[30]

15.69 On the broad question of whether small business has been subsidising the large corporate borrowers there was little evidence to demonstrate that this was or was not occurring. The Deputy Governor of the Reserve Bank suggested that it was more a case that the large borrowers were no longer subsidising the small borrowers as they had in the 1970s.[31]

Conclusion

15.70 Deregulation has resulted in small business paying higher margins than large business. There are two main reasons for this:

- the lifting of ceilings on interest rates removed the cross subsidies that favoured those small businesses able to obtain bank finance;
- the lifting of restrictions on the amount banks could lend;
- banks began to price for risk and small business generally was considered more risky than large business; and
- banks began to lend to businesses that previously would have received finance from other intermediaries.

15.71 The Committee considers that banks should review their risk premiums to small business in the light of the stability of some areas of small business and in view of the security over property taken on most small business loans.

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28 Evidence, p. 1749.

29 Evidence, p. S2829.

30 Evidence, p. S1698.

31 Evidence, p. 610.

Recommendation

15.72 **The Committee recommends that:**

45. banks review their risk premiums on small business loans in the light of the lesser risk of some areas of small business and in view of the security over property taken for most small business loans.

Disclosure of margins, fees and charges

15.73 A number of issues were raised about the disclosure of margins and fees and charges:

- that margins, fees and charges be disclosed as part of agreements between banks and small business;
- that comparison of the range of differing products available was difficult; and
- that sudden changes were made to margins and fees and charges without consultation and advice.

15.74 On the matter of margins generally, these tend to be advised at the time a loan is approved and the customer informed of the margin above the prime rate. Each bank regularly advertises its prime or indicator in the media and when these rise or fall the rate applied to a particular customer would rise and fall accordingly but the margin should not change unless particular circumstances apply. Fees and charges also are usually disclosed at the time a product is obtained.

15.75 A difficulty raised by small business was the lack of clarity of the total cost of the loan. It was stated that without the ability to accurately compare the cost of lending facilities between and within banks and other institutions, borrowers could not make informed judgements about relocating facilities. The Council of Small Business Organisations stated:

> ... the plethora of costs and charges applied by or through lending institutions confounds the client's perception of price and is a serious impediment to genuine competitive market activity. It would be a simple matter to require the collation and presentation of all costs and charges in a standard publicly agreed format on recurring documents and statements.[32]

32 Evidence, p. S2976.

15.76 The banks appear to have taken no action to overcome this problem and may benefit from the uncertainty and inability to compare the real costs of their products.

15.77 Standards Australia have developed a draft Australian standard for interest rate description.[33] While this standard was designed to apply to consumer credit, it could equally apply to credit for small business.

15.78 As part of the 're-visitation' process referred to earlier, there have been suggestions that banks have been establishing higher interest rate margins and fees and charges for small business customers. In some cases it was stated that this had occurred without warning.

15.79 The banks have indicated they are prudently adapting their pricing structures to take account of new perceptions of risk. For some borrowers this has meant an increase in margins. While it is legitimate for banks to review accounts and make adjustments, customers should be consulted and advised prior to any changes taking effect. It is important that banks make clear to customers why a risk assessment may have changed.

15.80 The banks indicated that where there had been a deterioration in the loan criteria which applied when the margin was set, any change in the margin would be advised in writing to the customer before the change occurred. However, the Committee is aware from some individual borrowers that this had not been done in all cases. While there may be a system within each organisation for formal notification of the borrower, it does appear to break down at times.

Conclusion

15.81 The Committee considers there should be better disclosure of information by banks to small business borrowers. The following areas require attention:

- that margins above the appropriate bank indicator interest rate, fees and charges be disclosed as part of agreements between banks and small business;

- any changes made to margins above the bank indicator rate, fees and charges during the course of a loan be implemented only following advice to, and in appropriate circumstances, consultation with the customer; and

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33 Draft Australian Standard For Comment, Interest Rate Description - Consumer Credit, Standards Australia, 1 January 1990 (No DR89224:R).

- that a rate for comparison incorporating all costs associated with small business loans be disclosed by banks to customers. The Standards Australia comparative interest rate for consumer credit should be used.

Recommendations

15.82 **The Committee recommends that:**

46. all margins above the bank indicator interest rate, fees and charges be disclosed as part of loan agreements between banks and small business;

47. any general changes made to margins above the bank indicator rate, fees and charges during the course of a loan be implemented only following advice to customers and any changes made on the basis of reviews of an individual customer's circumstances only be implemented following consultation and advice; and

48. a comparative rate incorporating all costs associated with small business loans be disclosed by banks to customers. The Standards Australia comparative interest rate for consumer credit should be used.

Means of redress

15.83 Concern was expressed by a number of small business people about the adequacy of means of redress available to them in cases of dispute with their bank. Incorporated bodies, which include most small businesses, are not able to bring disputes to the Banking Ombudsman. The limit of $100,000 placed on the Banking Ombudsman scheme excludes other small businesses that, because they are partnerships rather than incorporated bodies, may fall within the scheme.

15.84 The chief means of redress available to small business is through the court system. The cost of litigation and the powerful position of the banks in the litigation process were emphasised by small business as difficulties in enabling them to have disputes resolved satisfactorily. Small businesses advised that some of the difficulties they had in legal proceedings with banks included that banks unnecessarily protracted proceedings to ruin small businesses so they could no longer continue legal action and failed to ensure adequate discovery, or had belated discovery. The Committee views these allegations seriously. Similar problems were raised by foreign currency borrowers.

15.85 The Committee notes that the recent decision to extend to small business the coverage of section 52A of the Trade Practices Act concerned with unconscionable conduct will redress some of the disparity that exists between small business and banks in disputes.

15.86 An extension of the Banking Ombudsman scheme to cover small business generally could have a significant effect on the priority given to the consumer case load of the Ombudsman. Commercial matters usually would be more complex than consumer issues, and some could involve significant amounts of money. National Australia Bank expressed the view that the terms of reference of the Scheme would have to be altered for the inclusion of small business as it would not be appropriate in commercial matters to have the Ombudsman's decision binding on the bank but not on the borrower.[34]

15.87 In relation to redress available through the courts, the Committee is aware of an inquiry into the cost of justice being conducted by the Senate Committee on Legal and Constitutional Affairs. This will address issues such as the high cost of litigation.

Conclusion

15.88 The Committee is aware of the difficulties of small businesses in obtaining inexpensive and satisfactory resolution of disputes with banks. However, it can not support the extension of the Banking Ombudsman to cover small business generally. The size and complexity of many small business operations would swamp the Ombudsman's Office at the expense of small consumers. In Chapter 20 where the Ombudsman scheme is discussed, the Committee will suggest the monetary extension of the scheme and the inclusion of incorporated bodies up to this monetary limit. This will give to small business access to dispute resolution by the Ombudsman.

15.89 However, many small businesses will be required to use the court system to obtain redress. In this context, the Committee views the allegations of abuse of process by means of delaying tactics and poor discovery as serious. The courts have powers to ensure that their processes are not abused by any party. The issue of the cost of pursuing litigation is a further issue of concern. The Committee considers there should be an investigation by the Australian Law Reform Commission of the powers of the courts to deal with abuse of their processes and whether there is a need for legislation in this area. The Committee notes that the Senate Committee is undertaking an inquiry into the cost of justice and the Committee will refer the issue of the cost of justice in cases between banks and customers to that committee for inclusion in its consideration.

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34 Evidence, p. 2351.

15.90 In terms of redress available through the courts, the Committee notes the extension of the unconscionability provisions of the Trade Practice Act to cover small business. This will assist in reducing some of the disparity in the relationship between banks and small business.

Recommendations

15.91 **The Committee recommends that:**

49. **the Australian Law Reform Commission examine the powers of the courts to deal with abuse of their processes and consider whether there is a need for legislation in this area to assist the courts to deal with abuse of process: and**

50. **the Senate Committee on Legal and Constitutional Affairs, as part of its inquiry into the cost of justice investigate the issue of the cost of justice in cases between banks and customers. The Committee will refer the information it has taken on this issue to the Senate Committee.**

CHAPTER SIXTEEN

BANKING AND THE RURAL SECTOR

Introduction

16.1 The farming community as an industry sector is dependent on a number of influences peculiar to rural production. Being cyclical in nature, it is subject to external factors which often place the industry under periods of intense pressure. The international focus of the sector and its often adverse trading conditions, the variable nature of farm incomes due to continuing fluctuation in rural commodity prices, the reliance on uncertain weather patterns, and the diversity of rural enterprises in different regions all impinge on efficient rural production. It is a varying mix of these factors which has led to the growth in total farm debt to continuing high levels.[1] The unique nature of farming as a particular type of small business is also due to the prevalence of single family enterprises and the hereditary nature of occupation.

16.2 The risky nature of rural industry requires efficient and competitive banking services as an essential factor in production. This is because the vulnerability of farm businesses to the external factors listed above can often lead to the need to re-finance loan facilities or to the injection of additional capital at irregular intervals to ensure that they survive in the long term. Banking practices must continue to take account of these eventualities.

16.3 A number of problems in the relationship between banks and farm borrowers arose during the course of the inquiry. Submissions received dealing with the bank-farmer relationship consisted of complaints by rural borrowers about their treatment by the banks which ranged from allegations of failure to notify changes to interest rates to forced exiting from farm properties. As a result the Committee sought to examine the complaints of rural borrowers so as to assess whether this sector was subject to excessive lending costs and unreasonable lending practices.

16.4 Problems experienced by farmers when borrowing from banks were raised by the National Farmers Federation (NFF), the NSW Farmers' Association and the Department of Primary Industries and Energy (DPIE). Representatives of the NFF also appeared as witnesses to elaborate on the issues they had raised. As indicated in paragraph 1.17, the Committee travelled to Nyngan and Dubbo in July 1991 to take evidence on the relationship between banks and rural borrowers. A public meeting was held in Nyngan to allow those who were unable to appear as

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1 Reserve Bank of Australia *Bulletin* February, 1991, S29.

witnesses to express grievances that they might have with banks. The Committee also travelled to Charleville in October 1991 to examine financing provided to rural borrowers by pastoral houses. Evidence was taken from individual borrowers, rural counsellors, the four major banks, pastoral companies and Queensland Industry Development Corporation (QIDC).

16.5 While banking practices in Nyngan in NSW provided a case study for the banking inquiry, evidence was taken from borrowers from other regions to provide a representative perspective of farmers and their relationships with banks. Following public hearings follow-up questions were put to the banks on aspects of rural borrowing which needed further clarification. As with other categories of borrowers the Committee also wrote to the relevant banks on behalf of aggrieved clients seeking comments on individual cases.

16.6 An inquiry was conducted into the credit related problems experienced by NSW farmers in 1987 which focused on a wide range of issues.[2] In the context of the banking inquiry the Committee was able to gain an overview of the issues surrounding rural lending by investigating the form and method in which finance was provided to farm borrowers. Where appropriate the Committee has made recommendations to ensure that a more efficient banking system is delivered to this sector.

16.7 In this chapter the term 'farmer' has been used in the Committee's discussion of the banker-consumer relationship in the rural sector. Accordingly, the term can relate to individual farming activity, company farming arrangements and similar enterprises.

Availability of credit in the rural sector

16.8 Prior to deregulation, qualitative guidelines issued by the Reserve Bank ensured adequate funds were made available to the rural sector. The lifting of ceilings on interest rates and volume restrictions following deregulation meant banks no longer sought out those who had the greatest repayment capacity and least risk. The Committee sought to determine the impact this unrestricted availability of funds for borrowers had on the rural sector.

16.9 Evidence indicated there is still an availability of funds for farm lending despite the level of rural indebtedness. The availability of finance in the short and medium term has been adequate and continues to be so. The four major banks indicated that, providing a farmer can demonstrate viability, requests for loan assistance will be positively considered with no restrictions on the availability of funding. Both ANZ and NAB indicated they had a very healthy rate of growth in their rural lending with NAB lending levels having increased by 11 per cent over the

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2 *Rural Credit Inquiry.* Report to the Minister for Consumer Affairs and Assistant Minister for Health. Chairman: Clement Mitchelmore. (NSW 1987).

last year.[3] However, the Commonwealth Bank stated its lending volume had dropped off considerably as a result of decreasing demand in the present climate.[4] Westpac also pointed out that with the economy in recession there have been fewer applications for finance. A broader picture of rural lending is provided by the Reserve Bank which publishes annual figures of the total amount lent by the banks to this sector.[5] These figures illustrate that banks generally have maintained overall lending levels to farm clients.

16.10 While the banks had indicated that money was available for lending to the rural sector based on sound lending practices, some borrowers claimed too much money was available which had been aggressively marketed. A number of individual borrowers in Nyngan and Dubbo had indicated that the banks were 'throwing money' at them. The question of aggressive marketing of loans as a result of greater and more effective competition in the financial system certainly seems true of the Commonwealth Bank lending practices in Nyngan as discussed below. In this situation one witness told the Committee many bank managers were sent to 'sales training schools' and were 'ego boosted' to go out and lend as much money as possible.[6] Although three of the major banks had refused finance the Commonwealth Bank was extremely willing to provide it.[7] However, while the general impression was that the banks were increasingly marketing loans to the farming community it was not to the extent that had occurred in Nyngan.

16.11 In its submission the NFF stated that 12 per cent of farmers surveyed had changed their bank within the last 5 years. The reasons for these shifts were largely attributed to interest rates and charges.[8] The Committee found a number of rural borrowers had changed banks when unable to obtain the finance sought from their normal bank. While being free to do this, it raises the issue of these borrowers not being prepared to accept the assessment of their borrowing capacity by their normal lenders and, by changing banks, are inclined to rely more heavily on their own judgements. Additional to this is the cost of changing banks which can be considerable as a result of state government charges and bank re-establishment fees. In seeking to determine the causes of rural indebtedness the Committee took the view that fiscal responsibility must be shared between borrower and lender. In this case if rural borrowers are prepared to take risks of this nature then the possibility of future difficulties in servicing their loans must be expected.

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3 Evidence, pp. 2888, 2892.

4 Evidence, p. 2844.

5 Reserve Bank of Australia *Bulletin* February, 1991, S29.

6 Evidence, p. 2652.

7 Evidence, p. 2701.

8 Evidence, p. S1924.

Banking products provided to rural borrowers

16.12 The nature of the farm as a unique type of small business with different producers having different financial requirements means a range of flexible and convenient lending products is essential. The Committee was interested in the nature of documents and services provided specifically to rural borrowers and requested examples of any material made available to assist them in their financial decisions. The banks were also questioned at length about this aspect of rural borrowing.

16.13 As with other categories of borrowers a diverse range of banking products have been made available to rural clients in the deregulated environment. It was also revealed by the banks that they were attempting to assist this sector through the development of special products which included the initiation of a number of strategies to provide improved support to agribusiness customers.

16.14 All banks indicated they had established specific rural management accounts to meet the needs of the farm sector. The National Australia Bank listed a number of products it had set up to assist this category of borrowers.[9] Its Farm Management Account is a single account providing working capital and a line of credit which accommodated on-going borrowings and paid interest on seasonal swings into credit. Its aim is to consolidate accounts to provide more cost-effective and easier financial control. NAB also has a Cash Flow Budget Program which consists of a software package in rural branches allowing farmers to prepare a cash flow budget for their farms for better management decisions and monitoring purposes. A Gross Margin Service of 1500 Gross Margins covering a wide range of activities across Australia also assisted NAB farm customers to evaluate various options for their businesses. This database can be used for comparing farms to a regional average as well as assessing the farm's long term viability.

16.15 In recognition that farming was a small business with special needs, the Commonwealth Bank extended its range of publications in 1988 to include a booklet 'Your F.A.R.M' (Finance, Agriculture and Rural Management). This booklet is in its second reprint and the bank has distributed more than 40,000 copies since 1988.[10] The ABA also provided the Committee with a publication titled 'Financing Your Farm' designed to assist farmers in financial planning and management. These examples are indicative of the diversity of products now being provided to the rural sector by the banking industry.

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9 Evidence, p. S463.

10 Evidence, p. 2819.

Conclusion

16.16 Banks have produced a wide range of products to meet the needs of the farming community but widespread awareness of their availability may be lacking. Banks, government departments and relevant industry bodies should ensure that farmers are made aware of the availability of these products.

Recommendation

16.17 **The Committee recommends that:**

51. the banks ensure that farmers are made aware of the full range of products they have available by ensuring bank staff are familiar with the products and have the relevant expertise to advise customers on their application; and

52. the Department of Primary Industries and Energy, financial counsellors, the National Farmers Federation and the State based organisations and government departments provide information to the rural sector about these products including independent assessments of their usefulness.

The delivery of banking services to the rural sector

16.18 Deregulation allowed for the development of innovative financial products for farm enterprises. However, the delivery of these products and the quality of service at the point of delivery is also of importance. To assist in this process, banks in association with established branch networks have decentralised expertise to particular geographical regions. While there are obviously variations in such arrangements, banks have endeavoured to build relevant expertise by arranging branches within regions and zones which have a specific rural focus. With extensive rural branch networks borrowers are no longer tied to a bank by a lack of nearby alternatives. The devolution of authority has also meant that the decision making process is kept as local as far is practicable.

16.19 However, the Committee was made aware of the concerns about the closure of bank branches in farming communities. The closure of the Ivanhoe branch of the Commonwealth Bank was given as one example.[11] It was pointed out that as a result of commercial decisions by banks, the closure of rural branches will become a reality. The entry of foreign banks did not lead to an extension in branches in rural areas as was anticipated. Branch closure is discussed further in Chapter 19.

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11 Evidence, pp. 1024-5, 1030, 1037-9.

16.20 The ABA referred to the banks' recognition of the increasing sophistication of agriculture by forming agribusiness management structures which provide specialist advice and assistance.[12] These complimented and assisted the work of the rural branches. Westpac stated that it had established a national agribusiness centre which supplies and constantly updates its rural branch managers with current farm budget guidelines and commodity outlook information. This ensures that staff have up-to-date information on the present rural situation and outlook.[13] Similarly, NAB indicated it's rural market development department focuses specifically on rural product development and the delivery of services to farm customers.[14]

16.21 Another important part of the delivery process is the provision of staff who have an appreciation of the needs of rural borrowers. Since banks had been involved in the rural sector for many years this has allowed the banks and their staff to develop an understanding of the sector's need. However, with the increasing development of agribusiness the level of expert advice needed must by necessity become more sophisticated.

16.22 Banks have demonstrated that, where practicable, rural branches are staffed with personnel who are themselves from country areas and already have an understanding of rural life. This is achieved by actively recruiting graduates with an agriculture, science or related background who together are able to form rural finance teams. In some instances, these teams visit and provide banking expertise on the farm itself. For example, NAB has established Rural Finance Teams made up of an experienced rural banker and an agricultural graduate who, equipped with *portable computers, can analyse a farmer's financial performance and tailor a* financial package in the farm office.[15]

16.23 An important part of this process is the specific training of staff in rural lending requirements which the banks have been undertaking for some time. The Commonwealth Bank described its arrangements with the Tocal Agricultural College which allowed staff to learn about farm issues and spend time on farms so that they could appreciate more fully the rural conditions in which they work.[16] Westpac indicated that it had pioneered the establishment of the agribusiness diploma in conjunction with the University of New England.[17] Training in the ANZ Bank has been designed in conjunction with several agricultural colleges, notably the Marcus Oldham College in Victoria.[18]

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12 Evidence, p. S27.
13 Evidence, p. 2849.
14 Evidence, p. 2869.
15 Evidence, p. S461.
16 Evidence, p. 2819.
17 Evidence, p. 2849.
18 Evidence, p. 2888-9.

16.24 The sponsorship of a number of groups which concentrate on farm management, planning and productivity has also been undertaken by sections of the banking industry. Groups such as Farmfacts and Farm Advance, which help farmers increase financial and farm management expertise, are notable examples of such sponsorships.[19] The support of many local, regional, state and national field days, seminars and conferences and projects such as the land care movement are also attempts by the banks to assist the rural sector.[20]

16.25 The Committee is aware of the increasing role of financial counsellors in rural areas. These counsellors are becoming an important part of the negotiation processes between banks and individual borrowers.

16.26 The Commonwealth Government initiated the Rural Counselling Program in April 1986 to provide financial counselling to assist farmers in times of rural crisis. The program is in a state of continual expansion both in terms of numbers and in extension into rural areas to reach more farmers. The project is now a permanent program with on going Commonwealth Government funding. The Commonwealth Government provides 50 per cent of the cost of each counsellor. Some States provide funding of up to 25 per cent with the remainder funded by the local community group. Basic to the program is the use of Local Advisory Groups to employ the counsellor and provide local administration. It is a community orientated project with the group being the direct employer which in turn is supervised by DPIE. Reports are made six monthly, both financially and statistically, to DPIE and an annual report is produced. The initial thrust of the program was to assist those in financial trouble but the program has also developed an important role in the prevention of rural crisis.

16.27 In Nyngan evidence was given by Ms Fran Rowe, a rural financial counsellor from the Lachlan Advisory Group, Tottenham, NSW. The Group which she represented had listed amongst its sponsors the four major banks and the State Bank of New South Wales (SBNSW) leading to the criticism from a few borrowers that the group was only the mouthpiece of the banks in some of the counselling activity. Some borrowers implied that the counsellors assisted the banks in their endeavours to persuade farmers to exit their farms reducing the possibility of any confrontation taking place. No evidence demonstrated that this was the case. Furthermore, Ms Rowe indicated that bank sponsorship of the Group was necessary for financial reasons.[21]

16.28 The counsellor scheme was preceded by a pilot scheme by the ABA and the NFF on farm mediation. This is now the Farm Assessment Scheme under which farmers in difficulties can have their situations individually assessed by agricultural consulting and financial specialists. It runs along side the Rural Counselling Program.

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19 Evidence, p. 2870.

20 Evidence, pp. 2849-50.

21 Evidence, pp. 2680-1.

16.29 A range of financial advisory services are now available to rural producers. As with other sectors, it is important to distinguish between financial counselling services as described above and the variety of other financial advisers. These advisers may be accountants, solicitors, or individuals who claim to have specialist knowledge of rural affairs. Clearly it is in the best interest of the rural consumer in seeking financial advice to satisfy him or herself that such advisers are appropriately qualified.

Costs involved in borrowing for agricultural purposes

16.30 As with other sectors, the cost of pricing financial products for the rural sector is a complex mix of factors including the cost of funds, the cost of administering the funds and a component for bank profit.

16.31 Banks set interest rates by assessing the individual risk of the rural borrower with individual bank managers having discretion as to the rates to be charged to specific customers. While the impact of high interest rates was a common theme, the risky nature of lending means that the impact on the rural sector of pricing for risk was also substantial. The charging by banks of margins over their prime rate relative to the risk involved is one of the key means of assessing the costs to the rural sector of obtaining credit from banks and whether it is under reasonable terms. The issue of bank margins was examined to determine the current factual situation and to what extent complaints have been justified.

16.32 The NFF noted that the average interest rate margin charged to farmers appears to be about 1.5 to 2 per cent.[22] While this provides an overview of margins applied, the Committee was aware of instances of very high and significant increases, in margins. Banks indicated they provided finance to the rural sector at the same relative margins as applied for other comparable lending. In this way it was argued that the range of rates reflecting risk in the rural industry was no different to any other industry.

16.33 The NFF also stated:

> The increases do not reflect a significant increase in the risk of loss of the principal sum loaned by the bank, and would appear to reflect instead other factors within the banks. While the debt level is rising, the remaining equity is still very high and the debts are secured by fixed real estate assets.[23]

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22 Evidence, p. S1895.

23 Evidence, p. S1898.

The point has been made that deregulation and the ability to price for risk has shifted the burden from the banks to the rural borrowers. As banks reserve the right to alter the margins it is argued that this has been done in response to factors unrelated to the risk such as losses from other categories of borrowers and uncertain market outlooks for rural commodities.[24] Related to this is the allegation that farmers, amongst others, are being forced to subsidise reduced bank profitability caused by the bad debts of other categories of customers.

16.34 Variation in interest rate and bank margin policies has placed a greater burden on borrowers in the rural sector. This is heightened by the reassessment of the financial position of individual farms. Where the financial position of the farm has deteriorated, some banks have adjusted the interest margin to take account of a higher level of risk. The contention is that banks have either requested additional security for existing loans or increased interest rate margins after 'revisiting' farm clients. Banks were asked to comment on this issue in writing to the Committee. They indicated that loans were subject to periodic review for all categories of borrowers. The practice was followed regardless of the type or size of the business and the farming community had not been singled out for reassessment.

16.35 The Commonwealth Bank stated that increases in security or change in interest rate margin would not only be an infrequent occurrence but that the bank had issued a policy statement that such action should not be applied to rural clients who are apparently in financial difficulty. When such a review occurred ANZ would consider the latest financial accounts of the business, whether management had met its financial obligations, the value of any security held by the bank and the outlook for the business in question. Westpac's key considerations included realistic current and future cash flow streams, history of operations and updated financial position, profitability, economic risk, industry risk, value of security and management quality. It was also stated by the banks that any changes in margins as a result of reassessment were notified in writing.

16.36 Addressing the question as to why banks do not reduce interest rates to farmers who are in difficulties, ANZ stated:

> The simple answer is that the market does not allow it. In fact, there are occasions when the bank offers a rate reduction to help a farmer survive a temporary difficulty. The result is invariably an outcry from neighbouring farmers who are not so favoured. They see no reason why their successful operations, paying the market rate of interest, should subsidise their neighbours.[25]

The Committee is not persuaded by ANZ's argument.

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24 Evidence, p. S1895.

25 Evidence, p. S543.

16.37 Other complaints focused on the manner in which the banks go about varying interest rates and notifying borrowers. The ABA has indicated it intends to review it's disclosure standard for the notification of fees, charges and interest rates for borrowers. However, complaints were made that banks sometimes change loan arrangements including the altering of fee structures and interest rates with little or no advice to customers.

16.38 The Committee was told that banks engage in the art of deception by making things so difficult that farmers could not understand changes made which in turn hindered them in assessing their financial position. Borrowers must be equipped to know what variations have been applied, understand their impact on their servicing requirements and act to manage the risk in their loan commitments. They should also be in a position to compare costs of borrowings from various banks at the outset so as to assess the real costs of credit. Similarly, banks would be in a better position to make commercially sound credit risk assessments if there was full communication between borrowers and lenders.

16.39 Evidence indicates that banks have failed to provide simplicity and transparency in documentation. Communication between banks and rural borrowers is still insufficient. While banks have increased rural training for staff, improved written communication between borrowers and lenders would provide benefits for both. This need for change is addressed in relation to the draft Code of Practice governing the bank-farmer relationship discussed below.

16.40 Whilst the majority of rural producers have financial expertise and knowledge, some farmers often do not have the expertise to understand intricate financial detail. They have tended to take banks on 'trust'. This 'bush culture' places them in a vulnerable position in negotiating financial matters. Even in the deregulated market, farmers have continued to take banks on trust.[26] In addition, as the NFF has argued, the implication is that advice is offered in their best interests which must also conflict with an aggressive lending policy.[27]

16.41 While it is not just the rural sector that accepts bank staff as skilled financial advisers, an imbalance was said to exist between banks and rural borrowers. Some witnesses gave the impression that they saw their roles as rural producers and had little or no interest in the financial management side of the business. One borrower said:

> We were trusting the banks all the way because we had a job - to grow the cotton. Our job was to grow this cotton.[28]

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26 Evidence, pp. 2651, 2685, 2749.

27 Evidence, p. S1895.

28 Evidence, p. 2749.

Banks are, therefore, in a position to exercise significant influence over the financial position of rural customers. Furthermore, farmers are often tied to a particular bank for a long period of time during which the balance of power in the bank's favour can be used regularly for different reasons. As indicated, bank charges and fees may be imposed at the bank's discretion and interest rates and margins may be adjusted by the bank. Similarly, while misjudgment of prediction in interest rate swings can be attributed to both the bank and farmers, banks are still in a better position to judge than the farmer.

16.42 The NSW Rural Credit Inquiry recommended that farmers be educated to improve both their business skills and their awareness of their rights relating to credit transactions.[29]

Conclusion

16.43 The Committee has concluded that due to the trust held in banks, some farmers did not seek additional advice from solicitors, accountants, rural counsellors or other relevant professionals about their finances. While this is now changing, farm organisations should encourage farmers to seek opinions from other financial advisers.

Recommendation

16.44 **The Committee recommends that:**

53. farm organisations encourage farmers to seek opinions from appropriately qualified financial and other advisers.

Rural indebtedness and bank foreclosures

16.45 The first step in avoiding bank foreclosure and repossession is an accurate assessment of credit worthiness at the time of the loan application. An important question arises concerning the processes used by banks in assessing the credit worthiness of people living in rural Australia, in particular, whether bank staff counselled customers about over commitment.

16.46 A commonality of factors in assessing credit worthiness was indicated by the major banks. These included varying weights given to such factors as viability, capacity to repay, debt to equity ratios, security offered, ability to produce viable cash flow forecasts, expertise of borrower and intention and reliability to repay. It was indicated by the banks that the processes in determining creditworthiness had not changed significantly over the years and were similar to lending processes to non-rural Australia but with some special features. There was

29 Mitchelmore Report op cit Chapter 13.

also evidence that the banks now placed weight on economic information, Department of Agriculture publications and the opinions of district agronomists. It was pointed out that the advent of trained rural advisers with agricultural backgrounds also made for a more accurate assessment of credit worthiness.

16.47 In providing a lending facility the banks attempt to keep the decisions as localised as possible with what could be described as various levels of credit assessment. The first level is the local manager who has a discretion up to a certain amount to approve loans. Above that level, the discretion to approve rests with a regional or zone credit manager and above that with central administration for the State. Threshold levels of discretionary approval vary from bank to bank and within banks from State to State. One bank indicated that local offices are empowered to approve in the vicinity of 90 per cent of all lending applications.[30]

16.48 While farmers faced an interview with the banks prior to a loan approval the extent to which detail and explanation is provided to the borrower is also important. ANZ indicated that their managers or lending officers would explain the relevant models and cash flow projections. Some economic forecasting was also included and explanations given as to the likely effects of changing interest rate. However, the bank also indicated:

> The degree to which that [detail] is explained would depend, in crude terms, on the size of the proposition and its complexity. We have a series of what we call rural service advisers, who are specialists, and they tackle the more complex deals. The amount of information we put forward to an individual customer would vary, to some extent, on the complexity of the deal.[31]

16.49 A number of cases were examined where farmers had exited or were about to exit their properties. Complaints here focused on the action of banks in forcing borrowers off the land. It was claimed that banks actually wanted farms to fail. The argument was that banks would lend to marginal propositions aware that they would fail allowing the bank to acquire the property which it would resell later at considerable profit.[32] This was rejected by the major banks. It was indicated that sometimes the criticism actually worked in the other direction. The bank would really prefer the rural borrower to come to an early decision to sell and quit the property while the farmer still had some equity. However, pressure was applied from some rural borrowers to allow them to hang on until property values rose again and then they could sell.[33]

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30 Evidence, p. 2873.
31 Evidence, p. 2891.
32 Evidence p. 2708.
33 Evidence, p. 2893.

16.50 Allegations were also made that banks unreasonably refused to negotiate when a farmer had defaulted on his loan. Farmers had attempted to negotiate but it had often come to nothing. This was even the case where the farmer had gone to regional or central administration. It was argued that assistance was given to exit the property but no real assistance was given to try to keep the farmer going. However, all banks strongly emphasised that foreclosure was the last option with banks involving independent assessors including financial counsellors before this point was reached. The banks indicated that by the time they decided to foreclose any equity that was in the deal had disappeared. They argued that before foreclosure was instigated many options were explored such as loan restructuring and in certain cases one bank even foregoing some of the debt to allow the farmers to become viable.[34]

16.51 The State Bank of South Australia has adopted an alternative approach to assist farmers who were unable to service debt.[35] In 1988 the bank instigated the Individual Farm Trust Scheme under which the ownership of the farm is placed in a trust with the farmer and the creditors as unit holders. The farmer is given the day to day management of the farm and is paid a wage by the trustee with any surplus income being used at the end of each year to buy back units on behalf of the farmer from other unit holders. The scheme was set up for a five year period to allow farmers to farm themselves out of debt. As the scheme has not completed it's first five year cycle, assessment of its success has not been made.

Conclusion

16.52 The Committee has concluded that claims of widespread bank foreclosure in rural Australia for other than commercial reasons are overstated. However, in a number of cases it was clear that some banks were taking unreasonable action to force farmers in default of their loans to leave their properties. Some banks were also reluctant or simply refused to negotiate with rural borrowers facing financial difficulties. In these cases banks need to adopt a more sympathetic approach so that these farmers can attempt to trade out of their difficulties rather than being forced out of the industry.

Pastoral companies as providers of finance

16.53 As indicated in paragraph 16.4, the Committee examined the role of pastoral companies as providers of finance to the rural sector. Under the Financial Corporations Act pastoral companies provide balance sheet statistics to the Reserve Bank but are not supervised by it. These companies have played a significant role in the provision of finance to the rural sector with current lending to rural producers at December 1990 amounting to $555 million.[36] The Queensland

34 Evidence, pp. 2857-58.

35 Evidence, p. S2854.

36 Reserve Bank of Australia *Bulletin* February, 1991, S20.

Industry Development Corporation was also included in the Committee's examination which, although not a pastoral company, has 70 to 80 per cent of its lending to the farming community of Queensland.[37] The QIDC abides by the capital adequacy provisions of the Reserve Bank but reports to the Queensland Treasury.

16.54 Pastoral companies provide finance to the rural sector with an interest rate differential that at the moment is about four per cent above that provided by the banks. This higher rate of interest is a result of the source of funding and the risk given the nature of the security. While pastoral companies are providers of finance to the rural sector, the relationship between pastoral companies and their clients is of a different nature to that between banks and rural borrowers. This is because pastoral companies deal almost exclusively with these borrowers, provide a broad range of other services to their clients and do not provide the full range of banking facilities which is provided by banks. Because they are dealing with rural clients on a more regular basis pastoral companies would argue they are closer to their clients than are the banks. In addition to the provision of finance and deposit facilities, the range of services for reward include:

- acting as broker in the sale of wool;
- acting as livestock agent handling all aspects of purchasing and sales;
- rural real estate agency;
- contract shearing;
- insurance agency;
- rural merchandise supplier; and
- specialised services such as a commercial blood stock database service.[38]

16.55 Complaints about pastoral companies were similar to those raised about banks. These included failure to show interest rate charged on statements, failure to notify borrowers of changes in margins, forced exiting from properties and unreasonable request for quick repayment of debt. In one instance, a borrower claimed that he had received a financial statement from QIDC written on the back of a business card.[39] The Committee also heard that QIDC, by threatening bankruptcy, had demanded that one of their clients, who was in arrears, sign a mortgage over his interest in a property that was not part of the borrowing

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37 Evidence, p. 2457.

38 Evidence, p. 3896.

39 Evidence, p. 3871.

arrangement. The Corporation had also demanded that the client's wife sign a mortgage over her interest in the property even though she was not a party to the original loan facility.[40]

16.56 The nature of the particular relationship between pastoral companies and their rural clients and the range of additional services provided was described by a representative from Elders Ltd in the following terms:

> It is important to appreciate that these services are complementary and traditionally part of a client's expectation of pastoral companies' total service centre concept. Importantly, it means that within the pastoral company organisation a considerable amount of experience, knowledge and understanding has developed both of the rural community generally and of particular clients ... This has meant that the pastoral companies have traditionally been in a position to accept types of security such as stock mortgages and wool liens and crop liens or to lend unsecured on occasion with confidence where traditional banks and finance companies would not have the necessary degree of understanding of the client.[41]

Similarly, Dalgety Farmers Ltd said that approximately one-third of Dalgety's seasonal lending assets were unsecured and that, in other cases, security would take the form of stock mortgages and wool liens and not generally mortgages on property.[42] However, this special relationship between pastoral companies and rural borrowers has also led to additional allegations about these companies as providers of finance.

16.57 While pastoral companies play an important role in the buying and selling of stock for their farm clients, it was alleged by some borrowers that they failed to provide adequate documentation of the transactions involved. Allegations were also made that livestock was sold in some cases at a lower price than that which the borrower could have obtained. Given that these companies are also providers of finance the issue of conflict of interest arises. A number of witnesses claimed that some of the pastoral companies had made allegations about stock mishandling to the Police Stock Squad which were subsequently found to be false. However, it was asserted that since prime securities for finance were over livestock which is both perishable and transportable, it was inappropriate for pastoral

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40 Evidence, p. 3879.

41 Evidence, pp. 3896-7.

42 Evidence, p. 3913.

companies to delay the exercising of their legal mortgagee rights unnecessarily when, for example, the livestock was suffering from inadequate attention. As most pastoral companies also sell insurance one borrower indicated that he was forced to sign an insurance policy with the company that had provided him with finance.

16.58 With the downturn in the rural sector, the continued survival of pastoral companies was another issue that was raised. It was alleged that one pastoral company had taken unreasonable action to secure possession of properties and coerce some borrowers into selling. This was despite the fact that serviceability of loans had been demonstrated to the financier. When questioned about the role Elders Ltd intended to play in the pastoral industry in the future, it was stated:

> We see seasonal financing as a fundamental role of a pastoral house and there are no plans, current or future to terminate that service.[43]

Conclusion

16.59 The Committee was concerned to find that the special nature of the relationship between pastoral companies and government business enterprises such as QIDC and their rural clients had led to allegations of unreasonable behaviour by these financiers. It was concluded that the claims by borrowers were justifiable in some cases. As a result, the Committee believes that the lending policies of the pastoral companies should be revised to take account of sound business ethics.

16.60 The Draft Code of Practice relating to the bank-farmer relationship should be applied, with appropriate amendments, to the relationship between pastoral companies and rural borrowers.

Addressing the imbalance between lenders and borrowers in rural areas

16.61 Conflicting evidence from the rural sector and banks on a number of issues was received during the inquiry. The imbalance between banks and borrowers generally fell in favour of the banks who were in a stronger position in terms of financial expertise. However, it is emphasised that the farming community must also accept the fiscal responsibility for it's own decisions.

16.62 The Committee sought to correct the imbalance between banks and borrowers. A number of suggestions were canvassed which can be summarised as follows:

- Recognising that a significant cost of borrowing is the fees involved in establishing a loan, the NFF recommended that the Federal Government take action to remove all Federal and State

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43 Evidence, pp. 3903-4.

charges imposed on loan or mortgage establishment and registration;[44]

- Legal aid should be expanded providing access for farmers. Legal aid is provided in co-operation with the Commonwealth, state and territorial governments and it is doubtful whether large amounts of money necessary for farm litigation matters would be made available for such purposes;

- Reference was made to 'Settlement Week' organised by the Law Society of New South Wales in cooperation with the Attorney General's Department, the NSW Bar Association and the Law Foundation. 'Settlement Week' is designed to reduce court delays whereby mediation rather than arbitration or litigation is used to settle disputes out of court. Mediation as a distinct process is voluntary and the mediator who is an independent person does not impose a result but rather helps the parties reach their own settlement. The parties have to agree to go before the arbitrator although they do not have to agree to the decision. Settlement Week covers a wide range of matters and does not only relate to banking disputes;

- A suggestion for a two year rural and small business debt moratorium was supported by those present at the open meeting held in Nyngan. The implications of a moratorium could be considerable given it is unclear whether this would apply to interest repayments and include business enterprises that were still trading profitably; and

- The role of the Banking Ombudsman is discussed in Chapter 20. While the scheme has a limited application it was suggested that the terms of reference of the Banking Ombudsman should be extended to include the rural sector. The scheme, which is still in its early stages, was set up on a trial basis and to cover certain cases only. As a result there is still uncertainty about the type and number of claims with which the Banking Ombudsman should deal.

16.63 While these suggestions have been raised as possible solutions to the difficulties in the bank-farmer relationship, it was considered that they do not go to the heart of the problem. Difficulties in the bank-farmer relationship include problems of communication, negotiation and the provision of information. It is for these reasons that the Committee has welcomed the Draft Code of Practice on the bank-farmer relationship.

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44 Evidence, p. S1899-1900.

16.64 The proposal for a code of practice has been an issue between the NSW Farmers' Association, the NFF and the ABA since the mid 1980's when concerns about the calculation and quotation of effective interest rates were raised with the ABA. It was proposed that this code would not involve regulation but would require a uniform method of disclosing interest. Ideally, it should provide for a standard calculation of a comparison rate for all contracts and include the disclosure of that rate and all bank charges on statements thus increasing the transparency of bank decision making.

16.65 The Committee notes the timeliness of the announcement of the ABA's Draft Code of Practice made while the Committee was taking evidence in Dubbo. The Code relates to farm finance, including leases and commercial bills. A particular feature of the Code is the inclusion of the 'effective interest rate' for comparison purposes. It provides for the reopening of agreements which are unjust, enforcement of loans and security for loans (including repossession and sale) and dispute resolution. The ABA also indicated that it would release educational material to enable farmers to calculate their own effective rates and, if desired, to include fees and charges in the calculations using their own assumptions.

16.66 Written advice was received from both the NSW Farmers' Association and the NFF regarding a number of deficiencies they perceived with the Code. Some of the problems identified that:

- the Code includes the disclosure of three different interest rates which will create problems for clients when endeavouring to compare products;
- the definition of effective interest rates does not incorporate other charges imposed by the bank in addition to interest rate charges. Distinction is also not made between the interest rate component and fees component of the loan;
- the Code does not include the requirement that farmers be notified of changes to their margins and/or additional fees that may be introduced;
- the loan offer does not include the circumstances under which a bank would alter interest rates, margins and fees;
- there is no requirement to regularly print interest rates on bank statements;
- an undertaking by banks not to introduce any new fees that have not been detailed is excluded;
- the requirement that the disclosure of interest rates and other charges be in writing is excluded;

- the legal right to have an unjust contract reopened already exists and is unnecessarily included in the Code;

- detail as to how the Dispute Resolution mechanism is to work in practice is excluded;

- guidelines for the managed exiting from farm properties acceptable to both the banking industry and the farming community is not included; and

- the Code excludes provisions relating to its enforcement.

Conclusion

16.67 The Committee considers that a code of practice governing the bank-farmer relationship is a worthwhile concept. Properly developed, it has the potential to alleviate many of the difficulties experienced in farming communities. In particular, it provides the opportunity for farmers to obtain a better understanding of what banks are offering when providing a lending facility.

16.68 However, the existing draft Code of Practice is deficient in many respects. In particular, it lacks detail about disclosure, dispute resolution and guidelines for borrowers exiting properties. In addition the pastoral companies are not included in the existing draft Code. These deficiencies need to be rectified.

16.69 The need for wider consultation in developing the draft Code is required. Such consultation should occur between representatives of the banking industry and the rural sector. As with other codes, the Trade Practices Commission should be involved in the consultative process and provide final authorisation. Once implemented the Code should be reviewed on a regular basis.

Recommendations

16.70 **The Committee recommends that:**

54. the existing draft Code of Practice on the bank-farmer relationship be re-examined in consultation with the ABA, NFF, State farming associations, DPIE, rural counsellors and the Trade Practices Commission. The final code should be authorised by the TPC;

55. bi-annual reviews of the Code of Practice governing bank-farmer relationships be undertaken to ensure the Code is achieving its original purpose; and

56. the Draft Code of Practice relating to bank-farmer relationship be amended to include pastoral companies and government business enterprises conducting similar business.

Rural finance in Nyngan

16.71 As indicated in paragraph 16.4, the lending policies of the Commonwealth Bank in the town of Nyngan were examined in some detail due to the number of complaints received about the banking practices employed in the branch.

16.72 Nyngan is a sheep-wheat district in western NSW although it is considered to be marginal country for wheat production. Nevertheless, as a result of the relative cheapness of land and a deliberate expansionist campaign based on information provided by the NSW Department of Agriculture, Nyngan was targeted as a new growth area in the 1980s. The Commonwealth Bank joined this push for growth by adopting an aggressive lending policy. However, the Bank also attributed these more aggressive lending practices in Nyngan to the impact of deregulation.[45]

16.73 The Committee's attention was drawn to the unorthodox procedures employed by the manager of this Commonwealth Bank branch, Mr Littlehales, between 1982 and 1986. It was alleged that Mr Littlehales' policies, supported by the bank's State administration, were responsible for many rural borrowers overcommitting themselves, leaving them with massive debts. Two major criticism of the branch's lending practices concerned the apparent aggressive nature of the lending in terms of volume and the unorthodox procedures used by the manager.

16.74 Borrowers claimed that money was being marketed to such an extent that it was being 'thrown' at them. As a result, the impression developed that obtaining money from the Commonwealth Bank in Nyngan was relatively easy.[46] Borrowers stated that one reason for not questioning the amounts of money being loaned was the banks previous conservative reputation. The extent to which the push originated with the bank itself or the particular manager is unclear. At best it could be explained by a combination of the bank's lending power and the manager's aggressive marketing strategy.

16.75 Mr Littlehales was appointed to the Nyngan branch in 1982. While he had not previously been a manager he had worked as a senior loans officer for the bank. Prior to joining the Nyngan office, he completed the Commonwealth Bank's course entitled, Individual Commitment to Excellence in Selling Program (ICES) which contained a provision for bank staff being rewarded for winning new business.

16.76 It was alleged that a number of unusual lending practices were employed by Mr Littlehales. These included conducting business over the bar of the Overlander Hotel in Nyngan; requesting that cash flow documents be submitted in pencil; alteration of cash flow documents submitted; refusal of access to personal

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45 Evidence, p. 2843.

46 Evidence, p. 2682.

documents held on files by the bank; property being deliberately overvalued; and little regard to the security offered for a loan. These allegations were denied by Mr Littlehales.

16.77 An internal bank news sheet said of Mr Littlehales:

> He set up an Action Plan to achieve a minimum of 400,000 points with the main thrust being rural lending and the qualification that the total business would come from Westpac and NAB clients. The result: 1,228,083 *points - from Westpac, NAB and ANZ clients.* Bob assures us that this is not a one-off result.[47]

Mr Littlehales attributed his success in winning over business to his experience in rural lending which the other managers lacked. This meant they did not fully understand the problems faced by farm customers.[48]

16.78 The size of the staff at the Commonwealth Bank branch in Nyngan increased from a total of five when Mr Littlehales arrived in 1982 to 16 when he left in 1986. He attributed this to the growth in business, including business from clients in other States.[49]

16.79 Mr Littlehales indicated that his discretion to approve loan applications was limited, with those in excess of $100,000 requiring approval in Sydney. The Commonwealth Bank were questioned about its relationship with Mr Littlehales and its attitude to his lending practices. The Committee was informed that '... Mr Littlehales had set some goals for himself and he exceeded the goals. So in that context, yes, they were happy'.[50] In respect of volume of business emanating from Nyngan the bank indicated it had no need to question the quantity as Mr Littlehales was providing finance on the basis of capacity to repay.[51]

16.80 When asked whether the bank accepted any responsibility for the lending practices of its manager, the bank indicated:

> The answer is no. We do not accept responsibility but, as I said, we understand and feel for our clients who are now in trouble.[52]

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47 Sydney Morning Herald 2/4/91.

48 Evidence, p. 2720.

49 Evidence, p. 2740.

50 Evidence, p. 2838.

51 Evidence, p. 2839.

52 Evidence, p. 2840.

Conclusion

16.81 The Committee considers that the Commonwealth Bank has a legal and moral responsibility for the actions of its own staff. It regards the bank's attitude to the Nyngan problems as totally unacceptable. The bank has endeavoured to place blame for the unsound lending practices used in Nyngan solely on Mr Littlehales. Accordingly, due to the widespread nature of the problems in Nyngan a special conciliatory mechanism is required to deal with the situation.

16.82 While Nyngan provides a particular focus in examining the bank-farmer relationship, similar predicaments could well arise in other areas in the future. The Committee believes that it is appropriate to develop a mechanism which could be applied to address similar situations in other parts of rural Australia if required.

Recommendation

16.83 **The Committee recommends that:**

57. the Commonwealth Bank establish an independent mediator or panel acceptable to both the bank and the borrowers to mediate the disputes arising in the Nyngan region. This mechanism should include rural counsellors and should not affect recourse under the law which either party may wish to pursue; and

58. the mechanism should be developed to have application to other areas where similar circumstances arise. It could be activated either by the initiative of the bank involved or by recommendation of the Banking Ombudsman.