Regulation and australian financial system

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Historical review The Australian financial system evolved in five stages. The first stage was the introduction of financial institutions during the early colonial period in the 19th Century, where the influence of British institutions was a key driving force. The end of that period was marked by the 1890s depression which saw a major rationalisation of Australia's financial institutions. The start of the modern era of financial regulation can be traced back to the introduction of banking legislation in 1945 and the establishment of Australia's first central bank. In more recent times, Australia has seen two major waves of financial reform. The first wave, in the1970s and 1980s, involved a major deregulation exercise which transformed Australia's financial system.

In keeping with other policy measures aimed at opening Australia to increased trade, investment and international competition. A second wave of reform in the 1990s sought to address new regulatory issues that arose in the post-deregulation period. Financial sector reform did not occur in a vacuum but occurred in the context of a significant era of reform of the Australian economy. Reforms in other areas, and their relationship with the financial sector reforms, are also discussed in this section. Foundations of the Australian financial sector Origins of Australia's banking system Australia's monetary and banking system originated in the 19th Century and was modeled on British laws and institutions. Commercial banking began in Australia in 1817 with establishment of the privately-owned Bank of New South Wales, which issued legal tender.

This was followed in 1819 by the first savings bank, the New South Wales Savings Bank, which held for safekeeping the moneys of new arrivals to the

colonies (Peat Marwick 1985: 1). The number of banks expanded over the course of the 19th Century, including in the new territories of Victoria and South Australia. British banks took the lead in expanding the financial system of the Australian colonies. They introduced large amounts of capital, provided channels for the inflow of British investment, established foreign exchange markets, encouraged interest rate competition, and began the development of a branch banking network.

Growth in the banking sector was driven in the first half of the century by rapid expansion of the pastoral industry. The discovery of gold in the 1850s in Victoria was a driving force behind growth in the second half of the century. This latter period resulted in the establishment of more than 30 new colonial banks and several British banks. By the 1890s, more than 1000 branches had been established and retail branch banking became widespread.

The 1890s depression provided a watershed period in the history of Australian banking. During the 1880s, Australia saw increases in investment associated with extraordinary levels of building activity and property market speculation. At the same time, banks took on higher levels of risk in order to maintain 0-3 market share in the face of competition from non-bank financial institutions, such as building, pastoral and mortgage companies. Consequently, the collapse of the real estate market during the depression years led to a series of bank crashes and brought home to the banking industry the need for better prudential practices (Peat Marwick 1985: 1). Between 1891 and 1893 only 10 out of 64 banks were not forced to close or

refuse payment for longer or shorter periods (Gollan 1968: 28). The result was the rationalisation of the industry into a smaller number of viable banks.

It also led to pressure for a national bank along the lines of the Bank of England and for a paper currency in order to stabilise and protect the financial system (Gollan 1968: 18). However, action for a central bank would have to await Federation (Lewis and Wallis 1997: 49). Evolution of the central bank With the Federation of the Australian states into the Commonwealth in 1901, the Commonwealth parliament assumed power to make laws with respect to banking and currency. In the two months following the inauguration of the Commonwealth, banks were invited to give their opinions on a banking act and in particular on control of note issue.

The debate over establishing a national bank and its functions continued for the next decade as various models were considered. The Commonwealth Bank was created in 1911 under the Commonwealth Bank Act. It was empowered to conduct both savings and general banking business supported by a Federal government guarantee. The Commonwealth Bank became the first bank involved in both trading and savings bank activities (Peat Marwick 1985: 2).

The Commonwealth Bank did not specifically have a central banking remit and it was not responsible for note issue, instead it was established as a vehicle to provide competition for commercial banks and to keep accounts of the Commonwealth government. The Government took over note issuance from the private banks in 1910 and transferred that responsibility to the Commonwealth Bank in 1924 (the function was managed by the Australian

Treasury in the interim period). Increasingly, the Commonwealth Bank became banker to governments. The plan had been to allow the Commonwealth Bank to evolve into a central bank as had the Bank of England. In 1924, under an amendment to the Commonwealth Bank Act, a Commonwealth Bank Board was established and the Bank was given the power to discount bills and to establish a discount rate. This was intended to provide the footings for central banking, despite it taking 50 years for the discount rate to become an instrument of monetary policy (Lewis and Wallis 1997: 49).

Australian banks fared better during the depression of the 1930s than the 1890s depression, with relatively few bank closures and consolidations. However, the 1930s depression did highlight the links between financial system stability and economic growth and employment. As a result, banking activities came under close scrutiny and there was a Royal Commission into Money and Banking in 1936-37. The Commission recommended a number of measures to support the stability of the financial system in Australia.

Most of these measures were adopted in the Bank Act and Commonwealth Bank Act (1945). The Commonwealth Bank was given powers to operate formally as a central bank by allowing it to fix interest rates, control lending of private trading banks and to demand that some of the private trading banks' funds be held with it. As well, the Act regulated the spread of banks by making licensing mandatory (Peat Marwick 1985: 2). In the ensuing period, tension emerged between the Commonwealth Bank's central bank role and its commercial role, with the private trading banks arguing that the Commonwealth Bank had an unfair advantage in the banking business. This

eventually led to the separation of the Commonwealth Bank's trading and central banking activities, resulting in the formation of the Reserve Bank of Australia (RBA) in 1960, following the passage of the Banking Act (1959) and the Reserve Bank Act (1959).

Origins of financial deregulationThe post-war regulatory system essentially sought to achieve its monetary and supervisory goals via direct restraints on the activities of banks. The regulatory regime that was in place during this period restricted banks' operational flexibility and their ability to compete. For example, interest rate ceilings on deposit accounts restricted banks' ability to attract funds. Similarly, lending was restricted through guidelines on trading bank approvals.

Savings banks were constrained in their ability to lend for housing by the requirement to hold a majority of assets in cash, government securities or deposits with the central bank. The role of non-bank financial intermediaries grew to fill the gaps caused by restraints on banks – for instance merchant banks to service corporations and building societies to service the home lending market. Not only did the market share of commercial banks decline over the period 1955 to 1980, but bank assets declined as a share of GDP. This had important implications for the conduct of monetary policy, which relied on direct controls on banks, and also caused concerns from a prudential perspective. The Australian authorities were conscious of this trend at an early stage and a number of steps towards deregulation were taken during the 1960s and 1970s in an effort to bolster the position of banks and to begin to establish means by which influence could be exerted on the broader financial system.

For instance, maximum rates on large overdrafts were removed in 1972 and interest rates on certificates of deposit were freed up in 1973, allowing banks some scope to manage their liabilities. However, regulation was very much focused on the domestic market and competition among domestic institutions. Freeing up regulation in some areas, however, had the effect of increasing pressures on the regulations that remained. By the 1970s, these pressures were being aggravated by the increasingly interest-sensitive nature of capital flows – largely reflecting the establishment of merchant bank subsidiaries of foreign banks, which had access to funds from their overseas parent organizations. This volatile capital flows, together with a pegged exchange rate, complicated efforts to control domestic liquidity and aggravated the effects of differential regulation between various parts of the financial system. The need for the central bank to fund any shortfall in raising government debt as a result of inefficient debt-raising mechanisms added to problems with liquidity management.

Against this background, a major review of the Australian financial system was conducted through the Campbell Committee inquiry in 1979, the first major wave of financial sector reform. This inquiry responded not just to the increasing importance of non-bank financial institutions (NBFIs) and the difficulties with operating monetary policy, but also answered the need for a review and assessment of the range of regulatory changes that had occurred almost on an ad hoc basis during the 1960s and 1970s. The Campbell Committee inquired into the regulation, control and structure of the financial system in order to promote efficiency, while at the same time ensuring the stability of the system. The Inquiry recommended the removal of regulation,

which undermined efficiency, such as interest rate controls and lending restrictions, and the strengthening of prudential oversight to bolster stability.

In its report, the Campbell Committee argued that deregulation would increase efficiency of the financial system in three ways: ?? it would improve allocative efficiency by removing the barriers to the flow of savings into the highest-yielding investments; ?? it would increase operational efficiency by reducing the very wide interest rate margins maintained by the Australian banks; and ? it would enhance dynamic efficiency in the form of greater financial innovation to meet the needs of consumers of financial services. The Committee suggested a number of reforms that included the removal of ceilings on interest rates on bank deposits, the lifting of maturity restrictions on bank deposits, the introduction of a tender system for selling government securities, the relaxation of portfolio controls on savings banks, relaxation of capital controls and removal of restrictions on the entry of foreign banks. These recommendations were implemented in the first half of the 1980s. A further recommendation of the Campbell Committee was the floating of the Australian dollar. At the time, there was increasing recognition in Australia and elsewhere, that it was not possible to pursue an independent monetary policy while defending a fixed exchange rate with mobile capital.

This broader concern, in conjunction with short term pressures associated with speculation against the Australian dollar, led to the floating of the currency in 1983. As an entire generation had known only a highly-regulated environment, the Government understandably allowed time for the business community, bureaucracy and general community to absorb the Campbell Report. In 1983, the new Labor government adopted an investigation into

the financial system having regard to the Campbell Report and the new government's economic and social objectives. The Report of the Review Committee (the Martin Report) strongly endorsed the major recommendations of the Campbell Committee and from then on the Government's commitment to deregulation was unreserved and, n rapid sequence, major recommendations of both of the reports were implemented (Lewis and Wallace 1985). Developments post-deregulation The period of rapid deregulation in the first half of the 1980s sparked equally rapid change for Australia's financial sector. Over the period 1983 to 1988, the amount of capital in the sector rose from A$4.

5 billion to A$20 billion, the number of banking groups operating in Australia rose from 15 to 34, and the number of merchant banks increased from 48 to 111. 2 Credit also expanded rapidly, growing by 147 per cent between 1983 to 1988, but this brought with it some unanticipated problems. The lowering of barriers to entry into financial markets increased competition, which in turn facilitated technological innovation and enhanced consumer choice. Deregulation helped improve the efficiency of the sector by focusing activity towards innovation and away from the unproductive activity of circumventing outdated regulations. Deregulation accelerated the forces of globalization on the Australian market. While technological change lowered the costs of cross-border transactions, deregulation removed impediments to such transactions, allowing markets to become more global in nature.

This added to the pace of change in financial markets. These changes also created new challenges for regulators. Innovation in product design blurred the boundaries between financial instruments and institutions. With

regulation still following largely institutional lines, providers were able to exploit regulatory gaps – for example there was a further proliferation of non-bank financial institutions offering savings products which had the competitive advantage of not being subject to the same stringent regulation as the banks. Moreover, non-financial service competitors, such as retailers, airlines and telecommunications companies, were entering the industry and offering financial services to consumers.

These changes in the financial system led to products and distribution channels expanding beyond the traditional categories of banking, insurance and stock broking. This placed pressure on regulation to ensure competitive neutrality in the treatment of like products offered by different institutions. Increasing consumer sophistication was associated with new products and, importantly, the greater availability of information about those products. This factor, together with demographic factors (such as the ageing of the population) and government initiatives to promote retirement savings, led to changing consumer demands.

In particular, it saw a relative decline in the importance of deposits as a form of savings. In addition to these broader forces of change, specific developments in the post-deregulation environment provided pressure for further review of the financial system. The level of corporate gearing increased significantly over the 1980s. Underlying this trend was a rise in the number of highly leveraged corporate takeovers from 1984-87, while credit growth post 1987 was driven in large part by a property boom. A number of factors contributed to lower credit quality. Banks took some time to adjust risk assessment procedures.

In the deregulated environment, banks were able to take on higher risk borrowers and also needed to take account of exchange rate and interest rate risk to a greater degree than before (Valentine 1991). In addition, during the late 1980s high inflation, together with a taxation system that provided incentives to borrow to finance capital investments, led to large amounts of over-borrowing as investors took advantage of increasing asset prices. As interest rates rose over the late 1980s, the fall in credit standards began to manifest itself in significantly higher levels of non-performing loans and write-downs, resulting in substantial losses at two of the four largest banks, the re-capitalization or takeover of some State government owned banks, and the closure of some NBFIs. Foreign banks also carried a significant level of non-performing loans during the recession of the early 1990s. The share of non-performing loans to total assets peaked at 12 per cent for the foreign bank sector, which was twice the peak in the broader system.

The higher proportion of non-performing loans in the foreign bank sector, notwithstanding the experience of their parent institutions, suggest that actions of the domestics banks in protecting market share might have contributed to foreign banks taking on riskier business. The domestic banks began reacting to the possibility of competition from foreign banks through mergers, acquisitions and increased lending in the early 1980s, well before deregulation and before any foreign banks had actually entered the market. Managing country currency risk The move to a floating exchange rate in 1983 came in response to pressure from capital inflows, rather than capital outflows as is more frequently the case in other countries. Nevertheless, there was a learning phase for agents to recognise and manage currency

mismatches. Faced with new financial freedoms in the immediate post-float period, some agents began to borrow unhedged in foreign currencies to take advantage of significantly lower interest rates overseas. In particular, many farmers and small businesses borrowed substantial amounts in Swiss francs.

When the exchange rate subsequently fell sharply, in 1985 and 1986 (by about 40 per cent), these borrowers faced large losses, and many went out of business. The immediate issue that led to the problems of the Swiss franc loans was one of risk recognition. The Australian experience was that publicity surrounding the problems of farmers played an important role in educating the corporate sector more broadly about the risks and the need to manage them. While Australia worked through this period without a full-blown banking crisis, the ramifications lasted for some years. The economy's recovery from the 1990-91 recession was slowed by the need for banks and corporates to repair their balance sheets. At the same time, the Australian Banking Industry Inquiry in 1991 was set up to examine concerns about the performance of the banking sector in a deregulated environment.

As well as many recommendations with a competition focus, the report sought to strengthen the supervision of banks to address shortcomings that had been highlighted by the late 80s/early 90s episode. Many issues raised throughout the 1980s and 1990s were overcome with the appropriate regulatory adjustments, such as the establishment of coordinated supervision of banks and non bank financial intermediaries as well as the introduction of regulations into the insurance and superannuation industries. The financial system was transformed over this period and continued to undergo sweeping change. Against this background, the Government

decided in 1996 to establish a new inquiry to review these developments, to consider the factors likely to drive further change in an increasingly more global environment, and to make recommendations for possible further improvements to the regulatory arrangements. The policy response Financial system reform – the second wave In 1996, the Government commissioned the Financial System Inquiry, the Wallis Inquiry.

The Inquiry was commissioned to make recommendations on regulatory arrangements that would respond to the developments of the previous decade and ensure an efficient, responsive, competitive and flexible financial system. Specifically, the underlying objectives of the Wallis Inquiry were: •? To promote greater efficiency through enhanced competition; and •To maintain confidence and stability in the financial system while preserving the ability to be responsive to innovation and market developments. The Inquiry found that the intensity of prudential regulation should be proportional to the degree of market failure which it addresses, but should not involve a government guarantee over any part of the financial system. Fundamentally, it is the responsibility of the board and management of financial institutions to ensure that the financial promises made to consumers are kept.

Prudential regulation and supervision should seek only to add an additional discipline by promoting sound risk-management practices by firms and providing for early detection and resolution of financial difficulties. The Inquiry considered that while prudential regulation is warranted in certain limited circumstances, its more intense forms would need to be wound back over time and the regulatory focus shifted towards the conduct of market participants and disclosure of information. The financial regulation

framework recommended by the Wallis Committee in its Final Report of March 1997 was intended to be flexible in the face of ongoing change in the financial sector. In general, this evolution in the market requires a shift in regulatory philosophy towards an increased reliance on disclosure and market-based signals and away from highly specialized prudential or industry-specific regulation. Implementation of reforms The Australian Government accepted a majority of the recommendations of the Wallis Inquiry (Costello 1997).

The key recommendation was a new organizational framework for the regulation of the financial system. The Inquiry recommended a model of regulation based on functional objectives, with three ‘ peaks’ ?? single prudential regulator, a regulator for conduct and disclosure, and an institution responsible for systemic stability and payments. The regulatory framework prior to the Wallis Inquiry was based on a sectoral approach, where different regulatory institutions had responsibility for specific industries within the financial sector. Under the Wallis reforms, the Reserve Bank of Australia (RBA) is responsible for monetary policy, the overall stability of the financial system and the regulation of the payments system. The RBA focuses on maintaining stability in the financial system (including the payments system, which is an mportant contributor to stability). The RBA retained responsibility for systemic stability, as any system wide problems would likely require liquidity support by the monetary authorities.

The RBA liaises extensively with the other financial sector regulators in monitoring systemic stability. •The principal change to the RBA’s functions was the removal of responsibility for prudential supervision of banks and

depositor protection. This change assisted to clarify that while the RBA may intervene to assist systemic stability, its balance sheet was not available to guarantee deposits. It also clarified the accountabilities for the regulatory task. The Australian Prudential Regulation Authority (APRA) became responsible for the prudential regulation of all deposit-taking institutions, general insurance, life insurance and superannuation. This resulted in all prudentially regulated entities in the financial system being brought within the Commonwealth jurisdiction and regulated by a single agency.

This allowed for the removal of artificial and anti-competitive distinctions between different types of entities providing similar products and assisted the regulation of financial service conglomerates. Prior to the Wallis reforms, prudential regulation was carried out by several different agencies at both the Commonwealth and State government levels. The Australian Securities and Investments Commission (ASIC) became responsible for maintaining market integrity, consumer protection, and the supervision of companies across the financial system. These responsibilities were transferred from several different regulators with the intention of minimizing inefficiencies, inconsistencies and regulatory gaps that undermined effective competition in financial markets. To effectively perform their role, the regulators were given substantial operational independence from the Government in administering legislation and in dealing with particular cases in prudential supervision or conduct and disclosure. The financial sector regulators have a clear charter of objectives and accountabilities laid out in their enabling legislation.

Responsibility for the broad framework for the regulation of the financial sector lies with the Federal Government. Accountability for the operational or day-to-day supervision of financial institutions and markets lies with the regulators. The roles of the Government ?? through its ministers within the Treasury portfolio, ? includes setting the broad policy direction and priorities for regulation of the financial sector and bringing proposals to the Parliament for new legislation or amendments to legislation. Additionally, in March 1998 the Government established a high level Financial Sector Advisory Council (FSAC).

FSAC is a non-statutory body that brings together a range of financial market participants to provide advice to the Government on policies to facilitate the growth of a strong and competitive financial sector. The move in Australia to match the structure of the regulators to their functional objective and to consolidate supervision of financial institutions is consistent with international developments. Amongst OECD countries, Canada, Denmark, Norway, Sweden and the United Kingdom moved in the late 1980s and early 1990s to establish a single prudential regulator separate from the central bank. The post-Wallis regulatory structure has also provided a model for changes in other countries.

A number have established single financial sector regulator, while others have established arrangements similar to Australia. Insurance sector reforms Australian private sector general insurers are regulated by APRA under the Insurance Act 1973 (the Insurance Act). Over time, the prudential arrangements set out under the Act were increasingly considered to be blunt and unresponsive in an environment of significant market and regulatory

developments, including globalisation, convergence and improvements in domestic and international regulatory best practice. These changes had driven the need for more flexible and sophisticated ways for regulators to undertake prudential regulation of the general insurance sector.

In 2000, the Government announced that the regulatory framework for the general insurance industry would be reformed. The new framework commenced on 1 July 2002, with capital requirements to be phased in by 1 July 2004. The overarching objective in developing a new framework for the prudential supervision of general insurance was to provide a more secure environment for policyholders. The revised Insurance Act strengthens the requirements for general insurers to conduct insurance business and increases APRA's enforcement powers to undertake its regulatory responsibilities.

Consistent with other financial sector reforms, the amendments are designed to ensure the Insurance Act is more flexible and less prescriptive than the earlier legislation, allowing the prudential regime more easily to accommodate market developments over time. The power for APRA to set standards provides for the framework to be responsive to changes in commercial and international best practice. Australia has sought to develop a regulatory framework that is sufficiently flexible to remain robust in the face of future changes in the global environment. However, in recent decades the financial sector has been one of the most vibrant sectors in the Australian economy and this can reasonably be expected to continue over the foreseeable future.

The structure and operation of the financial sector will continue to evolve as globalisation, financial convergence and the introduction of new technologies alters the business environment. This suggests that the regulation of the financial sector will continue to be a dynamic task.