

CHAPTER 23: PARTICIPATION IN THE DOMESTIC PAYMENTS SYSTEM

A. INTRODUCTION

23.1 The range of financial institutions which might reasonably participate in the provision of domestic payments system services, and the basis of that participation, have been major issues for the Committee. The issue bears closely on a number of important matters including:

- entry to banking and the competitive environment;
- confidence in the payments system and protection of depositors;
- the efficiency and effectiveness of the financial system.

The involvement of the authorities is also a matter which deserves some consideration.

23.2 Apart from cash transfers, the Australian payments system, until recently, has been almost exclusively centred around transported paper documentation. That is gradually changing, with transfers increasingly being effected by electronic means. This trend will undoubtedly continue and could have, in the years ahead, important implications for the industrial structure of the domestic payments system.¹

23.3 Appendix 23.1 outlines the present structure of the Australian domestic payments system.²

B. DEVELOPMENT PATTERNS

23.4 The recent tendency overseas has been towards increased integration of the large commercial banks and other intermediaries in the provision of payments system services. In brief:

- It is the common practice overseas for non-bank deposit-taking institutions (as well as banks) to undertake to effect cashless payments drawn against the funds lodged with them. In a number of countries, the post office also provides a payments service supplementing that offered by banks and other financial institutions. In some cases this is based on deposit accounts held; in others it involves payment orders.
- Cheques are frequently the major means of settlement but the range of

1 Some issues relating to notes and coin are taken up in Chapter 2 in the context of the discussion of the role of the Reserve Bank.

2 For a summary description of non-cash payments systems in other countries (see 'Non-cash Payments Systems in Other Countries', in *AFSI Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981).

methods of effecting payments is widening; for example, computer-based inputs and transmission orders are increasing; there is also considerable variation in the extent to which the system limits the writing of cheques of unlimited value without back-up verification.

- Value date arrangements vary from country to country. In Canada immediate value is given. In the United States value is given in accordance with a specified schedule. It frequently involves the Federal Reserve providing credit in the form of float to the system. In West Germany and some other countries quite long periods can elapse before value is received, since cheques need to be cleared first; however, competition is tending to reduce delays. In the Netherlands the payments system is financed through value-dating using a five-day gap between the debiting and crediting of cheques.
- In many countries more than one payments system operates, the interconnection between the systems varying. In the Netherlands, for instance, the link between the postal giro and the bank clearing system is limited and commonly involves considerable delays in effecting payments. In West Germany there are three competing payments systems, one run by the Bundesbank (the central bank) and the others by the savings banks and credit co-operatives; the Bundesbank provides the link between them but as far as possible each clears its members' transactions internally. At the other end of the spectrum, a single system involving banks and other intermediaries is being extended in Canada.
- Most systems allow for both direct and indirect participation; the economics are such that those directly involved tend to be large intermediaries. Smaller organisations establish either correspondent arrangements with a direct participant or are represented by a central organisation handling transactions for a particular group of intermediaries (such as the credit co-operatives in the United Kingdom).
- Central banks are usually direct participants in the payments system. In part this reflects their role as banker to government. They also frequently act as banker to direct participants and the central settlement accounts are held with them. In many countries they provide some or all of the infrastructure for the settlement procedures. In a country such as Canada the central bank is legislatively at the centre of the payments system. More commonly central banks do not have a legal obligation to determine the rules of the system but are nevertheless in a position to exert considerable influence.

23.5 Forces underlying these developments include:

- *technology* — current and prospective developments in payments system technology have encouraged and assisted integration;
- *maturation of the financial system* — with the emergence of specialist financiers having the management capacity and market base to provide payments system services, pressures have developed for their recognition as 'secondary' banks;
- *investor protection* — the availability, in many cases, of comprehensive deposit insurance for non-bank institutions has placed them on a more comparable status with commercial banks in terms of risk;
- *government policy* — in many countries there has been concern with the concentration of economic power in the financial system which has reflected in policy decisions bearing on access to centralised payments clearing facilities.

23.6 The range of financial institutions in Australia which are generally regarded

as banks is presently much narrower than in many other countries. Moreover, non-bank financial institutions in Australia typically do not issue cheques or cheque-like instruments to be drawn on themselves; in the normal course they only facilitate their customers' use of the payments system by issuing cheques in payment of withdrawals and accepting cheques for deposit.

23.7 There are a number of reasons why integration has not developed as far in Australia as in other countries. Among other things:

- the introduction of new payments system technology has tended to lag somewhat behind developments overseas;
- until recently, non-bank intermediaries have not felt competitively disadvantaged by their lack of access to the payments system;
- the commercial banks have been reluctant to weaken their competitive position by facilitating the participation of non-bank intermediaries; and their ability to do this is enhanced by their joint ownership of the clearing house; and
- the authorities have endorsed the exclusiveness of the present cheque clearing system; moreover, government-owned banks participate in the provision of clearing facilities at both the national and state level and are, as a consequence, parties to the practices restricting access.

23.8 The stage seems set for substantial **evolutionary** change in domestic payments arrangements in Australia.

23.9 The paper-based elements such as cheques and Bankcard vouchers seem likely to increasingly acquire characteristics allowing the payment instruction to be electronically transmitted and activated using an integrated communication network and clearing facilities.

23.10 With the exception of certain 'consumer protection' aspects of Electronic Funds Transfer Systems (EFTS) taken up in Chapter 22, the Committee has not involved itself in detail with the new commercial or legal forms which will support the introduction of procedures to truncate the movement of cheques. However, it would emphasise the importance of developing a legal framework for the payments system which does not impede its development. For example, unlike Australia, the Swedish system allows cheques to be held at the receiving bank branch with the transfer being completed electronically from that point.

23.11 Quite apart from the truncation of paper flows presently associated with cheque and credit card transactions, it is expected there will be continued development of electronic-based procedures for direct debits and credits in substitution for cheques. Such developments would be in keeping with developments in other countries, whether they be predominantly based on cheque-style transfers or a centralised giro system.

23.12 With the development of co-ordinated electronic transfers, distinctions between key retail-user debit instruments — such as automatic teller facilities, cheques, credit cards, debit cards, cheque guarantee cards etc. — will be less pronounced than at present.

23.13 The developing technology would seem to be consistent with greater and more direct involvement of non-bank intermediaries in the payments system, subject to appropriate prudential safeguards to ensure confidence in the payments system.

C. FACTORS LIMITING PARTICIPATION

23.14 The essential characteristic of cheques and similar instruments is that they represent evidence of a debt and record the **drawer's** instruction to the **drawee** to pay a stated amount to a third party, the **payee**. Quite apart from the commercial relationship between the drawer and payee, the general acceptability of cheques and similar instruments may depend crucially on confidence in the drawee.

23.15 Cheques have special legal characteristics distinguishing them from other payment instruments. The holder of a cheque can require his banker to present it for payment. In addition, there is greater legal certainty and protection for the parties involved, in that the rights of the drawer, drawee and payee are more precisely specified by the Bills of Exchange Act for cheques than for other bills of exchange.

23.16 Customary usage and the legislation together endow cheques with a more certain status as an instrument of funds transfer — a status which explains why governments and users have a special interest in the standing of institutions on which cheques are drawn.

23.17 There are a number of factors presently limiting participation in the Australian domestic **cheque payments** system.

(a) Right to Issue Cheques

23.18 Under the Commonwealth Bills of Exchange Act a 'cheque' can only be drawn on a 'banker'. The Committee understands that in this context a 'banker' refers to an organisation undertaking the general business of banking. Other parties may be individually involved in the issue of cheques but this involves negotiation with a 'banker'. Under the Banking Act, the monetary authorities may set down the terms and conditions under which the business of banking is conducted.

(b) Access to Clearing System

23.19 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. Admission of new members to the banks' Clearing House for transferring cheques is at present at the discretion of member banks. The current Clearing House Agreement provides for admission of new members on approval by a simple majority of existing members, subject to the prospective new member being a bank.

23.20 It would be technically possible for non-banks to set up their own payments and clearing network. The Committee is not aware of any substantial development along these lines independently of the banks' cheque-based system, although there are, for example, small independent credit card systems.

23.21 Payments processes would, of course, be more efficient if there were some interconnection between the different clearing systems: a payee who did not hold accounts with both systems would be at a disadvantage unless some form of interface between them were established. Quite apart from possible losses in

efficiency by the duplication of an entirely separate system, parallel arrangements are unlikely to be as **effective** overall as an interconnected arrangement.³

23.22 Participation in a payments system requires acceptance of a set of procedures which mesh with the operations within individual organisations; there must also be mutual confidence that valid settlement obligations will be met unconditionally in accordance with agreed rules. These factors have tended to limit **direct** participation in the clearing system to a restricted group. They have also tended to involve the authorities; sometimes in a very active way, as in Canada and the United States of America; sometimes in a more passive way, as in Australia and the United Kingdom.

(c) Agency Arrangements

23.23 Participation in the cheque clearing system by institutions other than member clearing banks can presently be achieved by agency and other arrangements of various kinds. For example:

- (i) With regard to the mechanical processing of cheques, a bank which is not a member of the clearing system may arrange for a member clearing bank to be its agent for collecting cheques drawn on itself. In the past these agency arrangements have been used by some of the smaller banks and for the interstate collection of cheques drawn on banks not operating in all states.
- (ii) Financial institutions, other than banks, participate in providing cheque payment facilities to their customers in the following ways:
 - firstly, and most commonly, non-bank institutions may pay customer withdrawals by cheque, drawn on their banker, possibly payable to a third party nominated by the customer;
 - secondly (in a few instances⁴), non-bank institutions may allow customers to draw cheques on a bank account of the institution (subject to appropriate safeguards) with a corresponding debit to the customer's account with the institution providing the facility;
 - thirdly (and again in few instances⁵), arrangements may be made enabling certain customers to operate a bank cheque account in conjunction with an account with a non-bank institution; in essence, when such cheques are presented for payment, the cheque account at the bank is funded by an equivalent transfer of funds from the account of the drawer at that non-bank institution.

23.24 If a further development of these last two facilities is to be consistent with the requirement of **confidence** in the parties acting as 'banker', a bank would need to underwrite the capacity of the non-bank (in respect of transactions with other members of the clearing system) to meet valid claims on its customers' accounts. Without such underwriting, 'value dating'⁶ may need to be delayed — with a

3 The effect on efficiency of interconnected arrangements depends importantly on both technical arrangements and the impact of essential prudential requirements on these arrangements. These matters may, for example, impact importantly on dates for value in the system.

4 There are a few, generally long-standing, arrangements of these kinds in operation whereby, for example, the customers of some pastoral finance houses can draw cheques to the debit of their accounts **through a bank**.

5 There is, for example, an arrangement of this nature in Queensland linking accounts at a bank and some building societies.

6 Value dating denotes the effective date for which value is given on items lodged for collection.

consequent loss of efficiency of the financial system generally. A related crucial issue, therefore, is how the bank involved in the agency arrangement might ensure it is not at risk as a result of the arrangement.

23.25 The Committee believes that Australian banks generally have been extremely reluctant to extend agency and similar arrangements to non-bank financial corporations (beyond those few, usually long-standing, arrangements in place) except where associated financial institutions are involved. There are, understandably, some tensions in the competitive environment which limit the scope for mutual agreement.

23.26 The authorities have also been concerned to ensure that requirements under the Banking Act are observed, especially prudential requirements.

23.27 These issues have been resolved in a number of countries using a variety of prudential requirements and value dating arrangements. Agency arrangements, whereby cheques (or similar instruments) drawn on near-banks can be cleared through the banks' network, have been a long-standing feature of the Canadian system. Similar agency arrangements have, under the pressure of strong competition, become increasingly common in the United States, both between banks and between banks and NBFIs. A significant proportion of total transactions in the United Kingdom have traditionally occurred through clearances by the major London clearing banks on behalf of other institutions, including many intermediaries similar to the Australian 'money market corporations' or 'merchant banks'.⁷

23.28 Legislation recently introduced in Canada and the United States makes provision for the direct or indirect participation of selected NBFIs, or central institutions jointly owned by NBFI's, in the clearing system.⁸

(d) Economic Factors

23.29 The inability to negotiate either direct or indirect access to the clearing system may not be the only factors inhibiting participation of a broader range of institutions in the Australian payments system. There may also be cost factors working against the entry of new institutions.

23.30 The total cost of operating the payments system can be viewed as comprising four main elements:

- the cost of **account management**, i.e. maintaining the necessary records of transactions, balances, interest and other charges;
- the cost of **'float'**, i.e. depending on value dating arrangements, some institutions may have a disproportionate volume of funds tied up in items drawn on other participants; typically cheques are accepted for value, but not settled with the drawee, on the same day;
- the cost of **final processing** or **'batching'** and information capture before actual transfer for clearing; and

⁷ Two institutions — the Central Trustee Savings Bank and the Co-operative Bank — have recently joined the London clearing house. The National Giro Bank has been admitted to membership and is expected to participate as a member from around the end of 1982.

⁸ An earlier Canadian proposal to make mandatory the direct participation of certain classes of non-banks (as distinct from banks) offering transferable deposits was not acceptable to these non-bank groups, which preferred to have the option of either maintaining agency arrangements or being a direct member.

● the cost of **transporting** paper or electronic messages from the point of entry into the system to the point of final settlement.

23.31 The evidence points to the existence of some economies of scale in **account management**. It is likely, however, that these will continue to decline in importance as more electronic equipment is introduced.

23.32 The cost (to each participant) of **'float'** in the system as a whole will bear on the nature and costs of participation. More indirect participants could increase the time taken to settle debts between institutions and this expense would presumably reflect in the negotiation of the price of participation. If banks were to pay interest on current account balances additional costs may arise in respect of the float. Again, however, computer-based account management systems may permit a more accurate matching of value given and value received by participating institutions; also the cost of the float between participants could possibly be shifted to those conducting the accounts.

23.33 In the case of **transporting** networks, it is common practice to use contract operators where volumes are insufficient to justify an exclusive mechanism provided by individual clearers. Economies of scale in this area are thus unlikely to be significant. With the development of electronically based arrangements, there will be reduced emphasis on paper transportation.

23.34 Finally, economies of scale are said to occur in the **pre-clearing** processing or **'batching'**. A larger number of participants may:

- increase each individual institution's costs of operation as the total volume is separated into a larger number of smaller, separate groups; and
- result in duplication of equipment and less effective use of existing capacity.

23.35 The existing studies of this question⁹ indicate that, overall, there are economies of scale in the administration of the payments mechanism although not substantial ones. Such size economies may possibly discourage potential new entrants and the development of competing payments systems. However, as will be argued later, such economies do not necessarily justify official restrictions on participation.¹⁰

23.36 Technological developments may have the effect of reducing the economies of scale presently existing in the administration of the payments mechanism. For example, recent developments in microprocessing have substantially reduced the indivisibilities in computing equipment.

(e) The Involvement of the Authorities

23.37 The official attitude to non-bank participation in the cheque payment system has been uncertain — and could even be described as **'discouraging'**. In particular, there has been an implicit public understanding that authorisation as a bank is necessary for direct participation in the payments system. This stance by the authorities recognises and reinforces the **'uniqueness'** of cheques as payment instruments drawn on banks.

⁹ These studies are surveyed in K. T. Davis and M. K. Lewis, 'Economies of Scale in Financial Institutions', in *AFSI Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981. One specific study was carried out by the Committee's staff — T. J. Valentine and P. J. Williamson, 'A Note on Economies of Scale in Australian Banking', in the same publication.

¹⁰ Davis and Lewis, *op.cit.*, suggest that wider participation may be achieved through co-operative sharing arrangements which offer significant cost advantages for technical reasons.

23.38 The monetary authorities have a close interest in the payments system and its operation because they 'license' banks, and because the Reserve Bank:

- has responsibility for the supervision of participants;
- provides central banking facilities to settle obligations arising between banks in the process of clearing cheques and making other payments; and
- participates directly in the payments system, as banker for the Government and some other customers.

D. THE ISSUES

23.39 In assessing the desirability of making changes to the level of access to the payments system, the Committee has identified three main issues:

- security and reliability;
- efficiency; and
- competitive neutrality.

(a) Security

23.40 Once the instrument of transferable funds withdrawal moves beyond cash to cheques, and perhaps other instruments, the viability of the institutions responsible for the transfer of the funds becomes important to confidence in the payments system. At present one party to a cheque is always a bank, but, as mentioned earlier, non-bank intermediaries are increasingly being 'interposed' between the effective owner of the funds and the bank on which the cheque is drawn.

23.41 The exact volume of cheque transactions intermediated by **non-banks** is unclear, but the broad indications are that:

- such transactions amount to about 1 or 2% of all cheques drawn on banks; and
- their relative importance has increased strongly recently, as non-banks — particularly building societies — have promoted the service.

This trend would be greatly accelerated if non-banks were to allow their customers to draw cheques against their deposit funds. The issue of confidence would then become crucial.

(b) Efficiency

23.42 A substantial expansion in the number or range of institutions directly involved in the payments mechanism could reduce the technical efficiency with which the payments system operates, especially at the clearing end of the process. However, this does not necessarily justify official entry restrictions. The Committee points out that:

- Governments are not necessarily best placed to judge what the most efficient industrial structure is likely to be; competitive markets are generally better able to ensure that the appropriate degree of technical efficiency is achieved.
- Any loss of technical efficiency would need to be measured against the possibility of substantial gains in the broader context, arising from more widespread participation; users would benefit from easier access to payment services and stronger competition should assist efficiency.
- Duplication of payments systems could be an even more wasteful use of resources.

- Generally, a new institution would be aware of the advantages of size and would only enter if it thought it had superior skills or products to offer. If in fact it had superior skills, its entry would enhance the overall efficiency of the industry. (Other considerations will be involved in the case of foreign banks. See Chapter 25.)
- The threat of potential entry is important as a means of ensuring that established institutions remain competitively efficient.

23.43 In respect of **indirect** participation, through various forms of agency arrangements, the Committee sees even less justification for entry restrictions on grounds of economies of scale. Indeed, it is most likely that extension of agency arrangements to larger numbers and more diverse types of intermediaries would make the system **more** efficient, even from a purely technical viewpoint.

23.44 At present, customers of a non-bank institution wishing to transfer funds by cheque to a third party generally have to present themselves at the institution or forward written instructions to it. The procedures are costly in terms of resource utilisation and inconvenient for the customer. Overall, cost efficiency and levels of customer service would be improved by a system which extended the funds transfer linkages between the banks and NBFIs, so long as the arrangements (including prudential aspects) ensured the confidence of all participants. Some offsetting cost to the system would flow from any need — particularly of NBFIs — to hold additional liquidity.

(c) **Competitive Neutrality**

23.45 The provision of payments system facilities — both domestic and international — makes it easier for an institution to also provide related financial facilities; this is particularly so at the retail end of financial markets where the convenience and time saving involved in ‘one stop’ banking offer powerful attractions. The right to provide payments system facilities thus has significant implications for competitive balance across a wide spectrum of financial intermediation.

23.46 Developments in EFTS may ultimately reduce the competitive advantage to be gained from membership in an existing payments system. Technology offers the prospect of instantaneous linkages and the direct transfer of funds between customers through accounts at participating institutions; when that happens no one institutional account keeper need have a unique advantage over another.

E. CONCLUSIONS AND RECOMMENDATIONS

23.47 In the light of the foregoing, the Committee believes that the underlying objective of policy should be the evolution of a payments system which is:

- **secure;**
- **cost efficient;**
- **competitively priced;**
- **responsive and innovative;** and
- **as neutral as possible** in its consequences for the competitive position of different financial intermediaries.

23.48 Such a payments system will be best promoted if:

- (i) There is a core unit in which there is undoubted confidence in the capacity of all participating intermediaries; this requires:
- high standards of financial management;
 - effective prudential regulation; and
 - a legal and institutional framework which offers adequate protection to users, including in respect of such matters as fraud, misuse and violation of privacy.
- (ii) There is adequate opportunity for:
- new intermediaries to enter the payments system as cheque-issuing institutions, either as primary participants or by having their obligations cleared through the agency of a member clearing institution;
 - non-cheque-issuing institutions to offer, in conjunction with a cheque-issuing institution, a range of cheque facilities to their customers; and
 - all institutions (including banks) to participate in offering payments system services, using instruments other than cheques, subject to their acceptability to payees (who would need to have confidence in both the drawee institution and the drawer).

23.49 The objective of ensuring confidence and reliability in the core of the payments system is presently promoted by singling out the cheque payment system as that core segment and ensuring that, through prudent funds management and some degree of co-ordination and perhaps centralisation, the risk of default by cheque-paying¹¹ institutions is minimised. The Committee would be most unwilling to countenance any reduction in the underlying safety of the cheque payment system as it now operates or of any ultimate substitute for it.

23.50 The Committee envisages that participants in various areas of the payments system will be subject to prudential disciplines consistent with the degree of risk inherent in the arrangements.

23.51 It believes that, in the foreseeable future, cheques or their electronic counterparts will remain the principal means of payment for other than cash transactions, although other payments arrangements (involving both interfacing with the core unit and independent operation) can be expected to develop.

23.52 Compared with a cash transaction, accepting a cheque entails a risk against which the acceptor may not be able to take reasonable steps to safeguard himself. It is therefore of utmost importance that **financial institutions offering cheque payment facilities should have, and be seen to have, an undoubted capacity to meet their obligations to account holders.**

23.53 The Committee considers the features of security and reliability of the core segment of the payments system, and the community's general confidence in it, to be so important as to require that all cheque-paying institutions conform to the prudential standards of banks — and to that end, they should have a banking licence.

11 The terms 'cheque-paying' and 'cheque-issuing' are used interchangeably in this chapter.

23.54 Accordingly, the Committee *recommends* that:

- (a) Only banks should be granted the authority to have cheques (or their ultimate substitute) drawn on them.
- (b) There should, however, be no other legal barrier to the participation of any class of business or person in the provision of payments system services generally.

23.55 The question of entry to banking is discussed in the next two chapters. The Committee recognises that, within the general classification of financial institutions as 'banks', there will be a variety of sub-categories with different characteristics and status. **In particular a cheque-issuing institution should not be required to carry on the full range of banking business currently associated with a trading bank.**

23.56 The Committee views the cheque clearing house, its membership and ownership, as a private commercial arrangement among banks; the distinction between **clearing and non-clearing** banks is a purely functional one which does not in its opinion require formal legislative recognition. Nonetheless, the Committee does not see the operation of the bank cheque clearing house, and the terms and conditions on which new member banks are admitted, as being beyond the influence of public policy. There would be grounds for concern if those terms and conditions were unduly restrictive.

23.57 As a safeguard, therefore, the Committee *recommends* that **the Reserve Bank should exercise general oversight of applications for direct participation by new banks in the Australian cheque clearing system and, if invited to do so, give evidence to the Trade Practices Commissioner on any undesirable restrictions.**

23.58 All banks may be direct members of any central cheque clearing organisation but other arrangements are also contemplated. These would particularly include 'non-member' (non-clearing) banks making arrangements with 'member' (clearing) banks to collect their cheques (and other payments instruments) and settle on their behalf with other member banks. Again, the Committee would expect the Reserve Bank to be informed of arrangements entered into and **to exercise general oversight to encourage the availability of agency facilities for non-clearing banks on reasonable but commercial terms and conditions.**

23.59 To the extent that the relationship of principal and agent between 'member' clearing banks and other banks entails a responsibility for the clearing house agent to meet the liabilities of the non-member bank in the first instance, the Committee would expect either a suitable financial commitment of the 'non-member' bank to the 'member' clearing bank to underwrite the contingent liability or a deferment of settlement between participants pending payment of the cheques. While such arrangements might ordinarily be regarded as private between a banker and its customer, the Reserve Bank should be informed of these in the course of its prudential oversight.

23.60 The above relates to relationships between 'clearing' and 'non-clearing' banks. While financial institutions **other than banks** would not be permitted to issue cheques, the Committee, nonetheless, envisages that, to the extent prudential and practical considerations permit, the system would not inhibit customers of non-banks from drawing cheques on banks which would be ultimately funded by debit to the account held with the non-bank institution.

23.61 As previously mentioned, the general arrangement is already in place to a very limited degree in different forms, but the practice is not widespread largely because of a reluctance on the part of authorised banks generally to enter into such arrangements. The Committee is firmly of the view that a general prohibition is not in the public interest and would encourage a more competitively independent stance among banks.

23.62 The Committee in no way seeks to endorse any arrangement which is not commercially sound and acceptable to both parties and which does not satisfy the prudential requirements of the authorities.

23.63 While the required prudential and funds management standards may preclude the entry of small financial corporations in their own right as banks, these corporations might join with other small institutions to form a central unit able to assume the responsibilities of a clearing bank; or they could obtain indirect access to the payments system by forming appropriate agency links with national clearers and other banks.

23.64 To the extent that a bank acted as a central unit for a number of participating institutions, it might need a different balance sheet structure from a bank which did not. One way or another all payment system liabilities would need to be supported by an appropriately liquid asset structure.

23.65 The system ideally would be **flexible** and **responsive** enough to permit a range of non-cash payment instruments, other than cheques, to serve as instruments of funds transfer. Various instruments are beginning to serve as substitutes for cheques and can be expected to become much more important in the period ahead, especially as EFTS develop. It would not be necessary to bring all these instruments and techniques within the framework of regulation applying to the cheque clearing system. In this area, as in others, the Committee believes that a spectrum of risk should be accepted and it would not wish to see innovation inhibited by undue regulation.

23.66 Finally, there must be **effective competition** between cheque clearing participants to ensure fair and reasonable terms of 'indirect' participation for others. The Committee is confident that its recommendations on the deregulation of banking and entry to banking (see Chapters 4, 24 and 25) will provide the necessary competitive climate.

23.67 To the extent that competition is deficient, the issue should be resolved, as far as possible, within the broader context of the law bearing on restrictive trade practices. The way is of course open for action to be initiated by private corporations and there is evidence of this in recent events. In this regard the observations and recommendations of the Committee might be taken as expressing a view on the matter of the public interest. If a further safeguard is needed **in the initial period of transition**, it could derive from the scope for competitive leadership by the Commonwealth Trading Bank, and perhaps other government banks.

23.68 To summarise, it is the Committee's clear preference that **(to facilitate indirect participation by non-banks) there should be no barriers to individual, cheque-issuing banks entering into agency arrangements with non-bank institutions on terms that are mutually agreeable, subject to the conditions that:**

- **the participating cheque-issuing banks so structure the arrangements as to ensure valid cheques (and like claims) are met on presentation; and**

- the Reserve Bank is informed of the terms of the arrangement so as to facilitate its prudential supervision of banks.

23.69 The Committee sees no need for expansion of direct government participation through either a postal giro system or some other newly established channel. Having regard to the experience of Britain (which established a postal giro in the mid 1960s) and on the evidence of likely technological developments, some reduction is likely in future in the functional and operational differences between giro systems and their privately owned EFTS counterparts in other countries.

23.70 Similarly, a proposal to establish a channel of government influence over the structure and operation of the domestic payments system on the basis of participant usage of Telecom facilities does not appeal. There are a number of other channels for effective government influence on payments system developments and policy, and it would be inappropriate to use the leverage available to the Government as the owner of the facilities supplying essentially unrelated component services.

AUSTRALIA'S DOMESTIC PAYMENTS SYSTEM

1 This appendix sets out a brief description of the range and relative importance of payments **instruments** presently in use in Australia and some aspects bearing on **participation** in the payments system.

Instruments

2 Australia's domestic payments system operates with a number of funds transfer instruments. Currency and cheques are the predominant instruments now but there are a range of other instruments of increasing importance. The payments system in prospect will progressively become less dependent on both cash¹ and cheques.

3 The responsibility for the production and issue of **currency** in Australia rests with the monetary authorities. Some aspects of this matter and the related question of currency distribution are discussed in Chapter 2 in the context of the role of the Reserve Bank.

4 In terms of the **number** of transactions, currency is the most important payments instrument. The relative importance of currency transactions reflects a variety of factors which bear on the costs of holding and using it relative to other payments instruments; among the factors influencing demand for currency are the cost of using alternatives (such as stamp duty and bank charges for cheques), security risks, transaction costs of replenishing cash holdings, and relative yields.

5 The short-term impact of the Committee's various recommendations (e.g. for the payment of interest on current account balances), if adopted, is uncertain.² The major force likely to depress the demand for cash is the adoption of more efficient technology which will reduce the price to users for non-cash transactions.

6 **Cheques** are the major transaction instrument when assessed in terms of the **value** of transactions. About one billion cheques are issued annually in Australia, increasing at about 5% per annum. In the normal course, only banks presently offer chequing account facilities, but non-bank intermediaries use their bank cheque accounts to pay some withdrawals, including drawing cheques payable to third parties.

7 Most Australian banks participate directly in the cheque clearing system. Clearing houses operate in each state, administered by the Australian Clearing House Committee. In 1977, an association of clearing houses was formed by the member clearing banks. New members are admitted subject to member approval of a majority of the Committee; members must be banks. Settlement of cheque exchanges between banks is, for the most part, effected on the following business day by cheques drawn on banks' exchange settlement accounts with the Reserve Bank.

1 Currency holdings of the non-bank private sector have represented some 4% of Gross Domestic Product since the mid 1960s; in 1950 and 1960 the proportions were about 9% and 6% respectively.

2 The potential impact of allowing payment of interest on current account balances needs to be considered in the context of accompanying pressures to tie the price of payments system services more closely to costs.

8 Some banks have participated indirectly in the clearing system via an agency arrangement with member banks. Agency arrangements are also used to clear the cheques of banks presented for payment in states where the drawee bank does not operate.

9 The cheque is a particular form of a bill of exchange. The use of **bills of exchange** which are not cheques as a means of payment is not common: promissory notes and commercial bills have become primarily loan instruments.

10 Many of the operational features of the cheque payment system are decided as a matter of custom by the participating institutions. One important feature of present arrangements is that those receiving cheques for collection typically accept them for value at the time of deposit even though the depositor is not entitled to take value until the cheque is cleared. As a consequence institutions which pay interest on deposit balances may incur an 'expense' in respect of the 'float' arising from the delayed settlement. Conversely payees benefit and so do the drawers if delayed settlement either allows interest to accrue on deposit balances committed to meeting cheques drawn or alternately delays or reduces indebtedness on overdrawn 'overdraft' accounts.

11 There are a number of pressures already bearing on preferences for cheque usage and these will likely intensify as the recommendations of the Committee are implemented. It is important to recognise that some substitute instruments are conceptually identical with cheques in that they involve three parties — drawer, drawee and payee — in the transfer, and the difference is one of form rather than essential substance; for example, one cheque debit may fund multiple transfers by direct credits to other accounts.

12 Narrowly defined, a cheque is a paper-based payment instrument which has to be **physically transported** from the drawer to the payee, from the payee to a bank branch (possibly through the agency of a non-bank), from the receiving branch to a central processing centre and from there, generally through the interbank clearing house, back to the bank branch on which the cheque was drawn. This extensive process of physical transportation and associated processing is so expensive that it seems unlikely to endure for the great bulk of payments presently made by cheque. The uncertainties concern the speed of change and the technical characteristics of the 'new cheque' or substitute payments instruments.

13 The cheque itself has a measure of flexibility and adaptability which has not yet been fully exploited in Australia. In particular it may be possible to truncate the cheque transfer process in a number of ways to bring it closer to a less expensively processed direct instruction to transfer funds from the drawer's account to the payee's account.³ One difficulty in this process is that the drawer (and the participating drawee institution) surrender to the payee some control over the actual transfer of funds.

14 In essence the truncated procedure for 'new cheques' allows the institution into which a cheque is paid to retain the instrument, extract the instruction contained in it and activate the funds transfer as if that instruction were undoubtedly valid. There is a risk of course that the instrument is unsound and the instruction not valid; the question is whether the risks of eventual loss can be reduced to a commercially acceptable level, given that recourse would be available to recover funds wrongly credited to accounts.

15 In concept the **alternatives to cheques** as they have evolved are:

(i) *Pre-authorised fund transfers:*

- arrangements for payers to **directly credit** accounts of payees: such arrangements are long established in the distribution of bulk payments such as social security benefits, government bond interest etc., and are increasingly popular in respect of wages and other regular payments;

3 It is possible that the provisions of the Bills of Exchange Act relating to cheques hinder progress towards truncation.

- concurrent arrangements for **direct debit** of payers' accounts and their direct credit to payees; again the basic arrangement is of long standing but it is moving to a new phase as those liable to make payments authorise the payee to initiate the transfer; and
- (ii) *Guaranteed transfers*⁴
- the prime example of an instrument of guaranteed transfer is the **credit card**: for payments made by **credit card** there are ultimately offsetting funds movements between payers and payees, but an institution of acceptable capacity to the payee is interposed between the parties to make the payment; such transactions have two elements — **immediate 'guaranteed' payments** by the card issuer to the accepting payee and **deferred payment** by the payer, with attendant credit risks to the card issuer.

16 In practical effect a sound banker–customer relationship as evidenced at the retail level by the issue of a credit card (or debit card) allows a good deal of flexibility. The credit card account can be the vehicle for initiating direct transfer transactions quite remotely, by mail or phone, without actual presentation of the card. Again important issues are raised by the potential which such systems leave open for error, fraud and malpractice; these risks have so far been kept within commercial bounds and any residual liability negotiated at a professional commercial level. The rights of participating merchants and consumers have been protected and their exposure to loss kept to minimal proportions.

17 The next few paragraphs give brief operational details on non-cheque-payment instruments presently in use — direct debits, direct credits, credit cards and money orders issued through the postal system.

18 **Direct debits** reflecting pre-authorised payments have become increasingly important. Originally, this facility was restricted to bank customers and gave banks an authority to debit accounts and remit the proceeds to a third party — payments were generally for fixed times and amounts, such as insurance policy premiums and rent. The system now accommodates debits initiated by third parties holding an authorisation from the customer. Direct debits supported by paper documentation enter the cheque clearing system. More recently, direct debits have been processed using magnetic tapes to effect the funds transfers. Electronic entries are cleared through the Central Magnetic Tape Exchange (CEMTEX) — an organisation jointly owned by the Australian banks. Non-bank intermediaries can use the direct debit facility, for example, to collect loan repayments from customers' bank current accounts. In 1979 the total number of pre-authorised payments was estimated to be about 25 million for all banks.

19 A **direct credit** deposit clearance system is operated in conjunction with the cheque clearance system; typical transactions include: deposits at one branch to an account at another, both intrabank and interbank; and the deposit component of direct debit transactions. Direct credits have become increasingly important with the growth of direct payroll credits processed through the CEMTEX system. The number of deposit items cleared in this way is currently about 100 million annually.

20 Banks can similarly arrange direct **telegraphic transfer** of funds through an encoded message on the Telecom network from one branch to another. The facility is costly and the volume is small. Settlement of the transfer is made by raising paper documentation which flows through the cheque clearing system.

21 A comprehensive bank-based **credit card** system — Bankcard — was introduced in Australia in 1974 and by world standards has quickly achieved a high market penetration. While there are some other non-bank credit card arrangements, Bankcard is now the most

⁴ It is possible to combine the essential elements of **direct debits** and **guaranteed transfers** by the issue of debit cards; the card issuer guarantees the payment to the payee but the transfer is funded directly from the payee's account with the card issuer. A guaranteed transfer facility can also be attached to cheques by the issue of **cheque guarantee cards**.

prominent: the other schemes include, 'in-house' cards issued by retailers, and general tourism and entertainment cards such as American Express, Diners' Club etc.

22 Participating 'Bankcard' banks individually carry out credit assessment, monitor delinquent accounts, process customer and merchant inquiries, oversee security, levy credit charges and conduct promotional activities. A service company (Charge Card Services Limited), owned by seven of the thirteen participating banks, provides a computer-based information processing and account-keeping facility. The service company acts as a central payment authorisation centre. Until recently, standard agreements were made between the merchants and cardholders and their bank. Cardholders are afforded a 25-day 'free credit' period after receipt of statement on purchases. The balance outstanding after 25 days from issue of statement, or from the date of drawing cash advances, attracts interest charges (at presently 1.5% per month).

23 Australia Post participates directly in the payments system through the issue of **money orders**, usually for relatively small amounts. Orders may either be presented for cash at the nominated post office or deposited in a bank account; banks collate orders received in their central clearing houses and present them for payment at capital city post offices: Australia Post in return issues a cheque for the total amount of orders presented.

Participation

24 For the most part policy issues surrounding participation in the Australian payments system as it now operates, and as it may develop in future, are discussed in the body of the Report at Chapter 23. The discussion here concerns the more technical (as distinct from policy) issues as they bear on participation in the system by institutions, financial or otherwise, and by users.

25 The key to understanding payments system participation issues is the degree to which acceptance in the system is dependent on creditworthiness.

26 The foundation of the **domestic** payments system is government-issued fiat money — cash. The creditworthiness of neither the Government nor the holder of legal tender is at issue in cash transactions.

27 There are limits to the efficient use of cash in a modern economy and domestic payments systems have progressively become less cash-oriented. Participation in non-cash transactions largely depends on the creditworthiness of both the financial intermediary and the person offering deferred payments.

28 The system is protected in a variety of ways:

- the financial institutions entitled to participate are required to demonstrate and maintain their undoubted capacity — established reputation is important;
- participating institutions have some responsibility to ensure that their customers can be similarly trusted to only issue entitlements to deferred payment (e.g. cheques) which will be met when presented for settlement;
- the instrument used can be designed to eliminate the major credit risks: the use of a third-party credit card eliminates the risk (to merchants) of the customer being unable to pay.⁵

29 While problems arising in deferred settlement remain a feature of non-cash payments, there **may be** barriers to the unrestricted participation of both users and institutions:

- participation in non-cash payment transactions may reasonably be denied to those potential users unable to demonstrate their creditworthiness;
- participation as an intermediary **not accepting credit risks** in the provision of payment services will depend importantly on a capacity to demonstrate to both payers and payees that their valid claims will be met;

5 Ultimately, technological development may make it possible for non-cash transactions to be settled instantaneously thus eliminating credit risks altogether.

- participation as an intermediary **accepting credit risk** (by underwriting the payment) will depend on acceptance by payees that valid claims will be met;
- additionally, between intermediary participants, it may be important that they have confidence in the creditworthiness of each other, if that would facilitate the efficient transfer of value and thus final payment.

30 Even if these important conditions of creditworthiness are satisfied there may be other factors which reasonably bear on participation — particularly by intermediaries newly qualified as acceptable credit risks. In essence these are issues about the **property rights** of existing participants whose collective and individual commercial position may be disadvantaged by their facilitating the market acceptance of a new participant. The issue is particularly important when the property rights are effectively held **collectively** by the existing participants.

Public Sector Participation

31 The Committee sought the comments of Australia Post on the possibility that there may be a role in the Australian payments system for a giro-style facility offered at post offices.

32 The following is the relevant text of the response provided by Australia Post:

Description of a Giro

The following description outlines the main features of the Giro systems which have been established in a number of countries.

Giro is a money transfer system which allows anyone, either a private individual or a business, to open an account by depositing a sum of money at any Giro office. No interest is paid on deposits but transfers of funds between Giro accounts are carried out free of charge. Payments to non-Giroists may be made by means of a Giro cheque and it is also possible for non-Giroists to make payments into a Giro account at any Giro office. Both of these facilities incur a small fee. Additionally, for all orders for payments (either by transfer or Giro cheque), postage to the Giro centre is provided free of charge.

Another feature of overseas Giro systems is that all accounts are kept and processed (usually by computer) at a single national Giro centre. This results in a minimal time lag between the payer authorising payment and the payee's account being credited.

Account statements are usually sent out on a daily basis to business Giroists, and whenever there is a change in the account balance for private Giroists.

An Australian Postal Giro?

The feasibility of introducing a Postal Giro system has been reviewed on many occasions in the past decade by the Postmaster-General's Department, Australia Post and by the Vernon Commission of Inquiry into the Australian Post Office. The latest study was conducted internally by Australia Post in March 1976. The findings of that study have recently been reviewed and are still valid in principle. They form the basis of the following comments.

It has been suggested that an Australian Giro could take on the role of a 'poor man's bank' by providing the lower socio-economic groups with a cheap form of money transfer. However, this is unlikely, in light of UK experience which has shown that the lower socio-economic groups are just as unrepresented in Giro accounts as they are in other banking and financial services. A UK survey of Giro account holders has also shown that the proportion of Giroists with cheque accounts is higher than the proportion of people with cheque accounts in the population as a whole.

The potential Giro customers in Australia are private individuals and business and government organisations.

Giro initially offers more advantages to private individuals than to businesses although, as the number of private Giro accounts grow, Giro becomes increasingly attractive to businesses and government, particularly those enterprises which interface primarily with the general public, e.g. insurance, finance, hire purchase companies, public utilities, the Department of Social Security etc. The advantages of Giro to these organisations are that it would reduce costs and often streamline procedures for making payments to, and receiving payments from, their customers.

The Giro service offers a relatively cheap form of money transfer. The banks and other financial institutions provide similar and competing services: cheques, Bankcard, and direct account transfer are provided by the banking system, and some credit unions and building societies will write cheques free of charge for account holders on receipt of deduction authorities.

A Giro system operated through the postal system would have a number of advantages over the established cheque system, viz.

- expected lower cost of service;
- a more comprehensive distribution of outlets especially in areas of dispersed population;
- longer trading hours at Giro offices (i.e. designated post offices) than at banks;
- availability of more up-to-date information on the state of a Giroist's account;
- improved control of Giroists' cash flow due to speed of crediting and debiting accounts and greater frequency of provision of account statements.

There are also disadvantages in the use of Giro, rather than cheques, which may inhibit its use:

- the procedure for withdrawal of funds from a Giro account tends to be more difficult because there are maximum limits to the size of cash withdrawals that may be made without clearance through the Giro office;
- charges for withdrawals may be a deterrent;
- in some cases it may be difficult to identify the payer;
- lack of overdraft facilities; all drawings against an account must be covered in advance;
- non-availability of loans. (Although the British Post Office Giro is now undertaking this activity.)

Bankcard would be a second major competitor of Giro, especially in Giro's preferred market segment of money transfer (non-cash) transactions. Payments to public utilities such as electricity, water rates and payment of accounts which occur at regular intervals (such as rent, loan repayments, insurance, hire purchase payments), would be market segments into which Bankcard could logically move.

The advantages of Bankcard and other credit cards over Giro are:

- credit cards offer credit facilities;
- from the payee's point of view, credit cards are a more secure form of payment as a signed form is sufficient for the payee to collect, whereas with the Giro system the payee would need proof that his customer had a current Giro account (however, credit cards offer the payer less security);
- from the point of view of the payer and payee, credit cards offer a more convenient method of payment.

A third type of competition by banks could be the establishment of a 'Bank Giro' as has occurred in the UK.

Because the markets in which Giro would compete are already well (if not over) catered for by potentially aggressive suppliers and the potential customers for Giro in Australia are significantly orientated to the traditional banking methods, a slow and costly market penetration of Giro could be expected. The British Post Office (BPO) underestimated the above factors and it was largely because of this that profitability was poor in early years of Giro's introduction. In recent years the BPO Giro system has gained and maintained its profitability.

From Australia Post's estimates of the potential market, the rate of gain in market share and the expected costs of establishing and operating a Giro system, Australia Post has concluded that viability could not be reached within five years of Giro's inception. This conclusion is supported by the British Post Office experience. Estimates based on 1975-76 figures indicate that a loss of about \$50m could be expected by Australia Post over the first five years of operation.

A Giro service would be compatible with the concept of a cashless society. However, the development of integrated electronic funds transfer systems could have a strong impact on a Giro service in the future and further reduce the prospects of Giro becoming viable in the long term.

Cognisance has been taken of the comments made in the April 1974 Report of the Vernon Commission of Inquiry into the Australian Post Office, which considered that the Australian Post Office should not become involved in a Giro service, as it would represent an unnecessary and undesirable diversification.

It should be noted in this connection that, while post offices have for years provided a widespread network of outlets for the Commonwealth Savings Bank, this is done on an agency basis only, and largely utilises the existing skills of post office counter staff. The introduction of a Giro service by Australia Post would require a significant increase in banking skills and experience particularly at the higher management levels.

Conclusion

In the light of the issues and assessments outlined above, Australia Post has not sought to introduce a Postal Giro.

CHAPTER 24: DOMESTIC ENTRY TO FINANCIAL INTERMEDIATION

24.1 This chapter is concerned with the terms and conditions on which resident-owned financial intermediaries may be authorised to participate in various parts of the Australian financial system. The discussion focuses in turn on:

- banking;
- non-bank deposit-taking financial intermediation business; and
- financial intermediation carried out by businesses which are not primarily financial institutions.

24.2 The chapter is **not** concerned specifically with the related questions of investor protection, competitive balance etc., except as they may be relevant to considerations related to entry that might involve the authorities. The issue of non-resident entry and participation is discussed in Chapter 25.

24.3 In keeping with a basic theme of this Report, that strongly competitive markets carry with them many advantages, particularly from the point of view of efficiency, the Committee seeks an environment for entry by residents to financial intermediation which is characterised by:

- an absence of barriers to entry other than those required to maintain the stability of financial markets; and
- equal regulatory treatment of like institutions.

A. BANKING

(a) Present Position

24.4 Legislation at present identifies three **functional** classes of banks operating in Australia — **trading** banks, **savings** banks and **other** special purpose banks such as the Commonwealth Development Bank, the Australian Resources Development Bank, and the Primary Industry Bank of Australia. Within 'trading banks' provision is made for a special class (called prescribed banks¹) which are subject to lesser monetary policy requirements than other trading banks. Within savings banks the legislation presently permits lesser requirements to apply to trustee banks. The Australian Federal system and state powers mean that state banks can operate in all areas of banking including undertaking the general business of banking without being subject to the Banking Act.

24.5 Aside from state banks, only organisations authorised under the Banking Act (including representative offices of foreign banks²) are allowed to include the

1 The prescribed trading banks while subject to the Banking Act have a different status under that law to the major national trading banks: e.g. while a uniform SRD ratio must apply to all the major banks, a lower requirement may and frequently does apply to individual prescribed banks.

2 Representative offices of foreign banks are not permitted to do any financing business; they act purely in a liaison capacity.

title 'bank' in a registered business name; other institutions may describe themselves as 'banks' only where this would not cause confusion about the standing and functions of the institutions in question.

24.6 Considered simply as participants in financial markets, a major distinguishing feature of banks is their acceptance in the community as financial institutions of exceptionally **high standing**. Banks' deposit and other liabilities can typically be issued at lower interest rates than those of other private borrowers. Banks are also **functionally** unique as an institutional class because they alone provide the institutional base of the domestic and international payments systems.

24.7 The Committee does not propose any basic changes in the formal characteristics of a 'bank'. These characteristics, some of which are also discussed in Chapter 19 in the context of depositor protection, include:

- being separately incorporated enterprises³ primarily engaged in the borrowing and lending of money;
- having a special relationship with the Reserve Bank stemming from the latter's responsibilities to protect bank depositors;
- being required to observe relatively stringent prudential standards in respect of their capital structure and in the management of liquidity and depositors' funds; and
- being the only institutions legally authorised to issue cheques and (apart from some relatively minor exceptions) to deal in foreign exchange.

24.8 The Committee appreciates that in a number of countries many of the traditional functional distinctions between banks and other intermediaries have become less clear over time; in some cases the authorities have responded to such developments by recognising as banks those institutions performing bank-like functions.

24.9 This has been reflected in some important developments overseas, notably:

- regulations which govern particular bank functions have often been extended to embrace other intermediaries performing similar functions;
- a trend towards greater participation by non-banks in certain banking-type arrangements (such as cheque payment facilities). In some countries, groups of non-bank intermediaries have sought to co-ordinate their conduct of some banking functions through central units which have themselves been recognised as banks.

24.10 The Committee's broad approach to regulation and competition⁴ would not stand in the way of similar developments in Australia **except that its recommendations would maintain a clearer demarcation between banks and 'non-banks' than is the case in some overseas countries**. The Committee believes that confidence in financial intermediaries is crucial to a well-functioning financial system. At the same time, it feels that bringing all intermediaries under the umbrella of protection of the authorities would not enhance long-run efficiency. It believes that an appropriate balance involves a spectrum of risk; it sees banks as being near the 'no risk' end of that spectrum.

³ But not necessarily joint stock companies.

⁴ See Chapters 19 and 23 for example.

(b) Incentives to Entry

24.11 Since the Banking Act was introduced in 1945 virtually no new banking licences have been issued. The only exceptions are the savings bank licences issued to established private trading banks and the recently issued licence to the Australian Bank Ltd.

24.12 The Committee understands that no 'formal' applications for banking licences by domestic interests have been refused.⁵ However, factors which may have discouraged resident applications for banking licences include:

- the differentially heavy regulation of banking, in relation to non-bank intermediation;
- the perceived difficulty of establishing a viable banking business in a financial market dominated by a relatively few long-established banks⁶;
- the existence of the Banks (Shareholdings) Act; and
- the absence of publicly available criteria for entry, in conjunction with a public perception that licences would not be readily forthcoming.

24.13 The Committee attaches most weight to the first factor — the regulation of banking. Significantly there has been no reluctance to become involved in areas of financial intermediation other than general banking business.

24.14 An important aspect of the Committee's recommendations in Chapter 4 is that the techniques of monetary policy should be more broadly based and neutral in their impact on financial intermediaries, although it is recognised that banks must continue to be a focal point of monetary policy. It is expected that the adoption of these recommendations will provide increased incentives for those capable of conducting a banking business to seek formal status as a bank.

(c) Economies of Scale⁷

24.15 An important economic question which arises in the context of entry to banking is whether there are economies of scale in the industry. Economies of this type can arise from a number of factors. For example:

- greater specialisation of factors, particularly labour;
- the spreading of the cost of indivisible factors and other overheads (administrative labour, advertising expenses etc.) over a larger number of units;
- the spreading of the cost of evaluating potential investments over larger asset purchases;
- greater scope for diversification of activities (integration), which can lead to a reduction in costs if, as a result, plant is used more intensively or the risk attached to an individual activity is diluted;
- a larger financial intermediary may be able to economise on the liquidity reserves it needs to hold in order to carry out its day-to-day business; and

5 Banking licences have been sought, at least informally, by non-residents but it has been the policy not to grant new Australian banking licences to non-residents.

6 The competitive importance of size is reflected in the mergers between Australian-based banks that have occurred from time to time.

7 This section draws heavily on K. T. Davis and M. K. Lewis, 'Economies of Scale in Financial Institutions', *AFSI Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981.

- a large institution may be viewed by potential customers as being safer than a smaller institution. This may reflect its size and the perceived reluctance of governments to allow large financiers to fail, together with its greater capacity for diversification. In either case, the larger financial institution will be able to borrow at lower rates than smaller competitors.

24.16 As well, there are certain economies (often called **pecuniary** economies) which yield cost savings to the financial institutions in question, but no benefits to the community as a whole (i.e. there is no reduction in resource use). An example would be where a large financial intermediary derives economies from such sources as monopoly purchasing power in certain markets.

24.17 If economies of scale were substantially present, some would see an argument for limiting entry to the industry — both domestic and non-resident. Those who take this view acknowledge that the smaller, less efficient firms would eventually be eliminated by the competitive process, but warn that the instability arising out of this adjustment process may well impose unacceptable costs on the community.

24.18 However, the Committee does not accept that the possibility of economies of scale offers sufficient justification for limitations on domestic entry to banking. Firstly, although the history of consolidation in the banking industry suggests the presence of moderate economies of scale and this conclusion receives some further support from statistical analyses, the evidence is far from conclusive.⁸ The strongest evidence of the existence of economies appears to apply to the payments mechanism and this aspect was discussed in the previous chapter; over the full range of banking activities, the net benefits of increased size may not be great beyond a certain point, and this point may have been reached by most banks already.

24.19 Secondly, firms operating in a highly concentrated industry for some time may become inefficient — they have an excellent opportunity for collusion and operational and dynamic efficiency may decline. These problems are minimised by keeping alive the **possibility** of new entry. It seems likely that new institutions will enter the industry only if there appear to be opportunities for profit arising out of the inefficiency of existing institutions. If entry occurs in those circumstances, the ultimate outcome may well be a more efficient industry.

24.20 A related point, made by the Committee's consultants on this subject, is that there may be situations in which the authorities should prevent existing firms from amalgamating. This will be the case if any economies of scale present are of the pecuniary type because the mergers would not then confer a benefit on the community.⁹ The Committee appreciates the force of this argument, but has been given no reason to believe that the economies which arise in banking are largely of this type.

24.21 Another situation in which the authorities may be justified in preventing mergers is where the adverse effects on consumers of the resulting increase in monopoly power outweigh the benefits produced by the reduction in the average cost of production; that is, where there would be a substantial increase in

⁸ Davis and Lewis, op. cit.

⁹ This point is discussed in greater detail in K. T. Davis and M. K. Lewis, op. cit.

monopoly profits. This possibility does not appear to be relevant to the **future** competitive structure in banking, as envisaged by the Committee.

(d) Criteria for Entry

24.22 At various points in this Report the Committee has proposed that banks should observe certain prudent standards of funds management and corporate organisation.

24.23 In addition, the Committee proposes that access to a licence to conduct the general business of banking should continue to be authorised by the Treasurer on the advice of the Reserve Bank, on the basis of certain criteria which are outlined in Chapter 19, including an enduring managerial capacity. It is important, however, that any ambiguities in official policy be removed and that the criteria to be applied in assessing new entrants be set out clearly and unequivocally.

24.24 The Committee also proposes that apart from these essentially prudential requirements, designed to ensure that banks retain a high standing in financial markets, there should be no prescribed restrictions on the range of financial activities or types of financial or related business that banks may undertake.

24.25 As the bank authorisation provisions of the present banking legislation are drafted, it appears there may be an understanding that an authorised bank will conduct the **general business of banking**. The required scope of a general banking business is not defined and some existing banks do concentrate their business in particular segments and classes of transaction.

24.26 The Committee sees some dangers in an approach to bank authorisation which would **require** a broad-ranging banking and financing operation. An institution seeking bank status on the basis of its reputation and successful operation in either wholesale or retail banking might, for example, be inappropriately induced to offer facilities beyond its capacity and expertise (and perhaps against its prudential interests) if it were required to enter a broader range of financial markets.

24.27 In any case, the Committee regards such an approach as unduly restrictive. One can readily envisage a greater diversity of 'banks' in the future than is the case at present, with many specialist wholesale and retail banks competing alongside broad-ranging general banking institutions.

24.28 The question of the desirable structure of banking depends on two considerations:

- the effect of increased participation on the stability and efficiency of banking and, in particular, the payments mechanism; and
- the appropriate prudential standards to be observed to protect the interests of depositors and investors.

24.29 The provision of an equity base is an essential element of a bank's capital structure. This of course exists in a joint stock company — the form of organisation which predominates in the banking field. Nonetheless, in Australia and in other countries it has been possible to accommodate, as banks, corporations which are co-operatives without a separate class of proprietors. In some instances established co-operatives have accumulated reserve funds which take the place of formal capital, but these resources often fall short of the capital requirements which may be deemed appropriate for a bank. The gap might possibly be filled by the establishment of a class of subordinated deposit liability issued on such terms that

it would effectively substitute for conventional proprietors' funds. This matter is taken up in more detail in Chapter 19.¹⁰

24.30 While the Committee expects that there would continue to be provision for different types of banks subject to the Banking Act (including trading banks, savings banks, special purpose banks, 'universal', full service banks etc.), it is envisaged that institutions specialising in different types of activities would be eligible for a banking licence, and would be subject to prudential standards appropriate to the nature of their activity. The Committee would also expect that where conditions are attached to authorisations, these would be subject to review on request.

24.31 The Committee expects that while common principles will apply to the determination of required prudential standards, there may be different requirements for different types of banks, and even for banks of the same type.¹¹ The Committee feels that the requirement should reflect the nature of the business undertaken.

24.32 To the extent monetary policy requirements are imposed the Committee advocates that they be applied consistently to all banks. However, this should not preclude differences in application between types of banking activities.¹²

(e) Proposed Changes

24.33 The Committee believes the use of the title 'bank' should continue to be restricted and that banks should continue to retain in essence certain distinctive characteristics. Nevertheless, it is clear from the foregoing that there is a need for a number of changes to present policy on the authorisation of residents to conduct a banking business. Having in mind in particular the prospective deregulation of banks (as recommended in this Report), the Committee believes the scope for abuse of power should be minimised by removing all barriers to domestic entry other than those dictated by prudential or stability considerations.

24.34 Specifically, the Committee *recommends* that:

- (a) Recognition of a resident-owned financial intermediary as a bank should be primarily determined on the basis of its established or potential high standing in the general community and its capacity and willingness to observe the high prudential and operational standards appropriately required of a banking business.**
- (b) Eligibility for recognition as a bank should not require a broad-ranging banking and financing operation as a pre-condition; conversely, and subject to appropriate prudential safeguards, authorised banks should not be precluded from diversifying their operations as market opportunities permit.**
- (c) It should not be mandatory for new banks to adopt a joint stock corporate structure. Subject to appropriate prudential safeguards, registered co-operative institutions (or central institutions owned by a group of co-operatives) should be eligible for authorisation as a bank.**

10 This form of 'capital', however, is not favoured where there is a need for a government institution to be fully capitalised to the extent of its private sector counterparts.

11 This issue is discussed more fully in Chapter 19.

12 Even so, the continuing appropriateness of section 25 of the Banking Act — relating to prescribed banks — may need to be reviewed.

- (d) **Any monetary policy controls (e.g. variable reserve requirements) should apply on a consistent basis to all banks, according to the nature of their activities.**

B. FINANCIAL INTERMEDIATION OTHER THAN BANKING

24.35 A range of financial intermediaries (other than banks) accept funds from the public and make loans.

24.36 Some of these intermediaries are subject to entry requirements of a prudential character — imposed by state governments (e.g. building societies and credit unions) or by the Commonwealth Government (e.g. life and general insurance companies). Specific requirements apply to different areas of the securities industry under the Securities Industry Act. Some intermediaries are not subject to any substantial entry requirements (e.g. finance companies).

24.37 Where entry requirements are applicable, these are discussed in the relevant chapters on investor protection (see in particular Chapters 19 and 20) or in the case of authorised dealers in Chapter 9. The Committee seeks here only to reiterate some important general principles governing the role public policy should play in regulating entry into financial intermediation as financial corporations.

24.38 Governments must play a role in monitoring entry where they are setting and supervising prudential standards. In particular, new financial intermediaries intending to seek funds from the general public, and which are subject to prudential supervision, should be required to demonstrate reasonable managerial competence to the relevant prudential authorities and a continuing capacity to observe appropriate and consistent prudential and disclosure standards. They should also continue to register with the appropriate Commonwealth and State regulatory authorities and provide information on their operations, such as required by these authorities and under the Financial Corporations Act.

24.39 The Committee does not favour a system which would deny resident participation in non-bank financial intermediation to those judged capable of meeting prudential requirements, except in extreme situations. Of course, there may be circumstances where a restrictive public policy on entry can play a useful, but essentially temporary, role in rationalising industry structures which may be threatened with instability. That might mean new entrants at times need to be looked at more critically but it should not lead to the absolute exclusion of those which have a real contribution to make. Such exclusion could weaken the competitive environment and unduly restrict risk-taking opportunities, and thus the efficiency of financial intermediation.

24.40 **The Committee believes that, as a general principle, official policy should not be discouraging to the entry and participation of resident-owned non-bank financial intermediaries. This is broadly in line with present policy.**

C. OTHER FINANCIAL INTERMEDIATION

24.41 A significant amount of financial intermediation is carried out in conjunction with a business which is primarily **not** a finance business and not through a separate corporation. Moreover some financial corporations are not

subject to national legislation and a financial intermediary need not be incorporated.

24.42 For the most part, businesses are presently free to conduct financial intermediation operations at their discretion, subject of course to rules applicable to public borrowers and in some instances special legislation. The Committee proposes no change to this basic position. Nevertheless, it is of the view that national monetary management and policy would be assisted if appropriate authorities, such as the Reserve Bank, were supplied with statistics relating to the substantive financial intermediation activities of businesses which are not primarily financial in character.

24.43 The Committee accordingly **recommends** that **primarily non-finance corporations engaged in a financial intermediation operation in a substantial way should be required to supply statistics on that operation as if it were separately incorporated.**

CHAPTER 25: NON-RESIDENT PARTICIPATION IN AUSTRALIAN FINANCIAL INTERMEDIATION

A. INTRODUCTION

25.1 This chapter examines the question of non-resident participation in Australian financial intermediation.

25.2 The discussion concentrates on the economic issues. At the same time the Committee is mindful that the decisions of government must have regard for wider, non-economic considerations, which in this area can be very important.

25.3 The focal point of this chapter is non-resident participation in domestic **banking**. However, many of the issues discussed are equally relevant to non-resident participation in non-bank financial intermediation.

(a) The Present Situation

25.4 Two foreign bank groups, owned by the governments of France and New Zealand, have limited bank branch representation in Australia and a relatively small share of Australian banking business. Their presence pre-dates the now long-standing policy of prohibiting the establishment of new banks owned by non-residents and of restricting the participation of non-residents as substantial equity holders in Australian banks. As well, the Committee understands that the two foreign banks with branch representation have been discouraged from aggressively expanding their Australian businesses — particularly in retail banking.

25.5 Non-residents, while at present excluded from a new formal banking presence in this country, are able to participate in Australian financing:

- **through correspondent relationships** with Australian banks;
- **through their lending from offshore** to Australian borrowers (subject to exchange control); this is facilitated, in many instances, by the customer liaison activities of local **representative offices** (some one hundred foreign banks have representative offices in Australia);
- through the provision of letters of credit, guarantees etc. to support borrowings on Australian money markets;
- as a consequence of their ownership of Australian **non-bank financial intermediaries**: collectively, foreign banks hold very extensive equity interests in Australian merchant banks and to a lesser extent finance companies; non-resident-owned enterprises also have a significant presence in the life and general insurance sector¹; and
- through the ownership of businesses which, while not primarily financial

1 Some statistics are shown in Table 6.4 of the Interim Report.

institutions, nonetheless undertake borrowing and lending, as principals, in Australia.

B. BANKING

(a) The Case for Removing the Prohibition on Entry

25.6 The question of foreign bank entry to general commercial banking operations² must be viewed as a particular aspect of the more general issue of increased participation in the banking area.

25.7 Underlying the discussion in many parts of this Report is the Committee's firm belief that adequate and vigorous competition is an essential requirement for the efficient operation of financial markets. The Committee has reason to doubt that the level of competition in banking is at present adequate to ensure maximum efficiency and maximum benefits for all consumers of banking services (see Chapter 32).

25.8 Concern has been expressed in many submissions to the Committee that the Australian community may be 'paying too much' for its banking services; this is supported to some extent by limited evidence³ which suggests that Australian banks may be conducting relatively high cost operations at relatively generous earnings margins — by international standards. Some of these costs have emanated from the present complex of controls.⁴

25.9 The Committee is confident that the implementation of various recommendations in this Report will have the effect of intensifying the level of competition in the banking industry; in particular, reduced reliance on direct controls should give existing banks a greater incentive and capacity to compete with each other and with non-banks and make bank status more attractive to new entrants. Liberalisation of domestic entry conditions should facilitate the acquisition of a bank licence by Australian interests.

25.10 It is possible that these changes will be sufficient in the long run to ensure a healthy and vigorous competitive environment. However, in the opinion of the Committee such an outcome is unlikely (at least for many years), unless restrictions on the entry of foreign banks are relaxed. Factors underlying this assessment include the small (and declining) number of licensed banks now in existence, their traditional management attitudes, and the difficulties that a new domestic institution may have in breaking into established markets, given the size and cost advantages of existing banks in many areas of activity.

25.11 Foreign banks offer a more immediate prospect of providing an effective

2 There are extensive submissions on this question. K. T. Davis and M. K. Lewis, 'Foreign Banks and the Financial System' in *AFSI Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981, summarise the benefits perceived by foreign banks as likely to flow from their admission into Australian banking as well as the responses to these views from the Australian banks, other financial institutions and the monetary authorities. The authors give their own assessment of the deficiencies in the present competitive structure and the benefits that might flow from foreign bank entry.

3 K. T. Davis and M. K. Lewis, *ibid.*

4 On this point see E. Kiernan's comments on K. T. Davis and M. K. Lewis in the same publication.

competitive stimulus (particularly in the shorter term following deregulation of the banking system) than potential domestic entrants because they:

- already have the resources and banking expertise (especially in international trading and foreign exchange dealings) necessary to establish wide-ranging banking businesses in Australia;
- are often operating non-bank financial intermediaries in Australia (in some cases with a branch network, although less extensive than most banks), and thus, like many large non-bank financiers, face lower economic barriers to entry than some other potential domestic entrants;
- have internationally recognised standing as banks and should readily command the confidence of the Australian community; and
- are less likely to be deterred by the risks and uncertainties, and possibly less than average profit levels, associated with the early establishment years.

25.12 It is significant that except for a single recent new authorisation, domestic groups have not sought new authorities to conduct general banking business for many years. Indeed, the tendency has been for existing banks to merge. In contrast, foreign banks have persistently sought banking licences even within the present regulated system and where they already have an operational base in the non-banking sector of the financial system.

25.13 However, the extent of the contribution to be made by foreign banks should not be exaggerated. Foreign banks have already provided considerable competition through their activities in the non-bank financial area, as well as through their offshore operations. In part, what would be involved would be a rearrangement or rationalisation of existing activities. There can be little doubt, nevertheless, that they would be able to compete more effectively in these activities if they were also free to offer a full range of banking services and to structure their operations in the most efficient manner. Moreover, they would gain access to some markets which at present are the exclusive preserve of banks — in particular, foreign exchange and cheque account transactions. The Committee believes, therefore, that the competitive environment would be enhanced and the efficiency of the financial system increased as a result of more direct foreign bank participation.

25.14 Provided the **rate of entry** of foreign banks is **carefully managed**, the move towards the new competitive environment should present minimal disruption to banking operations.

25.15 It is true foreign banks would have the advantage of a broad customer base in their home country and, internationally, greater familiarity with other economies, access to foreign capital, and the opportunity to specialise, and exploit their unique skills in limited market segments. On the other hand, Australian banks would not be at a competitive disadvantage over the long term; they would retain their own areas of comparative advantage — their better knowledge of local markets and established customer base — while at the same time sharpening and maintaining their skills in international banking and trading finance. They would also have a strong incentive to adopt and maintain any appropriate new financing technology introduced by their new competitors from overseas and would be able to compete much more aggressively than they have in the sheltered, regulated

environment of the past. Many Australian banks have been competing successfully with foreign banks in international capital markets.⁵

25.16 The Committee accepts that non-resident-owned businesses may wish to bank with foreign banks — simply because of their common national origins or common ‘non-resident’ status. It would be unreasonable to deny the extension of what may be a natural, well-founded commercial relationship. The potential may be greater in the Australian case because the proportion of the business sector owned by non-residents is greater than in many other countries. That said the Committee does not expect the problem to be a substantial one in the overall sense; in terms of a bank’s Australian deposit base the benefit of established customer and nationality linkages must surely be with Australian banks. Overseas experience supports such a proposition and, in the opinion of the Committee, does not give substance to the concerns expressed in this area.

25.17 The Committee’s view that a gradual entry of foreign banks, as banks, need not be disruptive to the banking system receives some support from the experience of finance companies in the 1970s: relatively free entry has not had an excessively destabilising effect.⁶

25.18 Concern has been expressed about the scope of multinational enterprises to shift income between components to minimise Australian tax liability; such concern is not unique to financial enterprises, although it may have special significance in the area of financial flows. There are established standards which are expected to be observed and supervised in this regard, and this matter will require particular attention from the Australian monetary and taxation authorities.

25.19 Those who support a policy of complete prohibition often argue that allowing foreign bank entry will, by increasing the integration of the Australian economy with the international monetary system, generate instability in the domestic economy and impair the effectiveness of economic management. However, the evidence, although inconclusive, suggests that the Australian economy is already integrated to a considerable degree with the international financial system. This is reflected in what appears to be a strong and increasingly close relationship between Australian and overseas interest rate movements⁷ and arises from the growing capacity and willingness of large companies to adjust the composition of their borrowing requirements as between local and overseas sources in accordance with changing interest rate relativities. It also arises from the development of strong ownership and agency links between domestic and foreign financial institutions.

5 As E. Kiernan notes (op. cit.), Australian banks have expanded successfully overseas:

... [the] classification of Australian banks as ‘domestic’ is clearly misleading. The trading banks have branches overseas which participate in spot and forward currency markets and interbank markets. And clearly most large banks have subsidiaries involved, both within the country of domicile and in other countries, in merchant banking and foreign exchange business. Thus the *Statistical Bulletin* of the Reserve Bank of Australia (February 1981) reports that overseas assets of major trading banks as of June 1980 were 26% of domestic assets.

6 On an equity weighted basis about one-third of finance companies’ assets is presently owned by non-residents. See Chapter 5 of the Interim Report.

7 See for example D. Carland and T. J. Valentine, ‘The Relationship between Australian and Overseas Interest Rates’, AFSI, *Commissioned Studies and Selected Papers*, op. cit. It is argued in this paper that it is possible to explain the differential between Australian and international interest rates by reference to the factors which determine exchange rate expectations. This result is indicative of a high degree of integration.

25.20 Nor does the Committee accept that the entry of a number of foreign banks would weaken the impact of monetary policy, so long as the main instruments used are open market operations and a variable bank reserve requirement. Indeed, to the extent that their entry leads to an increase in the overall importance of banks, the ambit of the reserve ratio control would be widened.

25.21 The Committee believes, therefore, that the concern about the loss of monetary control following foreign bank entry has been overstated. This is a view supported by a number of advisers to the Inquiry.⁸

25.22 The Committee acknowledges that the entry of foreign banks would quicken the pace of integration between Australian and overseas capital markets. The changes would be gradual rather than sharp and should pose no more problems for macroeconomic policy than some of the structural changes experienced in the Australian financial markets in the 1970s. In any case, the trend to closer integration is likely to continue, whether or not overseas entities are granted bank licences. The Committee would, of course, expect that international funds flows would be closely monitored for purposes of economic policy and that the authorities would pursue an essentially market-determined exchange rate and monetary policy so as to avoid potential for 'one-sided' speculative activity. It might also be noted that the scope to effectively monitor and control the operation of foreign banks would be enhanced if these operations came within the scope of the banking legislation.

25.23 In summary, provided appropriate prudent funds management standards are maintained in order to protect the security of Australian depositors, the Committee cannot support the present embargo on the participation of foreign banks, as banks, in Australia.

25.24 The Committee accordingly *recommends* that the existing embargo on non-resident participation in Australian banking should be removed.

(b) The Case against Unrestricted Entry

25.25 While accepting the need for removing the present embargo on foreign entry and a rationalisation of the manner in which they can operate in Australia, the Committee sees many potential dangers in unrestricted foreign bank entry (having regard to the existing situation); in particular:

⁸ It is appropriate here to summarise views expressed by various consultants to the Inquiry:

... the complex interaction of the categories makes it extremely difficult to formulate simple rules for controlling an expanded money supply embracing these components. They are essentially problems of a more complex and competitive banking sector, not of foreign banks per se ...

Any immediate loss of monetary control intensified by foreign bank activities can be offset to some extent by operations in forward markets and by a more flexible exchange rate.

K. T. Davis and M. K. Lewis, op. cit.

They [Davis and Lewis] do not see a major argument against foreign banks arising from questions of monetary control, and I agree with this view ... flexibility of exchange rates aids monetary independence, as may the existence of forward exchange markets

R. H. Snape, 'Efficiency, Control and Nationalism: the Question of Foreign Banks', in the same publication.

One would have thought that avenues for importing and exporting funds were already sufficiently well developed for the entry of foreign banks to make little difference.

E. Kiernan, also in the same publication.

- although many foreign banks are already engaged in financial intermediation in Australia, the unrestricted extension of their activities could be disruptive and could generate instability, particularly in the transition period when domestic banks and other financial intermediaries are adapting to a less controlled environment⁹; as banking will continue to play a unique role in the financial system (e.g. as a safety haven for risk-averse depositors), it is important for general confidence that it should not be subject to undue stress in the market place;
- it could result in undue fragmentation of the financial institutional structure — at least in the early years — with unfavourable consequences for operational efficiency; in this regard the evidence suggests the existence of moderate economies of scale in some banking activities (especially in the management of the payments system) — at least over the present range of institutional size¹⁰; while this need not of itself necessarily justify restrictions in **domestic entry** (see Chapters 23 and 24) the potential effects of a large number of new foreign bank participants are much more significant. It is possible that the number of foreign banks may increase to a point where adverse effects on the cost-structure of the industry outweigh the benefits from increased competition; and
- it could lead to a period of over-aggressive competition which may have the effect of discouraging potential domestic entrants; there may be some danger of a **socially unacceptable loss of resident ownership and control**.

On balance, the Committee does not regard unrestricted foreign bank entry as a viable short-term policy option; there needs to be some restraint on the pace of change.

25.26 The Committee *recommends* that, **initially, the rate of entry of foreign banks (to establish an Australian banking operation) should be carefully managed.**

25.27 In the following paragraphs, the Committee develops a policy proposal for restrained entry and participation.

(c) Options for Restricted Entry

25.28 Options for restraining foreign bank entry and participation include the following:

- (i) **limit the number of licences** issued over any given period but otherwise allow foreign banks which are admitted the same degree of operational freedom as domestic participants;
- (ii) apply differential regulation to non-resident-owned banks; the constraints could take various forms:
 - **restrictions on relative size or rate of growth**, e.g. Canada limits foreign bank ownership and control to 8% of the banking system;

9 The Hong Kong experience of a significant influx of foreign banks after entry was relaxed in March 1978 supports this. Subsequently in August 1979 the Hong Kong authorities suspended the granting of new bank licences. This moratorium was partially relaxed recently. This points to the need for caution on the **pace** of entry, but it does not alter the fundamental case for freer entry.

10 K. T. Davis and M. K. Lewis, 'Economies of Scale in Financial Intermediation'; and T. J. Valentine and P. J. Williamson, 'A Note on Economies of Scale in Australian Banking', in *AFSI Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981; see also Chapter 24.

- **restrictions on functions**, e.g. new foreign banks could be restricted in their permitted functions to either 'wholesale' or 'retail' markets but not both;
- **prescription of a minimum range of services**, e.g. entry could be conditional on willingness to participate actively in a full range of activities, including retail branch banking;
- **limits on diversification**, e.g. preclude affiliation with non-bank subsidiaries so as to contain business within the banking sector;
- application of a differential '**tax**' on non-resident participants including a discriminatory reserve deposit requirement;
- **auctioning** of licences; and
- **local equity participation** requirement. (In the discussion which follows, this aspect is explored separately as it involves issues of domestic ownership aspirations.)

25.29 The Committee accepts that a limit on **numbers** is an essential element of a policy allowing foreign banks gradual access. Whatever other techniques of restraint are used, the rate of admission of additional foreign banks would need to be controlled to minimise any transitional problems which might otherwise occur. The following section discusses each of the other options.

(d) Consideration of the Options

(i) Restricted Size (or Rate of Growth)

25.30 The Committee does not favour the setting of firm limits on either the absolute size or relative growth rate of the Australian business of foreign banks (individually or collectively).

25.31 Apart from the risk that some of the more aggressively competitive foreign banks might be discouraged from seeking a bank licence, there would be quite adverse implications for incentives and the efficient operation of foreign-owned banks:

- the banks would be encouraged to divert part of their activity into 'non-controlled' areas, in which they might not enjoy the same comparative advantage; if that were to happen the gains to the Australian community would be reduced;
- the restrictions would reduce the incentive for foreign banks to compete vigorously against domestic banks; this would weaken their potential contribution;
- more fundamentally, such limits are contrary to the Committee's view expressed throughout the Report that the participants in financial markets should not be constrained by artificial directives as to rates of growth and business volume.

25.32 At the technical level, such limits might be difficult to monitor and enforce:

- there could be definitional problems as to what should be 'business' for the purpose of the regulation; and
- it would encourage 'off balance sheet' activities.

25.33 Where limits apply collectively to foreign banking, the practical problems of monitoring and implementing them equitably are multiplied.

(ii) *Limits on Functions*

25.34 It has been suggested that foreign banks might be authorised to participate in, say, 'offshore' banking, 'wholesale' corporate financing, foreign exchange dealing and trade financing, but not be allowed to set up a local retail deposit base. The rationale put forward for imposing such restrictions on foreign banks is that the Government should be **encouraging** only those operations in which foreign banks appear to have an **enduring** comparative advantage over Australian banks. It is also argued that established banks, with a legacy of regulation-induced structural imbalances, should not be exposed to a new, strong competitive force at the same time as the burdens of effecting structural changes (in the wake of deregulation) are strongest. Finally, there is a fear that without some restrictions of this kind, foreign banks might come to dominate the banking system.

25.35 The Committee has noted the arguments put forward by its consultants on this issue.¹¹ However, it sees considerable practical difficulties in implementing such a policy. For instance:

- it is difficult to draw a sharp distinction between certain classes of business, particularly between 'wholesale' and 'retail' financing;
- there is the problem of deciding in advance in which markets foreign banks are likely to have an 'enduring' advantage; and
- many foreign-bank-owned NBFIs already operate, and may continue to operate, over a wide range of business, including both wholesale and retail financing.

25.36 Moreover, limits on functions could nullify most of the potential benefits from foreign bank entry:

- new foreign banks might be denied the opportunity of participating in areas of activity of their own commercial choice;
- it might force them to develop in ways which are not efficient; and
- if they are restricted to the already competitive wholesale sector, it might encourage uneconomic expansion of facilities in areas which are already well supplied.

25.37 Of course, some potential foreign bank participants may, if authorised, voluntarily choose to concentrate their efforts in particular segments of financial markets, at least initially. Indeed, a majority of those seeking to do general banking business in Australia have indicated an intention to concentrate on providing so-called 'wholesale' banking services to the medium and larger businesses and government sectors. To the extent that different types of banks exist in future (and the Committee's recommendations are not inconsistent with such a development), it is the Committee's preference that they be voluntary commercial

11 K. T. Davis and M. K. Lewis, *op. cit.*, favoured issuing a limited number of 'conditional' licences to foreign banks to permit them to conduct a restricted range of 'wholesale' banking business.

E. Kiernan, *op. cit.*, was somewhat surprised with Davis and Lewis's recommendation that entry be restricted to the wholesale end. In his view it is 'new entrants to develop retail banking [that is] in short supply'. He further argues that should 'foreign banks choose to "go downmarket" [retail], it is difficult to see why they should be restricted. There are clearly gains to be had in consumer banking [from foreign bank entry in that area]'.

See also footnote 13 in this chapter.

choices. The Committee would not like to see **rigid** lines of demarcation established between banks, whether they be locally or foreign-owned.¹²

(iii) Prescription of a Minimum Range of Services

25.38 At the same time, the Committee does not favour prescribing a minimum range of banking services (e.g. branch outlets). Some domestic banks have suggested that this might be appropriate, on the grounds that new entrants should not be able to confine their activities to the more profitable areas and ignore the less attractive ones. The Committee's view on the cross-subsidising of services and activity is clear; such action is likely to impede efficiency by delaying a rationalisation of existing branch structures and, more generally, inhibiting the responsiveness and flexibility of the market.

(iv) Limited Diversification

25.39 Concerns about the diversification of banking group operations through ownership of non-bank subsidiaries and affiliates have largely been directed at banks as a group, not at foreign banks per se. The Committee has proposed in Chapter 19 a framework for consolidating — for regulatory purposes — the banking and other operating elements of a financial group.

25.40 Foreign banks operating as banks in Australia and Australian banks should not be treated differently in respect of their association with non-bank subsidiaries and affiliates.

(v) Differential Tax

25.41 The Committee has examined proposals that foreign bank licences should be subject to discriminatory taxes or differential reserve requirements.

25.42 Such proposals are implicitly based on the assumption that foreign banks (where they are relatively more efficient) will have 'production costs' well below the industry average and thus be able to earn 'excessive profits'. These 'excess profits' are referred to as 'economic rent' emanating from that activity. It has been suggested that as these activities are based in Australia, this surplus or 'rent' should be appropriated by the Government for the benefit of the Australian community. The argument has some similarity to the one for a resources tax on mining operations in Australia.

25.43 The Committee sees both practical and conceptual problems in the imposition of a discriminatory tax (to extract economic rent):

- The argument assumes that foreign banks will have a sustained cost advantage. It is not clear that this will be so. The Committee has already referred to the particular advantages Australian banks will have, and believes that the fostering of vigorous and healthy competition between resident and non-resident participants should minimise the risk of sustained supernormal profits occurring.¹³

12 In Chapter 19, the Committee expresses the view that subject to the setting of appropriate asset quality/capital adequacy ratios etc. banks should have full flexibility in the management of their operations.

13 E. Kiernan op. cit., comments that:

... the performance of Australian banks in less regulated overseas markets suggests that [the] domination [of foreign banks] is unlikely.

- It would be difficult to determine the amount of discriminatory tax which should be charged. There is always the danger of setting it too high and this would have a deterrent effect on foreign bank activities.
- More generally, it would hardly be consistent to allow foreign banks to participate in the Australian banking system on the premise that their participation would increase competitiveness and then to apply discriminatory taxes that have the effect of restricting their ability to compete effectively.¹⁴

(vi) *Auctioning Licences*

25.44 The alternative way to extract a 'price' from foreign bank entrants is through auctioning licences. The Committee also sees problems with this proposal:

- The authorities would have to reserve the right to change future banking policy and to issue an indefinite number of additional licences later. Any advance commitments would clearly introduce an undesirable degree of inflexibility in policy. This being so, the true value of the licence would be unclear to bidders. It is questionable, therefore, whether the conditions would exist for a 'true' auction, whereby certain 'proprietary rights' were attached to successful bidders.
- An auction system which applied only to foreign applicants would have the same discriminatory effect as differential taxes discussed earlier; again the desirable degree of competitiveness in the banking system might not be achieved.

25.45 The Committee does not therefore recommend the auctioning of licences. To the best of its knowledge, the 'pricing' of banking licences is not practised anywhere in the world. This may be relevant when the 'principle of reciprocity' in international relations is applied by other countries.

(e) **The Preferred Option**

25.46 On balance, it is the Committee's view that the Government should not impose any differential restrictions on foreign banks.¹⁵

25.47 The Committee's preferred approach is for the authorities to initially limit the number of licences issued. This of itself does **not** imply that only a **small** number of licences should be granted. In determining the appropriate number the authorities will need to take into account the prospective competitive environment in the deregulated banking system envisaged by the Committee and should recognise the already significant presence of foreign banks in financial intermediation in Australia.

25.48 Such an approach would achieve the desired objectives but avoid all the problems associated with the other options discussed above. Under this approach, the authorities would have a set of eligibility criteria to assess applications for a banking authority from non-residents (see later discussion). These criteria could not be laid down precisely for the obvious reasons that the weights the authorities

14 This problem would be reduced if the tax was of a once-and-for-all character and had no lasting effect on the cost structure or competitive capabilities of foreign banks; it is believed such a tax would be difficult to devise and apply. Some aspects of this problem are discussed in Section (vi)

15 Professor R. Snape and E. Kiernan in their separate papers commissioned by the Committee also concluded that, on efficiency and competitive equity grounds, there is no reason why bank licences issued to non-residents should bear any additional encumbrances to those borne by resident participants. (See *AFSI Commissioned Studies and Selected Papers*, op. cit.)

may wish to attach to each criterion would vary in importance from time to time. Having been granted a licence, a non-resident bank would then have the same rights as any other participants in that area of business in which it chooses to operate. Similarly, it would be expected to comply with the same monetary policy, prudential and other requirements as other banks.

25.49 A policy which regulates the number of foreign banks entering Australia but with no **additional** encumbrances attached to the licence has the advantage that:

- it is relatively simple to administer; it concentrates all the decisions at the **point of entry** and on the **number to be allowed in**;
- the policy is likely to receive international acceptance as, once admitted, non-resident banks would be treated equally with resident banks; this may be important in terms of reciprocal treatment to Australian banks operating overseas;
- it involves least bureaucratic interference with the competitive operations of the market place: non-resident banks would be free to make full use of their expertise in responding to market demands and searching for new business. Australian consumers would benefit from access to the full range of services and expertise offered by non-resident participants.

25.50 The Committee accordingly *recommends* that:

- (a) **Foreign bank participation in domestic banking should only be restricted through the number of licences granted.**
- (b) **Banking licences issued to non-residents should carry no encumbrances additional to those attaching to licences held by residents; both resident and non-resident-owned banks should have the same privileges and responsibilities.**

25.51 The adoption of such an approach does not obviate the need to assess and select the eligible entrants.

(f) **Local Equity Participation**

25.52 The Committee can see little justification, **from the point of view of economic efficiency**, for imposing **local equity participation** requirements on foreign entrants. Limitations on the level of foreign ownership in any individual bank may inhibit foreign participants from committing their full entrepreneurial resources and managerial expertise; and in circumstances where suitable local participation is not forthcoming, it may preclude them from participating altogether, thus possibly denying the community the benefits of competitive stimulus.

25.53 It is also possible that a rigid equity participation requirement might have the effect of reducing the potential strength and stability of some of the new banking institutions, especially those who are 'last in the "queue"' in obtaining Australian partners. The experience in the non-bank field has been that the marriage of local and foreign shareholders has not always resulted in sustainable arrangements.

25.54 The Committee notes that, to the extent that 'suitable' Australian capital is brought into partnership with foreign banks, there would be less of it available for investment in new 100% Australian-owned banks and non-banking activities.

25.55 Furthermore, the Committee does not see such rules as essential for ensuring protection against excessive control of Australian financing by foreign banks and non-residents generally: limitations on the numbers entering can ensure that the overall level of foreign penetration is not excessive.

25.56 In the Committee's judgment, the granting of a banking licence to a foreign bank **without** requiring any local equity participation would not necessarily be inconsistent with present foreign investment policy. The latter requires evidence of 'substantial' net benefits or effective local participation in cases where the industry is already subject to heavy foreign involvement. Each case must be considered on its merits. There is at present a very low foreign ownership content in domestic banks, and the cost of increasing it may not be as high as would be the case in some other areas, although that involves some judgments beyond the charter of the Committee.

25.57 Nonetheless, the Committee recognises that the Government may, on social or other grounds and pursuant to its general policy of encouraging Australian ownership of key industries, including finance, wish to set local equity participation requirements. If so, the Committee would suggest that the policy be applied flexibly — i.e. without rigid limitations. For example, the authorities could indicate publicly that, all other things being equal, they would favour those proposals that involved local equity participation over those that involved full overseas ownership.

25.58 The Committee believes that if such a policy were implemented, there would still likely be an adequate number of foreign banks prepared to contemplate partnership with Australian residents. Therefore while the Committee itself does not propose the imposition of local equity rules and views it as a 'second best' course, it would **not** regard such action as **nullifying** the net benefits expected from the admission of a limited number of foreign banks. This assumes that the policy is not applied too rigidly and that successful applicants are then allowed to conduct a full range of banking business.

25.59 The Committee therefore **recommends** that **banking licences issued to non-residents should not be subject to mandatory resident equity participation requirements. At the same time, the Committee recognises that the Government may wish to take into account the prospect of local equity participation when assessing applications from non-residents for a domestic banking licence, particularly when a limit on the number of such licences is envisaged.**

(g) Corporate Structure

25.60 In a situation where local equity is not a mandatory pre-condition set by the authorities, a relevant question is whether foreign banks should be permitted to establish in Australia as branches or fully guaranteed, wholly owned subsidiaries. (Some prudential implications are discussed in Chapter 19.)

25.61 The Committee understands that many interested foreign bank participants have a clear preference for their Australian operations to be conducted through a branch of the parent bank. Some suggest this structure offers some economic advantage to Australia — e.g. because of greater ease with which the Australian operation can be integrated in the international network.

25.62 On the other hand, it has been suggested that competitive equity considerations might make it desirable for any new foreign bank presence to be established in the form of a separately incorporated Australian-owned company.

This is based on the view that under such a corporate structure, resident and non-resident participants would be better able to compete equally given the common 'in-house rules'.

25.63 The Committee is of the opinion, on broad efficiency grounds, that the choice of corporate structure should be left to the individual institution. However the appropriate authorities may choose to require a particular structure for prudential and monetary policy reasons.

(h) Eligibility Criteria

25.64 The authorities will need to develop appropriate criteria for choosing between applicants.

25.65 The initial choice of a limited group from the large number of potential foreign bank participants would inevitably be a complex task for the Government.

25.66 The Committee deliberated on the essential economic factors which might guide selection; the foremost objective is to introduce an added dimension of competitive and efficiency stimulus to Australian banking. This objective suggests that the following broad factors would be among those relevant:

- The long-term prospect of a substantial commercial interdependence of Australia and the foreign bank's home country; the prospects for trade, capital flows etc.
- The status of the bank in both its home country and the international environment; this will have an important bearing on its prospective benefit to Australia. The bank would need to be of unquestioned integrity (and appropriately supervised) and the Committee would expect that those with more broad-ranging operations (both geographically and functionally) would be ranked more highly than those with less.
- The contribution it might make to diversity of choice, i.e. the extent to which it might have something new or different to offer.
- The nature and extent of established involvement in domestic financing activity in Australia — the assumption here being that those with some local background will contribute more quickly to the competitive environment.

25.67 It is not possible to rank the various criteria because their importance could be expected to change over time as economic circumstances and the community's preferences alter and because some non-economic judgments may be involved.

(i) Timing

25.68 Concern has been expressed about the timing of foreign bank entry. Some, particularly in the banking industry, while amenable to allowing foreign banks to compete in due course, believe their entry should be deferred pending the restoration of a competitive financial system and associated adjustment of the domestic competitive environment. Others, as noted earlier, fear a sudden influx of foreign banks could pre-empt (to some extent at least) the entry of new domestic banks.

25.69 However, overseas evidence on the impact of foreign bank entry suggests that foreign banks are unlikely to have a sustained competitive advantage. Moreover, to delay foreign entry once an in-principle decision had been taken to allow it could create uncertainty in the banking sector in the interim and unnecessarily hold up the development of a fully competitive financial

environment. The Committee doubts, moreover, that many local institutions would feel confident enough to apply for a licence in this unsettled interregnum; they might well prefer to see some of the effects of foreign bank participation before entering the market themselves. Thus, it would not seem to be an appropriate policy response to delay foreign bank participation in Australian banking simply to allow resident-owned banks to be established.

25.70 The Committee is thus not persuaded that the best course is to delay new foreign bank entry for some time. Specifically, it does not favour the Australian Bankers' Association's submission that no action with regard to the application of non-residents for banking licences be taken until at least five years after the existing financial system is fully deregulated. Bearing in mind, firstly, that some restraint is envisaged on the rate of access; and secondly, that it will take some time to plan and implement government policy in this area, the Committee sees no need for special transitional arrangements.

25.71 The Committee therefore *recommends* that **the recommended relaxation of policy should not be deferred.**

C. ADDITIONAL QUESTIONS

25.72 Some subsidiary problems remain to be discussed:

- the role of the two **established foreign banks**; and
- the role of foreign bank **representative offices.**

(a) Existing Foreign Banks

25.73 Consistent with its proposals that the policy on non-resident participation in banking be liberalised, and that foreign-owned banks be treated equally with local banks, the Committee *recommends* that **the existing foreign bank groups — the Bank of New Zealand and the Banque Nationale de Paris — should be given the option to restructure their Australian operations to enable them to operate on a similar basis to other new foreign and domestic bank establishments.**

(b) Representative Offices

25.74 There is, in the view of the Committee, a strong case for allowing the Australian representative offices of foreign banks to be restructured as limited agencies.

25.75 At present representative offices of foreign banks do not formally have a financing capacity, being restricted to a customer liaison role on behalf of their parent banks. In practice, however, the representative offices have been instrumental in seeking new Australian lending business financed by parent banks 'offshore', and are active in follow-up servicing of established customer needs. Thus if foreign bank representative offices were treated as agencies of their parents, with the continuation of the present requirement that they do not take any domestic deposits, it would more aptly describe if not 'legitimise' their actual function. In terms of the Committee's recommendations in Chapter 7, such offices would not be able to undertake foreign exchange transactions for other parties.

25.76 The Committee therefore *recommends* that **foreign banks should be permitted to establish agencies in Australia which would be restricted to an**

'offshore' lending role, with no authority to borrow on Australian markets or undertake foreign exchange business.

D. NON-BANK FINANCIAL INTERMEDIATION

25.77 Until 1973 non-residents were unimpeded in their ownership of NBFIs and around the end of the 1960s many took equity interests in local subsidiaries and affiliates — often in conjunction with Australian banks and other residents with experience in local markets.

25.78 Since 1973, restrictions have applied. Currently proposals for new or increased non-resident investments in Australian NBFIs (including insurance) must either demonstrate the probability of substantial net economic benefit to Australia or involve an effective partnership with Australian interests.

25.79 As described more fully in the Interim Report¹⁶, non-resident-owned financial enterprises — particularly subsidiaries and affiliates of foreign banks and insurance companies — hold substantial shares of the business conducted by particular categories of non-bank financial intermediaries. Non-resident ownership is especially prominent in the merchant banking sector where, on an equity-weighted basis, it accounts for around two-thirds of the assets managed by this group; in the finance company sector the non-resident share is around one-third and in general insurance it is around one-third.

25.80 There are a number of developments in recent months which suggest that the character and relevance of non-resident involvement in non-bank financing may be under some pressure to change — particularly foreign bank involvement through merchant banks and finance companies. The forces for change arise in:

- the scope which local banks now have to participate in merchant banks through majority-owned subsidiaries rather than minority-owned affiliates;
- the proposed amalgamations involving four local banks may have implications for the restructured banks' continuing involvement in overlapping merchant bank subsidiaries and affiliates.

25.81 Additional to non-resident-owned businesses of a primarily financial character, there is of course a substantial involvement of non-resident companies in Australian industry, particularly in the fields of manufacturing and natural resource development. These companies are relatively free to borrow and lend on Australian financial markets at their discretion. Significantly, foreign investment policy applies less restrictively to the incorporation of subsidiary finance companies particularly by manufacturing or retailing firms, where the proposed operations are strictly **ancillary to their main business** and are not considered likely to have major implications for the financial sector.

25.82 The Committee has proposed that a limited number of foreign banks be allowed to participate as fully licensed banks. Nonetheless, foreign banks as a group will in all probability continue to also have an important presence in non-bank financial intermediation.

25.83 The Committee has elsewhere in this Report drawn attention to the efficiency implications of imposing rigid resident equity participation requirements

¹⁶ See in particular Chapter 6 and related commentary in Chapters 3 and 5.

— both in respect of banking (see earlier discussion) and more generally in Chapter 35. However, it is recognised that there are other aspects for the Government to consider. Subject to the above, the Committee has no reason to suggest any change in present policy concerning non-resident equity investment in Australian non-bank financial intermediation; this policy tests proposals against the prospect of substantial net economic benefit to Australia. Efficiency considerations would, of course, form part of any such assessment.

This is a very important point, and it is one which the Committee has already mentioned in its earlier reports. It is a point which is often overlooked, and it is one which the Committee has already mentioned in its earlier reports.

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GOVERNMENT-OWNED FINANCIAL INSTITUTIONS

- Ch. 26 Government-owned Financial Institutions: General Approach
- Ch. 27 Government-owned Commercial Banks and Other Deposit-taking Intermediaries
- Ch. 28 Commonwealth Development Bank
- Ch. 29 Australian Industry Development Corporation
- Ch. 30 Housing Loans Insurance Corporation
- Ch. 31 State Government Insurance Offices

CHAPTER 26: GOVERNMENT-OWNED FINANCIAL INSTITUTIONS: GENERAL APPROACH

A. INTRODUCTION

26.1 Government-owned financial institutions (GFIs) have a substantial presence in the Australian financial system. Their operations range broadly across the banking and insurance fields, through the ownership of such institutions as the Commonwealth Trading and Savings Banks, State Banks and State Government Insurance Offices. In recent years they have also extended to a wide range of non-bank intermediation functions.¹

26.2 While active participants, these institutions do not generally hold dominant positions, except in quite limited segments of markets — e.g. the Export Finance and Insurance Corporation and the Housing Loans Insurance Corporation. Some other institutions, e.g. the Commonwealth Development Bank, are principally used as vehicles for sectoral assistance.

26.3 The general question of the role of GFIs is integral to many of the major issues before the Committee — in particular, sectoral assistance and competitive balance — and has received critical attention in submissions.

26.4 The participation of government-owned enterprises in a predominantly privately owned financial system is not always seen by competing private businesses as equal competition. There is most concern when government enterprises are growing faster than private enterprises and this is believed to be due, at least in part, to special advantages and status attaching to government ownership. On the other hand, supporters of GFIs argue that they are often meeting a demand that is not adequately covered by the private sector.

26.5 GFIs may have either a general **commercial** function (e.g. to enhance competition) or what might be called a **social** role (e.g. to encourage activities which are thought to generate exceptional 'externalities'² or to disburse sectoral assistance).

26.6 While in some instances specific social functions may reasonably be given to GFIs, such action should be very carefully evaluated to ensure that the objectives sought are being achieved in the most cost-effective way.

26.7 In that context, it is important to review what other options are available to governments for pursuing social objectives. The pursuit of these objectives through GFIs tends to involve a longer term commitment than many other courses open to government. A full discussion of these alternatives is contained in Chapter 36.

1 Appendix 12 of the Interim Report surveys the legislative and competitive framework within which State and Commonwealth instrumentalities participate in the financial system.

2 That is, yield returns significantly greater than their private returns.

26.8 The Committee has developed certain principles to assist evaluation of the commercial role and performance of GFIs and their impact on other intermediaries. They are outlined in this chapter.

26.9 Chapters 27–31 examine the role of particular GFIs in the light of the general principles developed in both this chapter and Chapter 36.

B. RATIONALE OF GOVERNMENT FINANCIAL INSTITUTIONS

(a) Considerations of Market Efficiency

26.10 Retention of government ownership of a financial institution is only justified from the point of view of efficiency of the financial system if both currently and on reasonable expectations for the future:

- (i) it fills a market 'gap' by:
 - providing on fully commercial terms an important financial 'product' or facility not otherwise available; or
 - enhancing, through its presence, the competitive environment;
- (ii) the market gap **would not be filled** as effectively if the institution were **privately owned**; and
- (iii) it represents the **most cost-effective method** of dealing with the market gap (e.g. it is not more sensible to deal with it through alternative means such as removal of restrictions on entry or more effective oversight of trade practices).

26.11 As well, in the conduct of its commercial functions, the GFI should desirably meet the following criteria:

- It should be **economically viable**, i.e. it should not require sustained government subsidisation and should yield a 'normal' return on funds invested (after appropriate allowance for any special advantages or disadvantages associated with public ownership). It must be emphasised that economic viability is a desirable but insufficient reason for government participation: for example, an established GFI may demonstrate managerial, operational and innovative qualities of a high order and achieve an adequate rate of return but that alone would not necessarily justify continued public ownership unless it were filling a market gap in the most cost-effective way and there were reason to believe its performance would suffer under private ownership. Conversely, a case can be made at times for retaining, at least temporarily, a GFI which is not economically viable if it is filling an important market gap. However, trade-off situations warranting compromise of this kind would be rare: certainly the Committee would not favour retaining in a GFI commercial functions which were not economically viable **in the long run**.
- It should be **operationally efficient** — when put to conventional tests in respect of resource use.
- It should **compete equally** or reasonably equally with its private sector competitors.

26.12 The Committee accepts that, in circumstances where it is judged that the prevailing market structure is lacking in competitive vigour and therefore inconsistent with an efficient market, policies of competitive leadership may sometimes be effectively pursued through government commercial enterprises. However, the Committee would expect governments to:

- exhaust alternative channels for the restoration of a commercial competitive environment before having recourse to competitive leadership; and
- ensure that any leadership initiatives are implemented with full regard for the need to achieve a level of long-term profitability comparable with a competitive private sector.

26.13 If the weight of government patronage were employed aggressively to put pressure on established enterprises without regard for an adequate level of long-term profitability, such action would not be consistent with many of the principles advanced above; nor would it be conducive to the promotion of an efficient financial system (with a reasonable mix of private and government operators).

26.14 At the same time, once a GFI is undertaking commercial operations, the Government should not impose arduous restrictions on its legitimate commercial pursuits; this would be the converse of unduly aggressive competitive leadership and inconsistent with the application of normal commercial standards in a freely competitive environment.

(b) Social and Other Considerations

26.15 In evaluating the gains or losses from the continued existence of a GFI, the Committee has focused basically on aspects bearing on the efficiency of the financial system. It recognises, however, that there are also other relevant factors which governments may regard as important and appropriately take into account. The assessment of costs and benefits can well change as consideration broadens from narrow economic efficiency aspects to encompass various other considerations. Specifically, there is a need to consider whether:

- The GFI is generating special **economic 'externalities'** (e.g. unusual benefits to other industries, benefits for economic management etc.) and these arise from government ownership per se.
- The GFI is **meeting certain 'social' objectives** (e.g. channelling assistance to particular sectors or groups, or provision of a safety haven for small investors) and doing so in a cost-effective manner.
- The sale or liquidation of the GFI, especially at a particular point of time, may create **serious staff disruption or transitional problems** (widespread individual hardship, industrial unrest etc). This might sometimes lead to a different attitude being adopted to the **retention** (at least for a time) of an existing GFI from that which might be adopted to the **introduction** of a new one.

26.16 While the Committee is able to comment on possible implications for the efficiency of the financial system, it is not in a position to make ultimate judgments about the weight that should be given to the social issues. To this extent, therefore, the Committee's recommendations are 'qualified'.

26.17 This said, the Committee believes that in those cases where it has recommended that a GFI be either sold or otherwise disposed of:

- the externalities arising specifically from government ownership do not appear to be very significant;
- there are generally more cost-effective ways of pursuing any social or sectoral assistance objectives being achieved by the GFI in question; and
- the potential staff disruption is fairly minimal; this is more likely to be so if the

GFI were sold as a going concern, or in some other way continues to function, than if it were wound up.

26.18 It is only too easy, especially in the financial area, to point to benefits from a particular intervention, since the benefits are in many cases specific and visible, while paying little or no regard to costs which commonly are more diffused and less immediately apparent, but which may be no less important (and indeed over time could be dominant).

26.19 The Committee is of the view that the onus should be on those who support retention of a GFI under government ownership to demonstrate **net positive** benefits from such retention. The onus should not be on those who recommend sale to prove that its continued existence is detrimental to the public interest.

26.20 Some see sunset legislation as a way to keep in regular focus the ongoing benefits of a government enterprise. Under this approach, precise time limits would be set on an institution's existence, and its existence would be subject to reaffirmation at fixed intervals following appropriate reviews. While the sunset legislation concept has some appeal, the Committee considers it could prejudice the viability of a commercial enterprise if doubts about its continued existence were so formally expressed in legislation. Of course, the operations of any government institution should be subject to regular examination to ensure that it is achieving its objectives more efficiently than alternatives available.

(c) Conclusions

26.21 In the light of the above considerations, the Committee has established certain principles which it has sought to apply consistently throughout this Report, and especially in Chapters 27–31. In respect of the **commercial functions** of GFIs, these principles are:

- (a) Each existing institution should be carefully evaluated to ensure that it is filling a market gap in the most cost-effective way and is expected to continue to do so in the changing financial environment. In addition, the conduct of these commercial functions should, over a period:
- be economically viable;
 - be operationally efficient; and
 - *not* cause market inefficiencies or distortions as a consequence of unequal competition³ with private sector competitors or, more generally, by inhibiting the development of a vigorous private sector.
- (b) Where the conditions set out in (a) are not substantially met and are not capable of being met, serious consideration should be given to ending (either by sale as a going concern or by winding up) the government ownership of the commercial operation, unless continuing government ownership of the institution is judged by the Government to generate overriding economic externalities or social benefits which could not be achieved more cost-effectively in any other way.
- (c) Reviews of the range of operations and efficiency of GFIs should be undertaken regularly (no less frequently than every seven years) to ensure that the tests under (a) and (b) continue to be met.

³ Measured in accordance with the principles of competitive neutrality discussed in the next section.

- (d) New GFIs should not be established unless they meet the tests under (a) and (b).

26.22 The rationale for giving GFIs **non-commercial functions** is fully discussed in Chapter 36, where it is concluded that:

- (a) The primary response in respect of non-commercial policy objectives should be the pursuit of those objectives by direct fiscal measures wherever practicable.
- (b) Where direct fiscal action is not practicable the Government should explore the possibility of achieving its non-commercial objectives through the medium of private commercial institutions instead of through GFIs.
- (c) In the event that a GFI continues to have an exclusive charter to perform specific non-commercial functions then its performance should be subject to stringent scrutiny and disciplines to ensure that these functions are conducted efficiently.

C. PRINCIPLES OF COMPETITIVE NEUTRALITY

26.23 The Committee believes that, where retention of a GFI is justified in terms of the criteria previously outlined, private and public sector participants should have equal opportunity to out-perform one another in a commercial environment. The market share appropriate to a government enterprise is not something that can or should be predetermined.

(a) Government Ownership and Guarantees

26.24 The Committee is mindful that there are special advantages deriving from government ownership — in particular:

- it may offer the GFI a capital servicing advantage, from being able to maintain a higher **gearing** ratio than its private competitors; and
- it is usually seen as conferring a **borrowing status in the market** above that of the general run of private sector organisations.⁴

26.25 In regard to differences in capital **gearing**, the Committee believes that full capitalisation to the standard of private sector competitors, together with appropriate profit performance targets, would come closest to achieving true competitive neutrality. It would also provide a clearer base from which to evaluate the costs of the operation against the benefits. The Committee believes that every endeavour should be made to overcome any practical difficulties in adopting this approach. It recognises that the effects on government budgets of overcoming current backlog capital deficiencies could be substantial and for that reason it may be difficult to avoid phased adjustment over a number of years. If such practical difficulties delay full capitalisation, then an essential interim procedure is to **impute** comparable capitalisation and reconstruct the accounts before applying an industry-based profit performance test.

26.26 The Committee believes that observance of the discipline of full capitalisation would not be sufficient to achieve full competitive neutrality; any gain in **borrowing status** arising from public ownership also needs to be

⁴ In the case of some GFIs which do not borrow (e.g. SGIOs, HLIC), the advantage of government ownership lies in the marketing advantage it confers.

neutralised. This stems, in part, from the perceived capacity of governments to meet commitments from general revenue: the commitment to creditors of a GFI may be seen as extending beyond its own capital resources, whereas in a private enterprise capital normally denotes the limit of the owners' present commitment to meet its liabilities. This advantage in borrowing status may not apply to quite the same extent, however, in industries (such as banking) where competing private institutions are perceived to have government 'protection'.

26.27 Where there is a clear net gain in borrowing status from the government association, various measures to neutralise this advantage have been suggested to the Committee. These include:

- (i) the rescission of any explicit government guarantee;
- (ii) more onerous balance sheet requirements than those which apply to private sector competitors;
- (iii) the sale of part of the equity to the general public;
- (iv) setting public enterprises the objective of earning a rate of return (on capital adjusted for any differences in gearing as explained in paragraph 26.25) somewhat in excess of the return earned by their private enterprise competitors; and
- (v) the charging of specific fees in proportion to total external borrowings.

26.28 Option (i) raises particular problems. While in some cases the granting of an explicit government guarantee can significantly alter the borrowing status of a GFI (especially if it were a borrower in overseas markets), rescission of the guarantee may not be sufficient by itself to achieve full competitive neutrality with private sector counterparts. The Committee believes that — at least in the domestic market — lenders will generally perceive an 'implicit' guarantee simply by virtue of the government association. The more crucial issue therefore is the competitive impact of government **ownership** per se, with its implication of unlimited liability in the event of 'insolvency'.

26.29 The Committee sees no merit in option (ii) — imposition of more onerous balance sheet requirements on GFIs — as it would entail the creation of a second distortion in order to offset an existing one.

26.30 Option (iii) — the sale of part of the equity to the public — has no more than limited appeal from the point of view of efficiency or equity. On the positive side, it may oblige the GFI to adhere to accounting and operational standards comparable to those observed by private sector institutions and it could be used to neutralise one of the advantages which government ownership may confer — the permitting of a lower capital base. However, it would not effectively deal with the 'borrowing advantage' derived from part-government ownership. There are, moreover, substantial conceptual and practical difficulties in achieving an effective amalgamation of private and public ownership — particularly where government is the dominant partner with effective responsibility.⁵ The rights (and obligations) of the private sector partners bear careful consideration.

⁵ Where the government equity holding is clearly viewed as a transitory phase of an institution's development pending sale of all the equity to private interests, the difficulties would not be as great. There are a number of possible situations of this general character; one is where government, having taken or shared the initiative to successfully establish an enterprise, is no longer an essential participant.

26.31 In the opinion of the Committee, the choice rests between options (iv) and (v). It is, in essence, a choice between allowing the offset to accrue as an element of operating surplus (profit) or requiring it to be deducted before determining the profit. The Committee considers that the advantage arising out of government ownership is in the nature of a reduction in commercial expense, particularly in the cost of borrowing, and accordingly prefers the offset to be treated as an expense akin to guarantee fees.

26.32 It therefore has a preference for option (v), with any commercial advantage in government ownership being assessed and priced as a specific operating expense in proportion to external borrowings. It is appreciated that the assessment of an appropriate fee must of necessity be somewhat subjective; in particular instances, advice might be taken from professional financial analysts as well as from the relevant intermediaries. Market performance will also provide some guide.

26.33 No matter which option is adopted, the Committee recognises that the intrinsic advantages associated with government ownership may be technically difficult to neutralise by simple changes in the charter or mode of operation of the GFI; indeed the very presence of the GFI in the market may discourage new entrants and hinder the development of dynamic private institutions.

(b) Profitability

26.34 The Committee believes that in the conduct of its commercial functions a GFI should strive to earn a return on capital consistent over time with the standards achieved by corresponding private firms.

26.35 There may be practical difficulties in precisely measuring the profitability of the commercial operations of government enterprises. These include:

- the problem of separating out revenues and expenses related to non-commercial functions conducted in conjunction with a commercial business;
- the virtual impossibility of quantifying in all respects the burdens of national and state policies imposed on government-owned enterprises; and
- complications due to differences in various tax impositions.

26.36 These difficulties, however, do not detract from the importance of objective assessment of the operational efficiency and management of government enterprises on parallel lines to those applied to their competitors in the private sector. In the Committee's view this assessment process should involve a reconstruction of balance sheet and revenue statements to adjust for the differences and facilitate comparison. The Committee is not aware of this being done in the normal course at present.

(c) Disclosure

26.37 The Committee sees it as important that government instrumentalities should keep the general public aware of their performance in both the commercial and non-commercial areas. To this end, and by way of extension of what was said in the previous paragraph, it would endorse the preparation and publication of a set of annotated accounts of government financial enterprises which:

- report separately on the commercial and non-commercial functions of government enterprises where these are both undertaken; and
- account for and report those operations on a basis as closely comparable as possible with competing private enterprises, after making the necessary

adjustments to allow for any differential tax impositions, other charges etc., and any differential incidence of policy requirements and procedures.

(d) Conclusions

26.38 In assessing the impact of government financial institutions on the financial system and their performance, it is important to remember that GFIs also carry out certain non-commercial functions. Issues relating to the latter are discussed fully in Chapter 36 and briefly in paragraph 26.22.

26.39 The Committee believes that where a GFI is to undertake commercial activities in competition with private sector institutions, it should be on the basis of fair and equal competition. The advantages flowing from government ownership should be fully neutralised. Otherwise the financial system will not function efficiently. The Committee therefore concludes:

- (a) In all essential respects, including capitalisation and profitability objectives, taxes etc., the operations of GFIs should, as far as possible, be placed on an equal footing with those of private sector competitors.
- (b) If there are benefits in terms of borrowing status arising from government ownership (whether there is an explicit guarantee or not), these benefits should be assessed independently, priced as a fee and treated as an operating expense; (however, the imprecise character of any such assessment must be recognised).
- (c) If practical difficulties delay full capitalisation, then a comparable capitalisation should be imputed before applying an industry-based profit performance test (see below).
- (d) If it is not practicable to achieve equality in operating taxes etc., the differences should be noted in the accounts of the institution.
- (e) GFIs should be expected to:
 - conduct their commercial functions so as to return an average long-term level of profitability similar to that of their private sector competitors (subject, of course, to the proviso that industry profitability is not excessive), after appropriate adjustments to the GFIs' accounts (e.g. for any gearing, tax etc. differences that have not been explicitly eliminated) to make the comparison meaningful;
 - pay a comparable rate of dividend.
- (f) Subject to meeting the above primary objectives, the *commercial* activities of GFIs should be no more fettered or subject to government interference than private sector institutions undertaking similar activities.
- (g) To assist meaningful comparison as far as possible, GFIs should account separately for their commercial and any non-commercial operations (the 'target' return mentioned in (e) applies only to the commercial operations). Where the two operations cannot be adequately separated, the notes to the commercial accounts should show the benefits and costs to the institution stemming from non-commercial rights and obligations bearing on the GFIs' commercial results.

CHAPTER 27: GOVERNMENT-OWNED COMMERCIAL BANKS AND OTHER DEPOSIT-TAKING INTERMEDIARIES

A. INTRODUCTION

27.1 This chapter is primarily concerned with financial institutions owned by Australian Governments that conduct commercial general banking operations. However, in recognition of recent developments which have seen governments emerge as owners or patrons of non-bank deposit-taking intermediaries such as building societies and finance companies, 'near bank' operations are considered along with general banking.

27.2 The aim is to consider whether, in the light of the broad policy guidelines set out in the previous chapter, continued public ownership of existing government banks and other deposit-taking institutions is justified, and if so, the appropriate basis of their continued operation.

B. ROLE

(a) Commercial Role

27.3 Government-owned banks are seen as supplementing the financial service facilities provided by the private sector. For example, they offer:

- deposit facilities with a very high safety rating; they may thus conveniently provide a unique product to very risk-averse investors; all bank deposits, however, receive some 'protection' under the Banking Act;
- competition for banking business in particular areas, e.g. retail banking; the potential for government banks to provide services on reasonable commercial terms may check any tendency for a dominant market position to be exploited.

27.4 The Committee also recognises the potential for government banks — on their own initiative — to give competitive leadership in an oligopolistic industry where vigorous competition might be sometimes lacking. For example, in the area of money transmission services, significant changes are taking place in technology and participation and a competitive leadership role for government banks may be beneficial during the interim period until the competitive structure is fully developed (see Chapter 23).

27.5 In the present banking environment, recently characterised by merger and rationalisation, a change in ownership of government banks might open the way for a significant competitive gap to develop in a few areas — at least for a period.¹

¹ It is true that a privately owned Commonwealth Trading Bank might compete just as vigorously as it does now; nonetheless, there is the possibility that the overall competitive climate could alter significantly.

27.6 However, the Committee believes that such a risk would be minimal if its recommendations on controls, regulations and entry restrictions were adopted and were given time to operate fully.

27.7 In the **long-term competitive environment** envisaged by the Committee, government-owned deposit-taking institutions should not be needed to fill any important market gap — leaving aside social externalities. The basis for this view is discussed more fully in Chapter 32.

27.8 There is, however, the present and the intervening period. It may take some time for freer entry and reduced regulation to make their full impact. It is also possible that, at least initially, the changes recommended by the Committee will be more effective in generating new competition in some areas than others.²

27.9 The Committee concludes that, **once its recommendations (especially those bearing on the competitive structure of banking) have been implemented and their full effects have been felt, there would, on present indications, cease to be justification on efficiency grounds for continued government ownership of banks. The Government should review the efficiency implications at that stage, given the potential a government institution has for disturbing competitive balance.**

27.10 There seems to be less of an efficiency case, even in the short term, for continued government involvement in other (non-bank) financial activities, such as those undertaken by finance companies. The Committee accepts that it may be necessary, on competitive neutrality grounds, for a government bank to operate a non-bank subsidiary or associate in order to compete effectively with private banks. However, given a much less regulated environment, and assuming that the Committee's recommendations concerning consolidation of the elements of a banking group operation in the administration of prudential and other regulations are adopted, it is unlikely that this issue will be important.

(b) Social Considerations

27.11 Of course, governments will wish to look beyond issues of efficiency.

27.12 They have traditionally accepted a broad-ranging responsibility to ensure that the community is reasonably provided with essential services such as transport and communication. Direct government participation in banking has, for many, the same overtones.

27.13 There is the very real question of social externalities associated with banking and the right of every government to decide the appropriate weight to be given to these. For example, there are sensitive issues concerning the provision of banking services on an Australia-wide basis and in particular in remote locations; such issues could assume greater significance if a changed regulatory environment were to induce private banks, for sound commercial reasons, to withdraw, in part or in whole, these services.

27.14 Public sentiment and opinion will bring further influence to bear, and the Committee is mindful of all of these elements. It recognises that the

2 For example, the level of interest, by potential entrants, in establishing new retail banking facilities does not appear to be as strong as that shown in respect of wholesale and other areas of banking; government banks with a retail base may well be needed for some time to enhance competition in that area.

Commonwealth Government (and other governments) may wish to maintain a presence in the commercial banking area — even after the strict efficiency justification has disappeared.

27.15 There are some further special political factors which may influence governments to conduct bank and like operations. The Australian Constitution left issues concerning state banking within the jurisdiction of the States and the ownership of banks by state governments undoubtedly bears on their capacity to influence state economic development somewhat independently of the Commonwealth Government and narrow commercial considerations.

27.16 Even at the national level, the financial and economic independence of the Federal Government within the Constitution may be enhanced by the existence of the Commonwealth Banking Corporation; the legislation, for instance, requires the board of the Corporation to direct its policy (and that of member banks) to the greatest advantage of the people of Australia and have due regard to the stability and balanced development of the Australian economy.

27.17 All of that said, the Committee addresses itself to the related issues of viability and operational efficiency and especially, of competitive equality.

C. VIABILITY AND OPERATIONAL EFFICIENCY

27.18 Given that government involvement in financial intermediation is justified on market efficiency or social grounds, it is also important that in the long run, the commercial business conducted by government banks be economically viable and operationally efficient. Ideally, in assessing the performance of government banks, any 'burdens' or privileges arising from government ownership should be identified and 'costed' and appropriate adjustments made.

27.19 It is not however possible to make historical assessments on such a basis. The accounts of government banks typically do not quantify the burdens and privileges attendant on government ownership. In many instances the intrusion of public policy influences into basically commercial enterprises is neither obvious nor can it clearly be measured from the published accounts: differences which do exist may simply reflect a different commercial orientation. This point is taken up again later but here it is important to stress that substantial and persistent differences in the balance sheet structures of government banks, as compared with private banks, necessitate adjustments to costs and revenues to make meaningful comparisons of profitability.

27.20 The accounts of banks as a group have, in the past, generally not measured up to the standards of disclosure required of, or made by, most other public companies. In particular it has been the practice until very recently for banks to maintain 'hidden reserves' and, in that general context, not to disclose property values, provisions for doubtful debts etc.

27.21 These specific shortcomings of banks' published accounts have less relevance now but in terms of the absolute standards of disclosure which would be required to enable accurate comparisons of efficiency, the published accounts of banks (and for that matter other corporations) are still deficient in some respects. For example, the accounts of banks are highly aggregative and do not readily permit a functional analysis of the costs incurred and revenues earned. The Committee understands that some information of this character is reported

confidentially to the Reserve Bank by individual trading and savings banks as required under the Banking Act in terms of Statutory Forms C and H. The Committee sees a case for these statistics to be published for reporting banks as a group.³

27.22 There are also difficulties in attempting to reconstruct the financial accounts of the 'pure banking components' of the various banking groups to put them on a consistent and comparable basis. Some of the difficulties include:

- different approaches to the ownership of and accounting for fixed assets (banking premises and related real estate) and to the recorded valuation of such assets;
- significantly different capital structures and consequent gearing ratios;
- inability to readily and totally separate 'pure' trading and savings bank assets and profits;
- varying degrees of subsidiary, sub-subsidiary and associated company and like relationships with non-bank intermediaries;
- varying degrees of 'off balance sheet' business in the form of bills endorsed, performance and other bonds granted, letters of credit, forward exchange contracts etc.;
- different approaches to provisions for doubtful debts and deferred liabilities such as staff pension schemes etc.;
- state geographic boundaries and the incidence of concessional loans by the Commonwealth Savings Bank under 'partner-states agreements' etc.; and
- inability to measure non-commercial influences and impacts.

27.23 Because of these inconsistencies and difficulties, the Committee found it could not make meaningful measurements and comparisons.

27.24 The Committee also notes that:

- (i) The efficiency with which a government instrumentality pursues its objectives is not always reflected in its ultimate profitability. Relevant questions are:
 - whether the geographical spread of the branch network of government banks entails a disproportionate number of less profitable branches in remote locations;
 - whether the decision to confine the business of 'state' banks to the one state rather than having them operate nationally under the Banking Act places them at an advantage or disadvantage compared with banks operating in the national market;
 - to what extent government banks are 'slow' to raise lending interest rates, through a reluctance to set the pace of events which may be unpopular; and
 - whether government banks benefit in terms of market acceptance and usage from being the vehicle for the disbursement of funds on

3 The case for such publication is stronger if, as proposed, banks were to continue to have unique privileges in respect of the provision of domestic and international payments system services. The past concern about possible effects on confidence of depositors is acknowledged but given the development of financial markets this has become less of an issue.

concessional terms; (e.g. do a disproportionate number of recipients of 'relief funds' bank with government banks?).

- (ii) It is not well placed to assess what would be a 'normal' or 'proper' commercial return on a banking sector investment in Australia in a fully competitive environment as that environment has not existed; private commercial banking does seem to have been highly profitable in recent years compared with most other industries (see Chapter 32); it may well be consistent with economic efficiency for government banks to operate 'less' profitably (as might seem to be the case) than the average. The question of competing equally may then arise.
- (iii) Any comparisons between private and government banks must have regard for differences in the character of their business and in some regards the composition of their assets. For example, the commercial Commonwealth Banks have a heavier component of savings bank business — the distribution of business being two-thirds savings banking and one-third trading banking. For the major private banks the proportions are approximately the reverse. This different mix of business has consequences for profitability:
- as to the interest cost of deposit liabilities: the proportion of non-interest-bearing current account deposits held by the Commonwealth Banks (15%) is about half that of the major private banks (28%);
 - as to earnings on assets:⁴ the Commonwealth Banks' holdings of public sector securities (including cash and deposits with Reserve Bank) as a **proportion of total Australian deposit liabilities**, at 40%, are some 9 percentage points higher than their private sector counterparts (31%); their holdings of savings bank loans (predominantly for housing) at 29% are some 10 percentage points higher and their holding of 'trading bank' loans some 26 percentage points less;
 - on balance, these factors, weighted according to relative interest costs paid and yields received, could result in the Commonwealth Banks having a net **domestic** intermediation margin significantly **less** than their major private bank counterparts; even so the significance of this difference cannot be fully evaluated because it is not possible to make proper allowance for any associated differences in demand patterns for, and pricing of, transactions services on trading and savings bank accounts. More generally, it is not clear to what extent the differences flow from commercial decisions by the Commonwealth Banks and to what extent they are a consequence of their ownership.

4 The composition of the major banks' principal Australian assets, at June 1980, as a percentage of their total Australian deposit liabilities was:

	<i>Commonwealth Banks</i>	<i>Private banks</i>
Public sector securities (including cash and deposits with Reserve Bank)	40	31
Savings bank loans (predominantly housing)	29	19
Trading bank loans and advances	29	55

D. COMPETITIVE NEUTRALITY

27.25 Concern about the operation of government-owned banks and other commercial deposit-taking intermediaries centres on the issue of competitive inequality. It is claimed:

- firstly, that in some key areas — e.g. ‘trading banking’ — government banks have grown faster than their private sector counterparts; and
- secondly, that a major reason underlying that faster growth is that they compete ‘unfairly’.

27.26 These issues are intangible to some degree and the Committee has generally elected to develop appropriate standards and practices for the future rather than to undertake a complex, detailed review of past performance.

27.27 Nonetheless, in order to give a broader perspective, the Committee considers it important to examine:

- how the **relative importance** (growth) of government deposit-taking institutions has changed in recent years; and
- whether there have been competitive advantages arising from ownership by government.

(a) Relative Growth

27.28 Questions about changes in the relative importance of government-owned banks and other deposit-taking institutions inevitably raise issues about the appropriate basis of assessment both in respect of the **range** of institutions considered and the **time span** over which the assessment is made.

27.29 It was noted in the Interim Report in the context of ‘ownership and control of financing operations’ (Chapter 6) that over the three decades or so to 1979 the proportion of the total assets of **all** financial institutions held by government-owned financial institutions declined from about one-quarter to a little more than one-fifth;⁵ if the focus were confined to deposit-taking institutions then the share held by government institutions⁶ declined even more substantially from 43% to 26%.

27.30 In respect of banks and banking groups, the statistics⁷ show that over the three decades to 1980:

- (i) the relative importance of **government banks**, measured in terms of all domestic bank deposits, declined marginally from 45.4% in 1950 to 44.1% in 1980;
- (ii) **government trading banks** increased their share of all Australian trading bank deposits from 9.8% in 1950 to 30.8% in 1980, while government **savings banks**⁷ share of all savings bank deposits declined from 98.0% to 60.1%;
- (iii) in respect of **government banks**, the share of Australian bank deposits held by the Commonwealth Trading and Savings Banks declined from 29.8% in

⁵ Interim Report, pp. 185–6.

⁶ Reference to government institutions means institutions owned by Australian governments, State or Commonwealth.

⁷ Detailed statistics on changing market shares are presented at Tables 27A.1 to 27A.4 of the Appendix to this chapter.

1950 to 27.7% in 1980, while the share held by banks owned by State governments increased from 15.6% to 16.4%;

(iv) if the perspective is broadened to the relative growth rates of **consolidated banking groups** — i.e. including overseas business, the business of subsidiaries etc. — then the compound annual growth rates of the three groups over the three decades to 1980 were:

- major private banking groups 10.2% p.a;
- Commonwealth Banks Group 9.3% p.a;
- state banks 9.0% p.a.

Over the past two decades the average growth of state banks as a group has exceeded that of the Commonwealth Bank but remained below that of the major private banks.

27.31 In the broad sweep of financial sector developments over recent decades two changes stand out as factors tending to reduce the importance of government financial institutions:

- the entry of private banks into savings banking, which until the mid 1950s was almost exclusively conducted by government banks; and
- the rapid development of non-bank institutions such as permanent building societies, finance companies and merchant banks; until recently, government banks did not diversify their operating structures to the same extent as their private banking-group counterparts.

27.32 Some government banks have recently formed non-bank subsidiaries (e.g. CBFC) and otherwise associated themselves with non-bank intermediaries (e.g. the Rural Bank of New South Wales and the Rural Building and Investment Society). This process of diversification will undoubtedly assist the relative overall growth of government banking groups. At the same time, changes in the regulatory environment may enable the balance sheets of banks, including government banks, to grow relatively fast in their own right.

27.33 In summary, the secular trend has been for government-owned deposit-taking institutions to decline overall in relative importance. Future developments are naturally uncertain but the possibility cannot be ruled out that the relative importance of government-owned deposit-taking institutions will increase. The Committee attaches no particular significance to changes in the relative importance of government-owned institutions of itself; if their presence in the market were justified (in terms of the principles enunciated earlier in this chapter and in the previous chapter) then provided they compete fairly and operate efficiently their relative importance should properly be determined in the market place.

(b) The Competitive Advantages

27.34 Some private banks (and other private intermediaries) have submitted that government banks have less incentive to efficiency and enjoy competitive advantages stemming from:

- 'captive' business which gives government banks some elements of monopoly power in particular market segments;
- less pressing obligations to make a full commercial return on the commitment of capital (actual and implied); this, it is claimed, helps them to compete

- aggressively with private banks which must have adequate regard to servicing their shareholders' equity;
- in some instances, special treatment in respect of taxes, stamp duties, charges etc.;
- in the case of state government-owned banks, **no formal** obligation to observe the banking and monetary policy requirements imposed on national banks and, certainly in some cases at least, greater flexibility as to responses to such requirements.

27.35 In defence of their position, the government banks argue that:

- government ownership imposes obligations as well as benefits (e.g. see paragraph 27.24);
- there is no evidence that government banks enjoy a substantial advantage in market borrowing status by virtue of their government ownership and solvency support: the authorities afford some protection to bank depositors generally and the community perceives no major differences, in terms of protection, in banking with a government bank or one of its affiliates;
- while government banks are often exempt from specific taxes and charges, they generally make contributions to government revenues which are in essential respects equivalent;
- as far as state government banks are concerned:
 - they must conform with the economic and other policies of the governments which own them;
 - this fundamental difference notwithstanding, they do in practice generally observe national banking policy where this is not inconsistent with their obligations to state governments;
 - in not operating **nationally**, their potential market is restricted and this is a disadvantage.

(c) Future Standards and Practices

27.36 This debate has led the Committee to examine possible **operational guidelines** to enhance competitive neutrality.

(i) Capital Structure and Operations

27.37 As indicated in the previous chapter, the Committee is firmly of the view that government-owned financial institutions should, in the area of their commercial business, be required to **operate on an equal footing** with their private sector counterparts. Applied to government banks, this means they should fully capitalise their commercial operations, set operational and profitability targets and openly account for their activities in a way which will enable an objective evaluation of their commercial efficiency and competitive position.

27.38 Whether, in addition to meeting those operational requirements, they should pay a fee to government to offset the borrowing-status advantage of government ownership is a difficult issue.

27.39 In view of the provisions of the Banking Act, which impose particular responsibilities on the authorities with regard to protection of the interests of **all** bank depositors, it is highly unlikely that government **banks** derive significant borrowing advantage from their parentage (at least on the domestic market) whether their obligations are explicitly guaranteed or not; nevertheless some

conclude that a degree of advantage (albeit slight) exists — as government credit should be regarded as the best in the land. If this view were to be reflected in the market, the Committee would deem it appropriate for government banks to be charged some fee for that advantage.

27.40 In respect of government-owned, **non-bank** deposit-taking intermediaries, the borrowing advantage relative to private sector counterparts seems to be clearer and greater. The Committee is of the view that the benefits which flow from government ownership should be explicitly priced and fully charged for.

27.41 Non-bank deposit-taking institutions with a government association **short of outright control** may also have competitive advantages arising from the relationship. If after careful assessment this is so, then these advantages could similarly be neutralised by the imposition of a fee payable to government.⁸

27.42 The borrowing activities of government-owned commercial banks have been exempt from the obligation of Loan Council approval. In Chapter 12, the Committee recommends that public authorities should only be free to borrow without such approval if they are considered to be subject to full market disciplines, they compete equally in all respects with their private counterparts and their borrowings are **not** guaranteed by government.

27.43 The Committee's general preference would be for these conditions to apply to government-owned commercial banks and for existing government guarantees (where applicable) to be formally rescinded. The Committee acknowledges that removing **existing** guarantees may not be a realistic option in many cases, at least for a time. Nevertheless, this step should be carefully considered by respective governments for implementation at an appropriate time. For any **new** government commercial financial institutions that might be established the Committee envisages that its borrowings would not be formally guaranteed where such borrowings are exempt from Loan Council approval.

27.44 The Committee therefore *recommends* that:

- (a) **The commercial operations of government banks and other deposit-taking institutions should be planned with the objective of earning a return on equity comparable over time with that earned by private banks (after appropriate adjustments for any capital and/or gearing differences).⁹ A comparable rate of dividend should also be paid. The performance of the institution should be evaluated periodically on that basis.**
- (b) **Every endeavour should be made to ensure that government banks and other commercial deposit-taking institutions are fully capitalised to the standards of their private sector counterparts. (Such adjustments as may be necessary should be made as soon as possible. Pending these adjustments, it would be appropriate to impute comparable capitalisation when setting and measuring profit targets and performance.)**
- (c) **Any *net* saving in operating taxes (income tax, stamp duty, local government rates etc.) arising out of government ownership, after deduction of any 'equivalent' payments made to government, should be noted in the annual accounts of the institutions in question.**

⁸ As a general principle the Committee does not favour such partnerships of government and private enterprises (see Chapter 26).

⁹ And subject to the proviso that industry profitability is not excessive (see Chapter 26).

- (d) A special fee should be paid to the appropriate authorities by government deposit-taking institutions to neutralise any advantages in borrowing costs (reflected in the market) arising from government ownership.¹⁰
- (e) In all other respects government-owned deposit-taking institutions should be treated similarly — in respect of their commercial operations — to their private sector counterparts. The effects of any non-commercial operations, as well as any operational constraints imposed by their government owners, should be noted in their annual accounts.
- (f) Subject to the above conditions being met, government banks should continue to be exempt from Loan Council requirements, but on the general understanding that borrowings would not be explicitly guaranteed — unless they already have such guarantees and it is not considered practical to withdraw them.

(ii) *Commonwealth Banks Act*

27.45 The Commonwealth Banks Act (and its Regulations) contains a number of provisions which do not sit comfortably with the operations of the Commonwealth Trading and Savings Banks as commercial institutions, nor with the Committee's proposals for the Commonwealth Development Bank. The previous section suggests that removal of the general guarantee granted in s.117 of the Act be considered at an appropriate time. Some other particular provisions are discussed in other chapters (s.56 is discussed in Chapter 37).

27.46 In Chapter 26 the Committee recommends that the commercial activities of GFIs should be no more fettered or subject to government interference than private sector institutions conducting similar activities. Given that, the Committee questions whether some provisions of the legislation remain appropriate; these include:

- the provisions set out in s.11 and s.13 of the Act relating to liaison between the Government and the Bank and the resolution of any differences of opinion between them;
- the *ex officio* position of the Secretary of the Treasury (or his Deputy in lieu) on the Board of the Corporation and his eligibility for membership of the Executive Committee of the Commonwealth Savings Bank (but not the Trading or Development Bank);
- the detailed specifications of conditions of service in Part VIII of the Act.

27.47 The Government, like the owners of any corporation, appoints the board members of the Corporation. Similarly the Act provides for annual reports, financial statements and Auditor General's reports to be made to the Treasurer and Parliament.

27.48 It is not clear to the Committee that the nature of the Bank's operations is such that Treasury oversight on behalf of the Government requires, or is consistent with, the Secretary to the Treasury having an *ex officio* seat on the Board. Not only is there the question of the consistency of the Secretary's departmental role with his responsibilities to a commercially oriented organisation, but there is the question also of consistency concerning his role as a member of the Board of the Reserve Bank, which the Committee has recommended should continue.

¹⁰ In the case of banks, see paragraph 27.39.

27.49 The Committee understands that the Secretary to the Treasury is excluded from the Executive Committees of the Trading Bank and Development Bank but not from that of the Savings Bank. The Committee believes that the Secretary, if he remained as a Board member, should be excluded from all Executive Committees. (There might be justification for him being involved with such a group for the Development Bank while it maintained a predominantly social role. However, in terms of the recommendation in Chapter 28 this would at most be a transitional phase.)

27.50 Similarly, s.11 and s.13 of the Act may have applicability if the Corporation were filling predominantly a sectoral assistance or some other social role. That is not the role the Committee envisages for the Corporation and it sees these provisions as raising the potential for undue intrusion into the commercial operations of the Bank. The Committee suggests the Government rest its oversight on more general reporting requirements.

27.51 There are a number of provisions of Part VIII and in the regulations to the Act which on a strict interpretation could fetter the Corporation Banks in their operations in a competitive environment.¹¹ The Committee suggests that such formal and detailed legal documentation of these matters be reviewed.

27.52 The Committee *recommends* that the Act and its regulations be reviewed. In particular:

- (a) Sections 11 and 13 of the Commonwealth Banks Act be repealed.
- (b) Sections 14 and 16 be amended to exclude the Secretary to the Treasury from the Board of the Commonwealth Banking Corporation.
- (c) The Act generally be amended to establish arrangements between the Government and the Corporation fully consistent with the conduct of a basically commercial operation.

(iii) *Conformity with National Banking Policy*

27.53 The Committee feels that the principles it has expounded above, including those specifically with regard to the Commonwealth Banking Corporation, have equal relevance from the point of view of efficiency for banks and deposit-taking organisations owned by state governments and it hopes they consider their implications sympathetically. One related issue that was raised a number of times before the Committee was the extent to which state banks conform to national banking policy.

27.54 It was not possible for the Committee to make an absolute judgment on whether state banks as a group or individually had reasonably complied with national banking policy, and whether their performance in this respect conferred any competitive advantages.

27.55 The difficulties in the way of such judgment are of two kinds. Firstly, because of the different operational structure of private and government banking groups (the former typically owning a number of non-bank intermediaries) it is inappropriate to single out one aspect of an interrelated whole — such as trading bank advances outstanding — in order to assess compliance with national banking policy.

11 For example, the regulation formally permitting the Commonwealth Savings Bank to require up to one month's notice of withdrawal from ordinary savings accounts.

27.56 Secondly, there is the question of policy influences originating from the state government parent which may reasonably differ from and override the preferences of the national monetary authorities. The Committee makes no judgment about the appropriateness of different emphases in state and national banking policy but simply observes that for the most part any policy requirements and influences of state governments that conflict with national monetary policy should be disclosed in the accounts of the respective government banks.

(iv) Government Patronage

27.57 There was reference in some submissions to government banks having exclusive rights in certain markets. Examples cited included: school banking facilities, government authority accounts, and post office banking facilities.

School banking

27.58 In some states government banks have exclusive access to government schools in the provision of account-keeping banking facilities for school children. Private schools, on the other hand, are generally free to offer access to whichever bank or banks they choose, that choice being a matter between the school authorities and their clients.

27.59 In justification of exclusive access to government schools, it has been pointed out that:

- these arrangements are generally long standing and pre-date the establishment of the private commercial savings banks; and
- the 'benefits' of providing school banking facilities may be tenuous and long term while the net running costs could be substantial.

27.60 Nevertheless, the case against freer and more open competition needs to be exceptionally strong to warrant present restrictions, given that:

- school children, like other consumers, stand to benefit from competition — in this case for the school banking accounts; and
- a greater degree of competition presently exists for the right to provide school banking facilities in private schools and has not been objected to.

27.61 The Committee believes that as far as possible there should be freedom of choice and competition for the right to provide banking or savings facilities to school children within the school environment, although it is realised that in some instances wider contractual commitments may be involved, e.g. in Queensland the State Government has agreed to enhance the position of the Commonwealth Savings Bank in return for certain benefits.

27.62 The Committee therefore **recommends** that, **where possible, the relevant state authorities should:**

- **allow the children of state schools freedom of choice in respect of the provision of school banking facilities; or**
- **if it is desired to restrict the number of banks, establish a system of open and competitive tendering for the rights to provide banking facilities to children in state schools.**

Government authority banking business

27.63 The Committee understands that governments do not generally direct their authorities and affiliated business enterprises as to the conduct of their

banking business. At the same time it is appreciated that particular banker-customer relationships could give the impression of being 'captive' business.

27.64 While not proceeding to a firm recommendation on the banking business of government authorities, the Committee nonetheless concludes that public enterprises desirably should be free to choose on the basis of cost factors. It is recognised that considerations other than cost may sometimes enter into decisions to conduct public authority banking business with government banks; however, it is believed by the Committee that the full cost implications of any such restriction should be assessed and revealed so that the decisions can be properly evaluated by the public.

27.65 Two related matters are treated elsewhere in this Report.

- the question of the terms and conditions on which governments may bank with the Reserve Bank and the exclusivity of the banking relationship between the Reserve Bank and the Commonwealth Government is discussed in Chapter 2; and
- the suggestion that the Commonwealth Government may place deposit funds with commercial financial institutions temporarily to alleviate seasonal liquidity fluctuations is discussed in Chapter 6.

27.66 The Committee has not otherwise concerned itself with the choice of banking arrangements by state governments as distinct from their commercial instrumentalities. However, it would be inconsistent with the Committee's general approach for the placement of state government banking business to be decided on non-commercial criteria simply to enhance the competitive position of a government-owned bank.

Post office banking facilities

27.67 Only Commonwealth Savings Bank facilities are provided at Australian post offices. This exclusivity no doubt had its origin in the common government ownership of the two business enterprises. It is also recognised that the arrangement pre-dates the establishment of the national private savings banks and that the costs of establishing and developing the joint venture over a long period have been substantial.

27.68 Recently the Government has also provided facilities at post offices for investors to apply for the issue, and give notice of redemption, of Australian Savings Bonds.

27.69 These two agency arrangements, together with Australia Post's own facilities for offering money transfer services, give the latter organisation some of the characteristics of a financial institution — albeit of a limited and ancillary nature.

27.70 The specific issue of post office involvement in the more extensive provision of giro-style payments system services is noted in Chapter 23 and discussed more fully in the Appendix to that chapter. The Committee's recommendations for enhancing the payments system envisage major development elsewhere.

27.71 The Commonwealth Savings Bank, other savings banks and various financial institutions such as building societies also offer private agency facilities

through retail stores, real estate agents and other businesses. Such arrangements are a matter of commercial negotiation between the parties.

27.72 The Committee accepts that governments may see the post office agency banking facilities as a useful addition to the range otherwise available — particularly for those not needing extensive banking services or without convenient access to a bank. It may also be thought that the need for these facilities may increase in the future if a more competitive banking system leads to a reduction in commercial bank branch representation. It is for government to decide if the additional call on resources is justified, having regard for the principles outlined in paragraph 27.44.

27.73 The question for the Committee to consider is whether the Commonwealth Savings Bank should continue to have **exclusive** access to agency facilities at post offices. It would be possible for post offices to act as agents for a wider range of banks and possibly non-bank intermediaries (as do some of the large retail stores).

27.74 The position might usefully be re-examined by Australia Post in conjunction with potential partners to ascertain whether a broader range of agency facilities might be offered at particular locations where demand may warrant an extended service.

27.75 Even where it is not economic to have more than one bank represented, the Committee believes that the exclusivity of Australia Post's savings bank agency arrangement with the Commonwealth Bank should be tested against commercial realities. It is possible that another bank would be prepared to take over as principal bank and would value the arrangement more than the Commonwealth Banking Corporation. If so, it would be consistent with the Committee's views on competitive neutrality to allow other banks to participate: however, the fact that the Corporation may have invested heavily to establish and maintain the service would need to be borne in mind.

27.76 The Committee therefore *recommends* that:

(a) **The provision of bank agency facilities at Australian post offices should be governed by sound commercial principles. To this end, the arrangements for the provision of banking facilities should be reviewed by Australia Post to determine:**

- **whether, if Australia Post continues to offer bank agency facilities at all or some post offices, the Commonwealth Savings Bank should continue to have exclusive rights to conduct this agency business;**
- **the commercial practicability of extending the range of both the banking services provided at post offices and the banks (and possibly other institutions) for which Australia Post acts as agent, either generally or at particular locations.**

(b) **The review should take appropriate account of the long-standing relationship of the Commonwealth Savings Bank with post offices. If it were decided to vary existing arrangements but to otherwise limit the number of principal banks (or other participants), then the agency facilities could be offered by tender to eligible principals.**

GOVERNMENT BANKS: RELATIVE IMPORTANCE AND COMPARATIVE PERFORMANCE

1 This Appendix presents the statistical background to the discussion in Chapter 27 of the relative importance of government banks in Australian financial markets.

Relative Growth

2 Tables 27A:1 to 27A:3 show respectively the 'market share' of individual banks — trading, savings and both 'consolidated' — assessed in terms of Australian deposits as of June in 1950, 1960, 1970 and 1980, together with the compound annual growth rate of Australian deposits and total Australian assets. The individual bank figures have additionally been grouped according to their government and private ownership and national and state orientation of their banking business. The tables were compiled from the banking statistics published in the *Commonwealth of Australia Gazette* and Occasional Paper 4B, 'Australian Banking and Monetary Statistics 1945-1970', published by the Reserve Bank of Australia.

3 Statistics are available separately for the trading and savings banks but there is no consolidation of the two. The 'consolidated' figures in Table 27A.3 are derived from a simple aggregation of the trading and savings bank statistics; as a consequence intra-group accounts have not been offset but any resulting 'double counting' is not expected to be of major consequence. As well, the separate statistics of banks which have subsequently amalgamated their businesses have been retrospectively consolidated by simple aggregation under the name of the now existing banking group.

4 Table 27A:4 shows for the three decades to 1980 the comparative compound annual growth rates of the consolidated assets of individual Australian banking groups. This table was compiled on the basis of the consolidated assets of the different groups (including overseas assets) as reported in their annual accounts. As such the table does not reflect, on an equity-weighted basis, the rate of growth in assets virtually 'controlled' (but not legally) by the subject groups as these, if any, are not consolidated. It is possible that as a consequence the overall growth rate of certain of the major national banks might be slightly understated. Conversely the inclusion of overseas assets — a fast-growing segment of the business of particularly the major national banks — may overstate the comparative growth of the major banks domestically; as well the table does not go beyond the formality of 'agency' relationships between some state banks and building societies which might reasonably bear on assessments of effective 'control' of financing in Australia.

5 The following table shows the compound annual growth rates of deposits and assets of the major Australian banking groups from 1950 to 1980.

6 The following table shows the compound annual growth rates of deposits and assets of the major Australian banking groups from 1950 to 1980.

7 The following table shows the compound annual growth rates of deposits and assets of the major Australian banking groups from 1950 to 1980.

TABLE 27A.1: TRADING BANKS: MARKET SHARE AND COMPOUND ANNUAL RATES OF GROWTH (1950-1980) (%)

	Compound annual growth rates											
	Share of deposits in Australia											
	1950	1960	1970	1980	1950-1960		1960-1970		1970-1980		1950-1980	
					Deposits	Assets	Deposits	Assets	Deposits	Assets	Deposits	Assets
ANZ/Adelaide	27.2	23.1	21.8	18.3	3.1	2.6	6.4	7.4	11.8	13.7	7.0	7.8
NSW	26.3	22.7	22.8	20.9	3.3	3.9	7.1	7.3	12.7	14.7	7.6	8.5
CBA	9.1	10.3	7.9	8.2	6.2	6.3	4.2	4.8	14.1	16.0	8.1	9.0
CBC	12.6	9.9	8.3	7.4	2.4	2.2	5.1	5.0	12.5	16.0	6.6	7.6
National	14.0	14.8	13.0	12.3	5.4	4.0	5.6	6.6	13.0	16.0	8.0	8.7
Subtotal	89.1	80.9	73.9	67.2	3.8	3.6	6.0	6.7	12.6	14.9	7.4	8.3
Bank of NZ	0.3	0.2	0.2	0.4	-0.3	3.1	5.2	1.6	24.9	24.0	9.4	9.0
Bank of Qld	0.2	0.2	0.1	0.2	3.1	3.4	6.1	5.5	17.2	15.4	8.5	7.9
BN de Paris	0.6	0.1	0.3	1.5	-10.3	-8.2	15.2	17.5	34.1	36.4	11.4	13.7
Subtotal	1.1	0.5	0.6	2.1	-3.9	-0.7	9.2	8.0	29.1	30.3	10.6	11.8
Commonwealth												
Trading Bank	7.5	15.0	19.4	21.3	12.4	11.1	9.8	9.7	14.8	16.4	12.3	12.4
Rural Bank of NSW	1.6	2.7	4.5	7.0	10.4	5.2	12.5	9.9	18.8	17.9	13.9	10.9
R & I Bank of WA	0.4	0.4	1.0	1.7	6.1	6.1	16.8	12.4	19.9	19.0	14.1	12.4
State Bank of SA	0.3	0.5	0.6	0.8	10.2	16.5	8.5	15.0	16.9	14.9	11.8	15.5
Subtotal	2.3	3.6	6.1	9.5	9.8	6.6	12.6	11.3	18.9	17.5	13.7	11.7
Total	100.0	100.0	100.0	100.0	4.8	4.5	7.0	7.5	13.7	15.7	8.4	9.1

TABLE 27A.2: SAVINGS BANKS: MARKET SHARE AND COMPOUND ANNUAL RATES OF GROWTH (1950-1980) (%)

	Compound annual growth rates													
	Share of deposits in Australia													
	1950	1960	1970	1980	1950-1960		1960-1970		1970-1980		1950-1980			
				Deposits	Assets	Deposits	Assets	Deposits	Assets	Deposits	Assets	Deposits	Assets	
ANZ/Adelaide	—	5.1	9.8	10.2	n.a.	n.a.	16.2	16.3	12.0	12.0	n.a.	n.a.	n.a.	
NSW	—	9.5	13.4	13.5	n.a.	n.a.	12.6	12.8	11.7	11.6	n.a.	n.a.	n.a.	
CBA	—	—	2.8	3.9	n.a.	n.a.	n.a.	n.a.	15.5	15.4	n.a.	n.a.	n.a.	
CBC	—	2.9	3.9	4.6	n.a.	n.a.	11.9	12.1	13.4	13.3	n.a.	n.a.	n.a.	
National	—	—	4.5	6.0	n.a.	n.a.	n.a.	n.a.	14.8	15.3	n.a.	n.a.	n.a.	
Subtotal	—	17.6	34.2	38.2	n.a.	n.a.	16.4	16.5	12.7	12.8	n.a.	n.a.	n.a.	
Commonwealth Savings Bank	62.8	52.6	41.3	35.4	5.3	5.3	6.2	6.3	9.8	9.9	7.1	7.1	7.1	
R & I Bank of WA	—	0.4	1.0	1.3	n.a.	n.a.	19.6	20.0	15.2	15.9	n.a.	n.a.	n.a.	
Savings Bank of SA	9.3	8.1	5.8	5.2	5.7	5.8	5.3	5.3	10.2	10.3	7.1	7.1	7.1	
State Bank of Victoria	26.0	19.5	16.3	18.2	4.1	4.1	6.9	7.1	12.8	13.0	7.9	7.9	8.0	
Subtotal	35.2	28.0	23.1	24.7	4.7	4.7	6.8	6.9	12.3	12.6	7.9	7.9	8.0	
Savings Bank of Tasmania	1.1	1.0	0.7	0.8	6.3	6.2	5.9	5.9	12.9	13.3	8.2	8.2	8.3	
Launceston Bank for Savings	0.9	0.8	0.7	0.8	6.2	6.2	6.7	6.6	14.0	14.1	8.8	8.8	8.8	
Subtotal	2.0	1.8	1.4	1.7	6.3	6.2	6.3	6.2	13.6	13.7	8.5	8.5	8.5	
Total	100.0	100.0	100.0	100.0	7.3	7.3	8.9	8.9	11.5	11.7	9.2	9.2	9.2	

TABLE 27A.3: TRADING AND SAVINGS BANKS: MARKET SHARE AND COMPOUND ANNUAL RATES OF GROWTH (1950-1980) (%)

	Compound annual growth rates														
	Share of deposits in Australia						1950-1980								
	1950	1960	1970	1980	Deposits	Assets	1950-1960	Deposits	Assets	1960-1970	Deposits	Assets	1970-1980	Deposits	Assets
ANZ/Adelaide	16.2	14.9	15.8	14.7	5.0	4.5	8.5	9.4	11.8	13.2	8.4	8.9	13.2	8.4	8.9
NSW	15.6	16.7	18.1	17.6	6.7	7.2	8.8	8.9	12.3	13.7	9.2	9.8	13.7	9.2	9.8
CBA	5.4	5.6	5.3	6.3	6.2	6.3	7.4	7.9	14.5	15.9	9.3	10.0	15.9	9.3	10.0
CBC	7.5	6.7	6.1	6.1	4.7	4.4	6.8	6.8	12.8	15.3	8.0	8.7	15.3	8.0	8.7
National	8.3	8.0	8.7	9.4	5.4	4.0	8.8	9.5	13.5	15.8	9.2	9.7	15.8	9.2	9.7
Subtotal	53.1	51.9	54.0	54.0	5.7	5.4	8.3	8.8	12.7	14.3	8.8	9.4	14.3	8.8	9.4
Bank of NZ	0.2	0.1	0.1	0.2	-0.3	3.1	5.2	1.3	25.5	24.5	9.6	9.1	24.5	9.6	9.1
Bank of Qld	0.1	0.1	0.1	0.1	3.1	3.4	6.1	5.2	17.2	15.4	8.5	7.9	15.4	8.5	7.9
BN de Paris	0.4	0.1	0.1	0.8	-10.3	-8.2	23.5	17.5	34.1	36.4	11.4	13.7	36.4	11.4	13.7
Subtotal	0.7	0.3	0.3	1.1	-3.9	-0.7	9.2	8.0	29.2	30.4	10.6	11.8	30.4	10.6	11.8
Commonwealth Trading															
Savings Banks	29.8	32.3	30.4	27.7	6.7	6.5	7.2	7.2	11.6	12.3	8.5	8.6	12.3	8.5	8.6
Rural Bank of NSW	1.0	1.5	2.3	3.8	10.4	5.2	12.5	9.9	18.8	17.9	13.9	10.9	17.9	13.9	10.9
R & I Bank of WA	0.2	0.4	1.0	1.5	12.4	9.1	18.1	14.7	17.8	17.9	16.1	13.9	17.9	16.1	13.9
State Bank of SA	0.2	0.3	0.3	0.4	10.2	16.5	8.5	15.1	16.9	14.9	11.8	15.5	14.9	11.8	15.5
Savings Bank of SA	3.8	3.7	2.9	2.3	5.7	5.8	5.3	5.4	10.2	10.3	7.1	7.1	10.3	7.1	7.1
State Bank of Victoria	10.5	8.9	8.2	8.3	4.1	4.1	6.9	7.1	12.8	13.0	7.9	8.0	13.0	7.9	8.0
Subtotal	15.6	14.8	14.6	16.4	5.3	5.0	7.7	7.9	14.0	14.1	8.9	9.0	14.1	8.9	9.0
Savings Bank of Tasmania	0.4	0.4	0.4	0.4	6.3	6.2	5.9	5.8	12.9	13.3	8.2	8.3	13.3	8.2	8.3
Launceston Bank for Savings	0.4	0.4	0.3	0.4	6.2	6.2	6.7	6.6	14.0	14.1	8.8	8.8	14.1	8.8	8.8
Subtotal	0.8	0.8	0.7	0.8	6.3	6.2	6.3	6.2	13.6	13.7	8.5	8.5	13.7	8.5	8.5
Total	100.0	100.0	100.0	100.0	5.9	5.6	7.9	8.1	12.7	13.9	8.8	9.1	13.9	8.8	9.1

TABLE 27A.4: CONSOLIDATED BANKING GROUPS: COMPOUND ANNUAL RATES OF GROWTH IN ASSETS (1950-1980) (%)

	<i>1950-1960</i>	<i>1960-1970</i>	<i>1970-1980</i>	<i>1950-1980</i>
ANZ/Adelaide	5.4	9.8	14.2	9.7
NSW	6.4	8.6	16.9	10.5
CBA	6.2	9.1	18.0	11.0
CBC	4.7	7.0	17.6	9.6
National	4.6	8.6	18.5	10.4
Subtotal	5.6	8.9	16.5	10.2
Commonwealth Banking Corporation	7.0	7.3	13.7	9.3
Rural Bank of NSW	5.0	9.8	17.5	10.7
R & I Bank of WA	10.3	14.5	16.6	13.8
State Bank of South Australia	13.5	14.7	15.2	14.5
Savings Bank of South Australia	5.8	5.4	10.3	7.1
State Bank of Victoria	4.2	7.1	13.5	8.2
Subtotal	5.1	7.9	14.2	9.0
Total	5.9	8.3	15.5	9.8

CHAPTER 28: COMMONWEALTH DEVELOPMENT BANK

A. INTRODUCTION

28.1 The Commonwealth Development Bank (CDB), wholly owned by the Commonwealth Government, is part of the Commonwealth Banking Corporation Group. Unlike the Commonwealth Trading and Savings Banks it is not primarily a commercial enterprise.

28.2 The CDB provides finance to fund primary production and the establishment or development of business undertakings, particularly small businesses, with good prospects of success but unable to obtain finance elsewhere on reasonable and suitable terms and conditions. It is this 'last recourse' finance role which gives the CDB its unique character.

28.3 In addition to the assessment of loan applications (many of which are not approved) and administration of loans outstanding, the CDB provides advice and assistance to those eligible for loans with a view to promoting the efficient organisation and conduct of primary production or other business undertakings.

28.4 The CDB states that:

- it neither actively seeks loan business, nor requires borrowers to be customers of the Commonwealth Trading Bank for their general banking and working capital needs (nonetheless, it seems likely that the CTB indirectly derives a commercial advantage from the close association);
- interest rates on its loans are judged to have generally been at or slightly below those charged by banks (but true comparisons are difficult);
- loan assessment criteria emphasise prospects for viability rather than security for loans advanced.

28.5 The policy governing CDB rural lending operations has altered over the last decade to reflect changing circumstances. Among other things an earlier emphasis on developmental aspects has been modified to accommodate, in addition, a specific capacity to finance:

- farm build-up to assist rural reconstruction;
- non-development loans for rural industry and fishing;
- beef cattle industry assistance; and
- rural plant and equipment financing.

28.6 The CDB's term loans outstanding are predominantly to the rural sector. In recent years, however, following a broadening of the CDB's involvement in non-rural business lending (including specific government policy initiatives to this

effect) and the establishment of the Primary Industry Bank of Australia (PIBA), there has been a greater emphasis on non-rural loans.¹

28.7 The CDB does not operate on a fully commercial business basis. The relatively low interest rate (especially when one allows for the higher risk involved in last recourse lending) and more relaxed loan assessment criteria have already been mentioned. The Bank's capacity to provide services and funds on concessional terms partly stems from particular features of its structure, funding and exemption from liability for both tax and dividend commitments.

28.8 The CDB's capital and reserves, \$183 million at June 1980, effectively represents an interest-free loan from government, net profits each year being credited to the Bank's reserve fund. The Bank is highly capitalised for a financial intermediary, equity being 35% of total funds at 1980. The operating profit (after no taxation) for 1979-80 yielded about 7% on capital and reserves.

28.9 Any borrowing on commercial markets by the CDB is subject to approval of the Treasurer, the requirements of the Australian Loan Council and clearance from the Reserve Bank. Total outstanding borrowings at June 1980 were \$310 million, of which \$120 million was borrowed at market rates using transferable certificates of deposit. The balance comprised loans from the Commonwealth Savings Bank (\$145.7 million) and the Commonwealth Government (\$44.3 million) on concessional terms. CDB has been required in recent years to borrow new funds at commercial interest rates. This decreasing reliance on concessional borrowings and increased emphasis on market placements has brought the CDB's cost of funds closer to market rates.

28.10 In summary, the CDB:

- is not primarily a commercial enterprise;
- is a vehicle for sectoral assistance; and
- as such serves as a supplementary 'last recourse' lender to small businesses, including those engaged in primary production.

Thus, whether the CDB is economically viable and operationally efficient — two of the tests mentioned in Chapter 26 — are not questions at issue at the present time.

B. FUTURE ROLE

(a) Sectoral Assistance Operations

28.11 The Committee's general approach to sectoral assistance matters is developed in Chapter 36. The appropriate future policy on the sectoral assistance role of the CDB depends on:

- the continuing need for such assistance; and
- the relative cost-effectiveness of alternative approaches to deliver it.

28.12 In the financial system envisaged by the Committee, the **availability** of finance will not be a problem. The **cost** of finance may, however, be of concern to

1 Over the three years to June 1980, term loans outstanding to non-rural businesses increased 71%, while those to rural businesses increased by only 23% but the latter still comprised 62% of the total increase. In addition to its general term lending the CDB also finances the acquisition of equipment; at June 1980 equipment finance outstandings totalled \$90 million. The CDB is an approved prime lender of PIBA and fully utilises its quota to refinance loans to rural businesses.

governments. In a competitive commercial market, free of artificial impediments, money will generally be available but not necessarily at a price certain farmers and small businesses will be able to afford. Governments may then need to decide, on social grounds, whether intervention is desirable and, if so, the form it should take.

28.13 If governments were to decide on continued assistance, the Committee's first preference would be for assistance to be provided **directly** to the 'target' group through specific annual allocations from the Budget (see Chapter 36).

28.14 On the other hand, if governments consider that a financial intermediary needs to be used, the Committee believes that assistance could be channelled through commercial lenders just as effectively as through a government-owned institution and in ways that minimise disturbance to competitive neutrality between various intermediaries. The Committee sees no sound economic case for retaining the CDB simply in order that it may act as a channel for concessional finance.

28.15 The demand for CDB loans principally reflects its ability to provide loans on a concessional basis. Because of this it has had the opportunity to develop a particular expertise which, with justification, is highly valued. There is nothing, however, to suggest that other commercial lenders could not and would not develop the same expertise if they were given equal opportunity to offer concessional loans.

28.16 The Committee believes that commercial financial institutions have the capacity to assess loan proposals and give, or arrange, suitable supporting advice to borrowers (as is presently done by the CDB). The issue is whether the demands on the public purse are likely to be more or less if the desired assistance were delivered through the CDB. There may be circumstances when a centralised administration may yield significant economies. In those instances, the scheme could be administered by a government department or agency. In all other cases it would seem more cost-effective to work through established commercial institutions.

28.17 Accordingly, the Committee concludes that the vehicle of the CDB is not the most cost-effective manner of granting assistance to primary producers or other small businesses.

28.18 The Committee therefore **recommends** that any subsidies to farmers or small business should either take the form of direct grants or tax concessions or be channelled through appropriate, already established commercial institutions.

(b) 'Last Recourse' Operations

28.19 The remaining question for the Committee is whether there will be a significant **commercial** role for the CDB in the financial system envisaged by the Committee.

28.20 Some suggest that CDB loans are filling a market gap arising from the conservative approach of commercial lenders to such matters as security etc.

28.21 The Committee believes that the demand for CDB loans has been a reflection of both the concessional element and the regulations imposed on the financial system (and banks in particular). It considers that in a more competitive, less regulated environment there will be increased opportunities for small businesses (including primary producers), with good prospects of success but

without full collateral, to secure required finance from private sector intermediaries. For example, banks (including new ones) would be expected to play directly a more active role in financing the development of businesses presently financed by the CDB, without breaching prudential standards appropriate for their operations. (See also the Committee's comments in respect of equity capital for small business in Chapter 38.)

28.22 However, in the initial period following deregulation, it is possible that the responsiveness of the system to small business (including rural) debt-financing needs may be slow. If this were the case, the Government may therefore wish to retain CDB as a separate entity **for a time at least**, in order to supplement market facilities. If so, the Committee is of the view that during this transitional period:

- the CDB should cease to operate as a last recourse lender; and
- it should no longer act as an exclusive funnel for government assistance.

28.23 The Committee's reasons are as follows:

- if the CDB were to retain its 'last recourse' character, loan assessment by the CDB would in many instances duplicate work already done by commercial banks (or other lenders) first rejecting the proposal; this is particularly likely to be so in future when banks will have commercial incentives to seek loan business on mutually acceptable terms; also anomalies can arise as between different borrowers, as explained below;
- on the other hand, if the CDB ceased to operate as a 'last recourse' lender and competed aggressively for business, while at the same time acting as an exclusive funnel for government assistance, it could well have an artificial competitive advantage over others and in this way damage could be done to the efficiency of the financial system.

28.24 The Committee specifically points out that the CDB, in applying its 'last recourse' policy, has apparently taken banks as its benchmark of next-to-last recourse. It believes that this standard has become increasingly inappropriate as the 'maximum overdraft' terms of small bank loans have been constrained below market levels and the non-bank intermediary sector has grown in capacity.

28.25 In so far as CDB has effectively become the 'first' recourse of marginal bank borrowers, present arrangements may discourage borrowers from making adequate use of the non-bank commercial finance sector and may act as a disincentive to commercial lenders to become involved in this area of business.

28.26 Reflecting these various considerations, the Committee would suggest that during the suggested transitional period the CDB should be free to compete for business but the interest rates charged by it should not be concessional and should make proper allowance for the risk involved, as well as for the higher costs of servicing its clients.

28.27 In addition the CDB should:

- be required to make the 'fullest' use of public borrowings as a source of funds and work towards obtaining a commercial return on its capital and reserve funds; this would ensure that unnecessary departures from commercial criteria would be minimised; and
- not be subject to Loan Council oversight in respect of its borrowings nor should these be guaranteed by the Government; they should be subject, however, to any monetary policy requirements imposed on other banks.

28.28 Longer term (for reasons explained in paragraph 28.21), the CDB's role as a specialist commercial financier is expected to decline if the Committee's recommendations are implemented, and its reasons for separate existence will then be open to question. The Committee recognises, however, that the CDB has built up a specialised technical capability, particularly in the rural and small business finance areas. It would be concerned if this special capability were lost. It would therefore see it as desirable that, following a transitional period (as suggested above), the CDB be absorbed into the commercial structure of the Commonwealth Trading Bank.

28.29 The Committee *recommends* that:

- (a) In the initial period following deregulation, the CDB should continue as a separate entity but be required to operate with regard to new business on a fully commercial basis.**
- (b) Following this transitional period, the CDB should be absorbed into the commercial structure of the Commonwealth Trading Bank.**
- (c) Such merger should take place on fully commercial terms.**

CHAPTER 29: AUSTRALIAN INDUSTRY DEVELOPMENT CORPORATION

A. BACKGROUND

29.1 The Australian Industry Development Corporation (AIDC)¹ is wholly owned by the Commonwealth Government. Its general functions, according to its charter, are:

- to facilitate and encourage the establishment, development and advancement of Australian industries concerned with the manufacture, processing, treatment, transportation or distribution of goods, or the development or use of natural resources or of technology;² and
- to secure, to the greatest extent that is practicable, participation by Australian residents in the ownership and control of companies engaging in any such industries or activities.

29.2 As can be seen from Table 29.1, AIDC performs these functions primarily by providing loan finance (including loan guarantees). The figures for equity commitments include redeemable preference shares which have more of a loan, as distinct from an equity, characteristic.

TABLE 29.1: AIDC : RECENT COMMITMENTS

Year ended	1978		1979		1980		1981	
	\$m	%	\$m	%	\$m	%	\$m	%
30 June								
Term loans	68.3	87.0	112.3	85.3	156.6	86.1	164.0	87.9
Standby and overrun facilities	0.5	0.7	6.5	5.0	0.2	0.1	2.5	1.3
Leases	9.2	11.7	0.3	0.2	1.7	0.9	—	—
Equity	0.5	0.6	12.5 ^(a)	9.5	23.4 ^(b)	12.9	5.0 ^(a)	2.7
Guarantees & underwriting	—	—	—	—	—	—	15.0	8.1
Total	78.5	100.0	131.6	100.0	181.9	100.0	186.5	100.0

(a) Comprises redeemable preference shares only.

(b) Comprises \$18.5m in redeemable preference shares.

Source: AIDC

29.3 It is important to emphasise that, as presently structured and managed, AIDC's financing activities are essentially motivated by commercial considerations, although there are a number of other factors which the Corporation is required to take into particular account (see paragraphs 29.39-40).

1 A brief outline of AIDC's operations and the regulatory framework within which it operates were provided in paragraphs 18.39-46 and Appendix 12 of the Interim Report.

2 Service industries, such as tourism, transportation (of people) and the leasing of equipment to those not engaged in the specified types of industries, are not covered by AIDC's charter.

29.4 There has been significant growth in AIDC's financing activities which is evidenced in Table 29.2. The future obligations to lend, reflected in commitments made but undrawn at the various financial year ends, should be noted. These must be taken into account in any assessment of its future role.

TABLE 29.2: AIDC: OPERATIONAL LOANS AND INVESTMENTS (\$m)

Year ended 30 June	1977	1978	1979	1980	1981
Outstanding	194	211	266	364	457
Committed but undrawn	47	85	146	150	162
Total	241	296	412	514	619

Source: AIDC

29.5 Several characteristics of AIDC's financing activities should be noted:

- It is principally engaged in medium to long-term lending, the finance it provides predominantly having maturity patterns in excess of four years; a large part is in excess of seven years (Table 29.3).
- It caters primarily for the needs of medium to large-scale business operations, as reflected in the size of individual commitments (Table 29.4).
- In some instances, it gives 'commitments' to obtain or provide finance in respect of large-scale projects before all consortium or syndicated arrangements are finalised.
- While it undertakes leasing of large items of equipment, this has not been significant in recent years.
- While taking equity interests on its own account, it seeks to dispose of such investments as soon as this is feasible, as required under its Act. However, the figures in Table 29.1 do not fully reflect its general role in this area, as it also acts as a catalyst in finding other Australian equity participants in small or large enterprises or projects.

29.6 In assessing AIDC's current and future role, the Committee has sought first to apply the principal efficiency tests developed in Chapter 26, namely whether:

- the continued government ownership of AIDC is **necessary to fill**, presently and in the reasonably foreseeable future, a **commercial 'market gap'** (by providing an essential competitive presence or financial services inadequately provided from other sources);

TABLE 29.3: AIDC: TERM OF RECENT COMMITMENTS^(a)

Year ended 30 June	1978		1979		1980		1981	
	\$m	%	\$m	%	\$m	%	\$m	%
2 years and under	17.1	21.8	6.0	4.6	7.0	3.8	—	—
Over 2 years and up to 4	2.2	2.8	18.0	13.7	15.4	8.5	39.5	21.2
Over 4 years and up to 7	15.9	20.3	14.9	11.3	70.0	38.5	39.5	21.2
Over 7 years	43.3	55.1	92.7	70.4	89.5	49.2	107.5	57.6
Total	78.5	100.0	131.6	100.0	181.9	100.0	186.5	100.0

(a) Includes 'equity' investments, predominantly in the form of redeemable preference shares, of definite maturities (see paragraph 29.2).

Source: AIDC

TABLE 29.4: AIDC : SIZE OF RECENT COMMITMENTS (\$m)^(a)

Year ended 30 June	1978		1979		1980		1981	
	Total	Av.	Total	Av.	Total	Av.	Total	Av.
Up to \$2m	10.6	0.8	12.1	1.1	7.9	0.8	5.0	1.7
Over \$2m and up to \$5m	13.9	3.5	13.5	4.5	32.5	4.6	13.0	4.3
Over \$5m and up to \$10m	7.0	7.0	31.0	7.75	36.5	7.3	17.4	8.7
Over \$10m	47.0	23.5	75.0	18.75	105.0	52.5	151.1	25.2
Total	78.5	3.7	131.6	6.0	181.9	7.6	186.5	13.3

(a) Includes 'equity' investments, predominantly in the form of redeemable preference shares, of definite maturities (see paragraph 29.2).

Source: AIDC.

- the vehicle of AIDC is the **most cost-effective method** of achieving the desired objectives;
- AIDC is **economically viable and operationally efficient** as reflected in its rate of return on capital and in other measurements;
- it **competes equally** with its private sector counterparts.

29.7 The Committee had also considered whether AIDC has a role to play in undertaking specific non-commercial functions, against the background of the views expressed in Chapters 26 and 36.

B. PRESENT ROLE

29.8 In its report, the House of Representatives Standing Committee on Expenditure (SCE) concluded that:

- The AIDC has an established role in the Australian capital market, generally for lending sizeable amounts in the medium to long-term area . . .
- It is useful for AIDC to continue to complement the activities of other lending institutions in the organising of financial packages, in which it may participate as a lender or equity holder, or both.
- There is a role for AIDC as financial adviser in the restructuring of industries and in the development of new techniques for financing industrial development . . .³

29.9 AIDC sees its function as helping to fill a gap in the financial market by providing large-scale, medium-term finance, particularly in the nature of packages arranged on a consortium or syndicated basis. Four distinctive features are stressed by AIDC.

29.10 Firstly, loans are firmly committed for medium to longer terms, with the interest rate being varied at intervals of one or two years — the choice within the reset range being with the customer. The Australian Resources Development Bank (ARDB), which is probably AIDC's most comparable competitor,⁴ makes Australian dollar loans for up to ten years, but at rates which are fixed at the time of drawdown. Trading banks, merchant banks and finance companies tend to lend for

3 Report on the Australian Industry Development Corporation by the House of Representatives Standing Committee on Expenditure, AGPS, Canberra, 1980, p. 17.

4 See Interim Report paragraph 18.42. By the choice of its shareholders, ARDB lends only to the natural resources sector and related manufacturing activities. AIDC lends to a wider range of enterprises.

shorter periods than AIDC, while life insurance companies and superannuation funds have increasingly moved away from debt investment (other than obligatory purchases of government paper). The Committee draws attention, however, to the growing importance of trading bank term loans.⁵

29.11 Secondly, AIDC attaches significance to the fact that it is able to make 'commitments' to obtain or to provide finance before all the syndication arrangements are finalised. The **value** of such a catalytic or lead position is acknowledged but it is not clear to the Committee that there is a large demand (not otherwise satisfied) for advance 'commitments' of this type.

29.12 Thirdly, there is the role played by AIDC in consortium financing in recent years. In the three years to 30 June 1981, AIDC committed itself to provide \$243 million (or about 50% of its total commitments) as part of fifteen syndicated and consortium-type debt financings. This amounted to about 25% of the total amount raised in these particular financings. Most of this took the form of Australian dollar commitments.

29.13 Fourthly, AIDC has pointed to its ability to take an **equity** position in a company or development project and to find Australian equity participants for particular ventures. Although incidental to its overall financing activities (see Table 29.1), AIDC sees itself as a catalyst in various projects which might otherwise have been frustrated.⁶

C. FUTURE ROLE

(a) Commercial Activities

29.14 It has been suggested to the Committee that AIDC is doing no more than filling a 'gap' created by regulation of the banks and that, given freedom from present restrictions and controls, existing financial institutions could meet the needs of the market. It was the view of the SCE that AIDC's present role:

... reflects weaknesses in the Australian capital market, possibly attributable in part to official controls on other financial institutions.⁷

29.15 This raises the question whether AIDC will have a role to play as a **commercially based** financial intermediary in a less regulated environment.⁸ (The general question of a deregulated environment was outside the purview of the SCE.)

(i) Loan Financing

29.16 Banks have pointed out that AIDC has more flexibility in its borrowing and lending operations. They make particular reference to the maturity restrictions on

⁵ Advances outstanding from the Term Loan Fund accounted for 11.4% of the major trading banks' advances in January 1981, of which a little more than one-third was allocated to the mining and manufacturing sectors. This would, however, significantly understate their 'real' term lending, as much of their other lending is effectively on a long-term basis at variable interest rates.

⁶ After a period in the 1970s when AIDC was active in finding Australian equity participants for particular ventures, slower growth — particularly in the resources sector — meant there was less call on AIDC for this service. However, with the acceleration of development in the past two or three years, there has been an increase in requests for AIDC advice on the introduction of Australian equity to new and existing companies and projects.

⁷ SCE Report, *op.cit.*, p. 17.

⁸ The question of non-commercial operations is taken up in paragraphs 29.39-43.

bank borrowings (for less than thirty days or more than four years), interest rate controls and quantitative lending controls. (The LGS/SRD requirements also effectively increase the cost of funds, although it could be argued that the banks enjoy offsetting privileges.)

29.17 It is not clear to what extent abolition of the **maturity restrictions**, as recommended in Chapter 4, would alter the level of competition between the banks and AIDC. AIDC at present obtains a high proportion of its funds in direct competition with banks; at end June 1981, 67% of AIDC's borrowings (by value) was for an original term of between thirty days and four years. It should also be recorded that, while the trading banks cannot borrow for periods in excess of four years, their affiliate, the ARDB, can and does.

29.18 As for **interest rate controls**, the Committee notes that there have been no limitations since 1973 on rates banks can pay on certificates of deposit — a quite significant source of funds. Interest rate controls on fixed deposits were abolished in December 1980, leaving the banks free to compete for funds in most areas of the market.

29.19 It would seem, therefore, that banks are now in a position to compete more directly with AIDC in the area of large-scale, medium-term financing. (As noted earlier — see footnote 5 — trading banks are already significant term lenders.)

29.20 The flexibility of the banks would be further enhanced if maturity restrictions on bank deposits and quantitative lending controls were abolished and if a market-related interest rate were paid on the reserves they are required to hold with the Reserve Bank — all of which are recommended by the Committee (see Chapter 4).

29.21 If certain of the Committee's other recommendations were accepted, there would also be increased competition from foreign banks licensed to operate as banks in Australia. It is true that AIDC has assumed an important role in respect of large-scale consortium financing in **Australian currency** despite the substantial number of foreign-owned merchant banks. However, if foreign banks were to gain a significant deposit base in Australia, their ability to compete with AIDC in providing Australian dollar loans will increase. (At present, competition from foreign banks is principally in respect of foreign currency financing, usually in US dollars.)

29.22 While AIDC is **currently** filling a role in the area of large-scale, medium-term financing, the Committee does not believe that this will continue to be so in the more competitive climate for financiers envisaged, having regard also for the fact that certain advantages presently enjoyed by AIDC may be removed (if the Committee's recommendations in paragraph 29.67 are adopted).

(ii) Equity Financing

29.23 Given present community attitudes to Australian ownership and control, the Committee believes there will be a continuing need for investors able to take large equity positions in major development projects. It considers that the implementation of other recommendations in this Report (such as those in respect of captive market arrangements) should lead to the mobilisation of additional domestic supplies of equity finance. The Committee therefore does not see a role in this area for a government-owned organisation, even for 'temporary' purposes.

29.24 The question of the specific need for a government-owned institution specialising in small business and venture financing is examined in Chapter 38. The conclusion reached there is that commercially viable projects which meet appropriate financial criteria should generally be able to obtain equity finance in a less regulated environment. It is concluded that if the Government nevertheless wished to assist in this area, it would not be cost-effective to do so through a government-owned venture finance institution operating predominantly on commercial lines.

29.25 Even if a need for such an institution were established, the Committee does not consider that AIDC would be an appropriate organisation for providing risk capital to small business. It accepts the view of the AIDC itself that it is not structured to cater for the financial requirements of small business.⁹

(iii) Conclusions

29.26 The Committee does not believe that in the competitive environment envisaged by it, there will be a gap in the supply — on commercial terms — of financial services and facilities of the type now provided by AIDC — and sees no need for government involvement in this area of the market.

29.27 This being so, the Committee concludes that retention of AIDC as a **government-owned** financial intermediary is not necessary for an efficient and competitive financial system.

29.28 It is possible that AIDC's position in the market partly reflects the fund of management experience and knowhow built up over the period of its existence. Hence, although AIDC may not be able to offer a **unique** range of services in a deregulated environment (if it were to operate on a completely equal footing with its competitors), it may well be capable of operating in the future under private ownership as an efficient, commercially oriented intermediary.

(b) National Interest Provisions

29.29 The national interest provisions (s.8A) were inserted into the AIDC Act in 1975 to enable the Government, with the approval of the Parliament, to provide AIDC with funds or guarantees for the purpose of assisting particular projects of national importance which would otherwise be beyond the Corporation's financial capacity or which would fail to meet its commercial criteria. The provisions have never been invoked.

29.30 It is doubtful that government ownership of AIDC is the best means of achieving such national interest objectives.

29.31 To the extent that a financial intermediary is necessary at all to transmit government assistance,¹⁰ it should be more cost-effective for the Government to obtain quotes from a range of commercial institutions to perform that function, rather than retain AIDC as a government-owned intermediary for that purpose alone.¹¹

9 A further suggestion put to the Committee was that AIDC's role should be extended to enable it to take over businesses on behalf of the Government and to start new enterprises. Such a redirection of AIDC's activities involves social judgments, which the Committee believes are better made by others. Its views on some of the issues are set out in Chapter 26.

10 As explained in Chapter 36, direct fiscal grants to the ultimate target groups would be generally preferable to credit-specific forms of sectoral assistance.

11 This is consistent with both the views expressed in Chapter 36 and the views of the SCE.

(c) Recommendation

29.32 Having regard both for efficiency and other considerations, the Committee *recommends* that AIDC should be disposed of to private sector interests.

D. VIABILITY AND OPERATIONAL PERFORMANCE

29.33 If, notwithstanding the above considerations, the Government were to retain AIDC as a government-owned institution, it would be important to ensure that it met the last two market efficiency tests set out in paragraph 29.6, viz.

- economic viability/operational efficiency; and
- competitive neutrality.

29.34 The rest of this chapter is mainly concerned with issues of competitive neutrality but the Committee has also looked at some aspects of the commercial performance of AIDC. The main findings are in Appendix 29.1.

29.35 Briefly, the Committee has concluded that, while the AIDC experienced difficulties in the early years of its existence, there has been a turnaround in recent years and the trend in profitability now appears to be in the right direction.

29.36 Nonetheless, commercial viability has not yet been clearly established — especially when one has regard for the advantages enjoyed by AIDC relative to some of its competitors.

E. COMPETITIVE NEUTRALITY: SPECIFIC ISSUES

29.37 If the Government were to decide ultimately that AIDC's links with government should remain, the Committee believes that, in the area of its commercial operations, it should be placed on the same competitive footing as its private sector counterparts. This position does not presently exist. This section examines ways of achieving competitive neutrality.

29.38 A number of issues regarding AIDC's competitive advantages and disadvantages have been raised with the Committee. Other related aspects were taken up by the SCE in its report on the AIDC.

(a) Non-commercial Criteria

29.39 AIDC is required to act in accordance with sound business principles in the performance of its functions; it must not finance a company or participate in a venture unless its Board considers that it will be operated in an efficient manner and in accordance with sound financial principles (s.8(2)).

29.40 However, the AIDC Act also imposes a range of other, largely non-commercial, considerations which AIDC must take into account. Specifically, AIDC must have regard to:

- current monetary policy and Australian Government policies in relation to trade practices, the environment, industrial relations, urban and regional development and the efficiency of industry (s.8(1)); and
- the importance to the Australian economy of the industry concerned and the extent to which the provision of finance to it will contribute to the effective performance of AIDC's functions (s.8(3)).

29.41 The Committee does not wish to overstate the impact of these criteria on AIDC's operations relative to those of its private sector competitors. However, it believes that they may, at times, be incompatible with the requirement that AIDC operate in accordance with sound business principles; it further agrees with the view of the SCE that the requirement to have regard for such criteria may cause confusion as to the aims and objectives of AIDC, and make it more difficult to judge its commercial performance.

29.42 The SCE recommended that the AIDC Act be amended to require AIDC to place **primary** emphasis on acting in accordance with sound business principles, with non-commercial criteria being secondary in AIDC's evaluation of proposals. In the Committee's view this would not entirely remove the potential for confusion. If the non-commercial criteria were to have any meaningful application, it is difficult to see how they would not still potentially intrude on the decision-making process of the AIDC Board.

29.43 It has been noted already that AIDC should not have advantages or disadvantages in competing with private intermediaries. While the latter could be reasonably expected, as good corporate citizens, to take account of some of the non-commercial criteria to which AIDC is also subject, they are not obliged to have regard to all of them at all times.

29.44 The Committee therefore **recommends** that sections 8(1) and 8(3) of the AIDC Act should be repealed.

29.45 The Committee is strongly of the opinion that if any non-commercial activities are undertaken by AIDC on behalf of governments, in pursuit of national economic and social policy, they should be clearly separated from its commercial activities. The national interest provisions of the Act are capable of achieving the desired separation. However, the Committee agrees with the SCE that, in their present form, these provisions are unnecessarily complex and cumbersome and should be more precisely defined.

29.46 The Committee therefore **recommends** that the commercial activities of AIDC should be separated from those activities it undertakes on behalf of governments, in pursuit of national economic and social objectives.

(b) Capital Structure

(i) Gearing

29.47 If AIDC were to continue to play a commercial role in the future, the Committee believes that its ability to perform its functions would be improved if certain changes were made to its capital structure. These would remove some unnecessary restrictions on AIDC's operations.

29.48 One requirement which the Committee considers to be unnecessarily restrictive is the gearing limit imposed by s.7(3) of the AIDC Act.¹² It is inappropriate, in principle, that legislation should dictate what ought to be a matter of commercial judgment for AIDC; however, it is acknowledged that so long as AIDC remains a government-owned intermediary, the Treasurer should retain the ultimate right to approve (or reject) any gearing ratio set by the AIDC Board. The Treasurer would, of course, take into account prevailing commercial practice. At

12 S.7(3) formerly limited aggregate borrowings outstanding (other than for temporary purposes) to the sum of five times AIDC's paid capital and reserves. In September 1980, the Act was amended to increase the gearing ratio to eight times paid capital and reserves.

the same time, however, it is believed that, in the interests of competitive neutrality, AIDC should be fully capitalised to the standard of its competitors.

29.49 The Committee does not see the need for the Reserve Bank to be required to exchange views with the AIDC on what would be an appropriate gearing ratio, as suggested by the SCE, unless AIDC were to obtain a banking licence (see paragraphs 29.66–67).

29.50 The Committee therefore *recommends* that:

- (a) **Section 7(3) of the AIDC Act should be repealed. The AIDC's gearing ratio should be determined by its Board and be subject only to the approval from time to time of the Treasurer.**
- (b) **In determining the AIDC's gearing ratio, particular regard should be paid to the prevailing gearing ratios of AIDC's competitors, whether these are set by regulatory authorities or as a matter of industry practice.**

(ii) Servicing of Capital

29.51 If AIDC is to compete equitably with other financial institutions, it should be expected to earn an appropriate and comparable return on capital and to pay a like dividend.

29.52 The Committee *recommends* that AIDC should be expected to:

- **earn a return on capital comparable to that which would normally be earned by its private sector competitors; and**
- **pay a dividend to the Government comparable to that which would normally be paid by its private sector competitors to their shareholders.**

(c) Use of Capital

29.53 Unlike other financial institutions, AIDC may not ordinarily use its capital directly in its operations, as 'it is the intention of the Parliament in providing moneys as capital of the Corporation that the moneys so provided will serve principally as an inducement to persons to make loans to the Corporation ...' (s.24(8)). AIDC has claimed that this restriction creates artificial problems within the Corporation and is a source of misunderstanding outside. It proposes that the restriction be removed.

29.54 The Committee considers that this restriction interferes with the flexibility inherent in the concept of 'capital', and has little current relevance to the attitude of lenders towards AIDC. Government-owned corporations are usually regarded as having superior borrowing status to their private sector competitors and the latter commonly have no need for the requirement of 'marked capital'. The Committee sees no advantage in retaining it.

29.55 Moreover, s.24(8) impacts adversely on AIDC's ability to make longer term investments, such as in new development projects which often require a significant lead time before earnings flow and cannot therefore prudently be financed from borrowed funds.

29.56 The Committee therefore *recommends* that **the AIDC Act should be amended to permit the use of AIDC's capital for all purposes associated with its role as a financial intermediary.**¹³

¹³ Although not strictly consistent with the principle of competitive neutrality, the Committee — on philosophical grounds — would not wish to see AIDC having the right to acquire a controlling interest in a non-financial enterprise under its charter.

(d) Domestic Borrowing Status

29.57 AIDC has pointed out that the interest rates on its medium-term borrowings are higher than it would have to pay if it had specialist bank status, or an explicit government guarantee or trustee status. It has also suggested that its effectiveness could be increased if it were permitted to borrow (for terms up to four years) outside Loan Council programs.

29.58 Others have pointed out that:

- AIDC enjoys the ability to mobilise funds without the maturity and other restrictions imposed on banks;¹⁴
- its securities are exempt from stamp duty on issue, transfer and redemption (this is said to be of particular advantage for short-term borrowings);
- AIDC securities with a maturity of five years or less can be held by authorised money market dealers up to 5% of their gearing limits; and
- certain bodies established, funded or regulated by Commonwealth and State Governments are permitted to invest cash surpluses or liquid reserves in securities of public authorities, including AIDC securities.

29.59 The SCE believed there would be advantages to the Commonwealth, from a budgetary point of view, in guaranteeing AIDC's borrowings, reducing as this would the need for capital appropriations. It saw this as doing no more than converting an implicit guarantee into an explicit one.

29.60 While appreciating the fiscal considerations which led the SCE to this conclusion, the Committee does not accept that there would be no real change in AIDC's position in the market place; AIDC itself has claimed that provision of a guarantee would increase its effectiveness. The Committee considers that provision of an explicit government guarantee would alter AIDC's competitive position by enabling it to borrow more cheaply — both on domestic markets (through entitling AIDC securities to trustee status) and on overseas markets. It would also, in effect, confer a subsidy on those companies which borrow from AIDC.

29.61 The Committee sees capital as a buffer for depositors/lenders against loss. It would not — as a matter of principle — endorse the giving of a guarantee as an alternative to capital, as it believes that AIDC should be subject to the same disciplines and yardsticks of performance as private intermediaries.¹⁵

29.62 It is recognised, of course, that the mere fact of government ownership gives AIDC something of an advantage (especially in borrowing) in competing with other **non-bank** intermediaries.¹⁶

29.63 AIDC has acknowledged that its implicit government backing gives it the

14 However, as inferred in our discussion of competition between banks and AIDC (see paragraphs 29.16–22), this advantage is not so great in practice and may be less relevant in the future.

15 The Committee does not see this as inconsistent with its recommendation that the Commonwealth Trading Bank should retain its guarantee until such time as it is appropriate to withdraw it; there would be obvious practical difficulties in suddenly **taking away** a government guarantee; moreover, the CTB does not borrow significantly in markets where a guarantee would provide a major competitive advantage.

16 It is also possible that AIDC may, on occasion, be invited to participate in consortiums for the financing of particular projects because of its government association. On the other hand, it is possible that some business may be withheld from AIDC because of that association (e.g. because of concern about confidentiality).

status of a prime borrower. In the Committee's view, this should be recognised through the payment of an appropriate fee — this fee should be greater if the ownership were to give rise to an explicit, as distinct from an implicit, guarantee.

29.64 At the same time, the Committee is conscious that **ARDB** and the **trading banks** are major competitors of AIDC and will probably become increasingly so in the future. Against such competitors, it doubts that government ownership alone — without any explicit guarantee — confers a significant advantage, in terms of superior borrowing status in the domestic market.

29.65 AIDC has submitted therefore that the balance of competitive advantage would swing against it if its own privileges — not least, exemption from stamp duty — were removed. AIDC would, of course, claim that the payment of a fee on its borrowings would compound the problem.

29.66 The Committee acknowledges that the changes it is proposing (both in this chapter and elsewhere in this Report) could affect the competitive position of AIDC relative to banks and others. It points out, however, that the intention of these changes is broadly to **restore competitive neutrality** in the financial system. Nonetheless the Committee accepts that, to the extent that ARDB and the trading banks prove to be the principal competitors of AIDC in the future, it may not be consistent with competitive neutrality to **debar** AIDC from applying for a bank licence — especially as merchant banks would not be so precluded.¹⁷

29.67 The Committee therefore *recommends* that:

- (a) **AIDC's liabilities should not be subject to an explicit government guarantee.**¹⁸
- (b) **AIDC should be required to pay a fee to neutralise any advantages in borrowing costs (reflected in the market) arising out of its government ownership.**
- (c) **The following special concessions AIDC enjoys in respect of its domestic borrowings should be abolished:**
 - **the exemption of its securities from any stamp duty on issue, transfer and redemption; and**
 - **the arrangement whereby its securities with a maturity of up to five years can be held by authorised money market dealers (up to 5% of gearing limits).**
- (d) **AIDC should not be debarred from applying for a bank licence.**¹⁹

29.68 AIDC has claimed that, as it and the Commonwealth banks do not use their borrowings for public sector expenditure, they should be exempt from Loan Council requirements.

¹⁷ Of course, if the granting of a licence were considered necessary on grounds of competitive neutrality, the Government may at that point wish to consider the justification in keeping AIDC and the Commonwealth Banking Corporation as separate entities.

¹⁸ This recommendation applies, of course, to AIDC's commercial borrowings. If the Government were to decide that AIDC should undertake lending on a **non-commercial** basis to achieve broader social or economic objectives, it would need to be considered whether it was more efficient for AIDC to have a guarantee to enable it to raise funds specifically for the purpose more cheaply in the market (especially overseas).

¹⁹ If AIDC were to obtain a banking licence the general question of a borrowing fee would need to be reviewed.

29.69 Such an exemption would be consistent with the Committee's principle that AIDC should not be subject to any regulations or constraints to which its private sector competitors are not subject. It would also be consistent with the recommendation, in Chapter 12, that the volume of borrowing by 'commercial' authorities and the terms and conditions of such borrowing should be freed from Loan Council control. Under the Committee's proposals, the Treasurer would have the power to approve AIDC's gearing ratio (see paragraph 29.50) and to determine its dividend policy; these powers should confer adequate government control over all AIDC's borrowings.

29.70 The Committee therefore *recommends* that **AIDC should not remain subject to the Loan Council in respect of its commercial transactions.**

(e) Prudential and Other Legislative Requirements

29.71 Again with competitive neutrality in mind, the Committee *recommends* that **AIDC should be required to observe the same prudential standards as those observed by similar institutions and should be subject to the same legislative and monetary policy requirements as its private sector competitors, e.g. the Financial Corporations Act.**

(f) Interest Withholding Tax

29.72 All of AIDC's foreign borrowings are exempt from interest withholding tax, unlike 'private' borrowings by other intermediaries which are subject to a case by case examination and exemption only if funds are on-lent to Australian entities.

29.73 It has been submitted to the Committee that this exemption enables AIDC to borrow overseas funds, and to on-lend to businesses which do not satisfy the 'Australian entity' test of the Income Tax Assessment Act, on terms more favourable than many other predominantly Australian-owned institutions operating in the same market. In Chapter 16 the Committee concludes that the efficiency of the financial system would be enhanced if the exemption from interest withholding tax for private borrowings meeting the 'Australian entity' tests were withdrawn.

29.74 Consistent with its view that AIDC should compete equally with its private sector counterparts, the Committee therefore *recommends* that **AIDC's exemption from interest withholding tax should be withdrawn.**²⁰

29.75 If exemption from interest withholding tax were considered necessary for AIDC to undertake **non-commercial** activities, the exemption should apply only in respect of this component, if any, of its operations.

(g) Variable Deposit Requirement

29.76 AIDC enjoys an exemption from the variable deposit requirement (VDR) when it is operative. The VDR has been applied in the past as a method of restricting overseas borrowings, for monetary policy purposes, by requiring the lodgment of a percentage of the borrowings with the Reserve Bank.²¹

29.77 To ensure that AIDC competes on an even footing with its private sector competitors, the Committee *recommends* that **AIDC should not be exempt from**

20 Of course, if the Government retains the case by case approach, AIDC should be subject to a similar examination.

21 It was last used in 1976. For further discussion of the VDR, see Chapter 8.

any exchange control measures that might be applicable to private sector intermediaries.

(h) Foreign Currency Operations

29.78 AIDC has submitted that it should have the capacity to place funds temporarily offshore from time to time, and be permitted to contract directly with overseas banks; it should, for example, be permitted to hedge in overseas currencies itself rather than having to do this through an Australian bank.

29.79 Foreign exchange arrangements are dealt with in Chapters 7 and 8. The Committee does not believe that it would be appropriate to treat AIDC differently, in respect of its commercial activities, to other financial intermediaries.

(i) Range of Activities

29.80 The SCE recommended that the functions of AIDC should be expanded to include service industries, such as tourism, which may be currently excluded by the working of the Act (see footnote 2). The Committee sees no reason for the application of any restrictions on the range of AIDC's activities as a financial intermediary.

29.81 Consistent with its view that AIDC should be able to operate on a comparable basis to its private sector counterparts, the Committee **recommends** that **AIDC should not be subject to limitations on the range of companies or industries to which it can lend.**

F. OTHER ISSUES

(a) Loans (AIDC) Act

29.82 The Loans (AIDC) Act authorises the Government, at the request of AIDC, to advance moneys to the Corporation out of borrowings raised overseas. A maximum limit of \$250 million applies.²²

29.83 AIDC states in its submission that the application of this Act, which was designed to meet an emergency situation, is likely to be extremely rare. The SCE report notes that AIDC accepts that the Act should be repealed, and recommends accordingly, with a saving provision to cover the ongoing validity of actions already taken under the legislation.

29.84 As several major Australian companies and the ARDB have borrowed successfully overseas in recent years, and as AIDC has now established its borrowing capacity in overseas markets, the Committee is of the opinion that there is no longer a requirement for this Act for new borrowings.

29.85 The Committee therefore **recommends** that **the Loans (AIDC) Act should be repealed.**

(b) Executive Structure and Location of Head Office

29.86 The SCE recommended that the AIDC Act should be amended to:

- provide for the separate appointments of a part-time non-executive Chairman of the AIDC Board and of a full-time Chief Executive; and
- remove the requirement that the AIDC's headquarters be in Canberra.

²² The Act has been used only once, in 1975.

29.87 The Committee has no reason to offer alternative recommendations on either of these matters.

(c) Periodic Reviews

29.88 It has been suggested that AIDC should be subject to sunset legislation, i.e. legislation providing for its **automatic termination** unless, in a regularly scheduled legislative review, it is found to meet stated criteria and its charter is renewed by legislation.

29.89 AIDC has pointed to the adverse impact on the Corporation's efficiency that would arise as a result of such legislation, given the uncertainty which would be generated about the Corporation's future. As noted in Chapter 26, the Committee does not believe that sunset legislation is appropriate for commercial organisations.

29.90 In the event that AIDC is retained under government ownership, it would not be sensible to impair the Corporation's ability to compete with other intermediaries. In particular, the Committee is conscious that sunset provisions might inhibit AIDC's relationships with domestic and overseas financial institutions. It would have a deleterious effect on its efforts to raise longer term funds. It is also likely that sunset provisions would impair AIDC's ability to attract and retain staff of appropriate quality and calibre.

29.91 However, it is believed that the role, operations and efficiency of AIDC should be under continuing scrutiny by the Parliament, with reviews taking place at least every seven years. Each review should involve a full evaluation of AIDC's performance, having regard to any special circumstances that may have prevailed in the period under investigation.

29.92 The arguments in favour of periodic reviews are even stronger if AIDC is asked to undertake non-commercial activities. Its role in relation to these activities should be more regularly reviewed and, if judged to be unnecessary, such activities should be terminated.

29.93 The Committee **recommends** that **if AIDC were retained under government ownership its role, operations, performance and efficiency should be reviewed not less frequently than every seven years.**

AIDC: VIABILITY AND OPERATIONAL PERFORMANCE

1 In its report on the AIDC, the House of Representatives Standing Committee on Expenditure (SCE) examined AIDC's profitability in some detail as it regarded this as an important measure of its overall performance and the competence of its management. The SCE found that:

- (i) substantial losses on foreign exchange transactions were the result of overseas borrowings by AIDC in hard currencies and for long terms and its failure before 1975 to pass on exchange risks to borrowers;¹ and
- (ii) a substantial cumulative loss on AIDC's financing operations resulted from a hybrid of:
 - lack of adequate income from operational equity participations;
 - margins too fine (for the risks involved) on loans made in its early years;
 - bad debts written off in respect of operational loans and investments;
 - interest forgone on non-accrual loans; and
 - loans made at fixed interest rates but funded on a variable rate basis during a period of rising interest rates.²

2 The SCE acknowledged that a turnaround in AIDC's profitability had occurred in recent years. AIDC has drawn this Committee's attention to the fact that, since the beginning of 1977, its policy has been:

to write enough sound and profitable business to be able to work past losses out of the system within a reasonable time; and then, with a continuing and growing base of sound commercial lending, be able to devote more time and resources to carefully selective investment in riskier venture capital situations within an overall sound and profitable financial structure.³

3 Specifically, AIDC:

- now passes on to borrowers the currency risks of its overseas borrowings or covers exchange risks (in respect of both principal and interest) in the domestic hedging market;
- has, in respect of the early foreign borrowings still outstanding, limited its exposure to future variations in exchange rates through the foreign exchange hedging market and other means;
- is now (and has been since 1975), predominantly a domestic borrower, its loans being mainly in Australian dollars; and
- now lends principally at variable interest rates.

4 As already noted in paragraphs 29.39–40, the AIDC Act (s.8(2)) requires AIDC to act in accordance with sound business principles, but also (in s.8(1) and s.8(3)) that it have

1 AIDC was originally required under its Act to borrow principally outside Australia. This requirement was abolished when the Act was amended in March 1975.

2 *Report on the Australian Industry Development Corporation* by the House of Representatives Standing Committee on Expenditure, AGPS, Canberra, 1980, pp. 12–13.

3 AIDC Submission to the Inquiry, 1979.

regard to a number of criteria of a largely non-commercial nature, some of which are potentially conflicting.

5 While the Committee has some reservations about the non-commercial criteria AIDC must meet as part of its normal operations, it does not believe that their application has had a **major** impact on AIDC's profitability.

6 A summary of AIDC's financial results over the period 1971 to 1981 is provided in Table 29A.1. From this it might be noted that:

- Income from the investment of AIDC's capital⁴ progressively rose — generally at a faster rate than capital and reserves. The decline in 1981 reflects the sale of investments in that and the previous year. (Lines 1 and 2.)
- Capital profits were earned from the realisation of investments, especially in the last two years (line 3).
- The net income from operational activities (loans and operational investments) rose considerably after 1975 (when it was negative). The apparent peak in 1979 reflected significant profits from the sale of certain operational investments (line 4).
- Heavy charges/provisions of a specific and general nature were made for operational (loan) losses — although the 'specific' component of these was significantly lower in the later years — 1981 in fact, shows a net recovery (line 8).
- Very heavy charges were made for the amortisation of adverse foreign exchange movements and realised foreign exchange losses — these reached a peak in 1979 but have since declined (line 10).
- There was a significant increase in profits **overall** in the last two years (line 13).

7 The hybrid of special components in the financial results of AIDC influenced the Committee to prepare Table 29A.2, which attempts to recast for the last five years the more material of those components — allowing for some subjectivity in the recast. From that table, the Committee makes the following observations:

- (i) As regards operations:
 - the income therefrom contains a significant component of rebateable dividends (with a 'before tax gross up value') (see footnote (d)) especially in the later years (see footnote (a));
 - such income also contains profits from the sale of operational investments (see footnote (c));
 - although, prima facie, no 'surplus' has yet been achieved from the operational (as distinct from the capital investment) side of the business, a pre-tax surplus in 1981 might be said to have been achieved when the rebateable dividends are 'grossed back';
 - on the same basis of 'grossing back' rebateable dividends, an operational surplus, **before** foreign exchange charges, could be said to have been achieved in the last three years.
- (ii) As regards capital:
 - the income therefrom also contains a significant component of rebateable dividends (see footnote (b));
- (iii) The incidence of the above elements (and their taxation significance) tends to distort the true underlying trend in profits.
- (iv) Profits overall materially increased in the last two years. A non-assessable (for taxation) extraordinary component (from the sale of capital investments) in these profits, together with reduced foreign exchange charges and greater 'grossed up' income from operational loans, were the principal apparent contributions.

4 Which can be viewed as a 'marked' allocation of funds.

TABLE 29A.1: AIDC - CONSOLIDATED FINANCIAL RESULTS (\$'000)

Year ended 30 June	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
1 Average capital and reserves	12 722	32 198	45 704	53 956	55 065	55 174	63 075	71 465	73 722	78 313	85 807
2 Income from capital investments	1 079	1 897	3 431	3 812	4 045	4 329	6 008	6 932	6 991	7 630	7 243
3 Gain/loss on realisation of capital investments	-	13	167	215	(293)	156	225	52	426	3 075	3 200
4 Net income/(loss) from operational activities and temporary investments	(7)	532	562	683	(100)	1 514	2 788	1 758	5 867	3 734	4 878
5	1 072	2 442	4 160	4 710	3 652	5 999	9 021	8 742	13 284	14 439	15 321
6 Less: corporation overheads	219	763	922	1 262	1 414	1 428	1 457	1 777	2 108	2 886	3 847
7 Operating profit (before special charges)	853	1 679	3 238	3 448	2 238	4 571	7 564	6 965	11 176	11 553	11 474
8 Less: specific provision for operational losses	-	250	750	2 608	1 723	1 605	1 911	960	489	220	(625)
9 General provision for losses	-	-	-	392	246	-	79	147	275	1 500	1 500
10 Foreign exchange charge/gain	-	(64)	829	(1 972)	1 461	2 137	2 989	3 504	7 644	2 400	1 913
11 Profit before tax	853	1 493	1 659	2 420	(1 192)	829	2 585	2 354	2 768	7 433	8 686
12 Less: tax expense/(benefit)	410	483	657	(580)	(410)	(170)	282	377	231	787	345
13 Net profit/(loss)	443	1 010	1 002	3 000	(782)	999	2 303	1 977	2 537	6 646	8 341
14 13:1 (%)	3.5	3.1	2.2	5.6	(1.4)	1.8	3.7	2.8	3.4	8.5	9.7

Source: AIDC.

8 Whilst the Committee felt it was able to offer some observations in respect of the overall profit record of the AIDC, it experienced difficulties when aspiring to make profit comparisons with competing institutions, as there were none absolutely identical in structure. AIDC is not a bank (as is ARDB) nor does it have the leverage of a bank. Its leverage has been closer to that of a finance company. However, unlike a finance company, AIDC's capital cannot be used in its ordinary financing activities. The asset portfolio of a finance company is also vastly different. Because of the benefits and obligations peculiar to AIDC, a reasonable comparison with other financial intermediaries is not possible.

9 That said, the Committee's assessment of the profitability of AIDC revealed a trend in the right direction. The Committee especially notes the marked policy change in respect of foreign exchange exposure and the fact that no delinquent loans have arisen from transactions entered into during the last six years. Whilst these factors reflect considerably improved operational efficiency, commercial viability has not yet been clearly established — especially when one has regard for the advantages enjoyed by the AIDC relative to some of its competitors.

TABLE 29A.2: AIDC — CONSOLIDATED FINANCIAL RESULTS (Recast) (\$'000)

<i>Year ended 30 June</i>	<i>1977</i>	<i>1978</i>	<i>1979</i>	<i>1980</i>	<i>1981</i>
<i>Income — operational loans etc.^(a)</i>	2 788 ^(c)	1 758 ^(c)	5 867 ^(c)	3 734 ^(c)	4 878 ^(c)
<i>Less overheads (apportioned)</i>	1 093	1 333	1 581	2 165	2 885
	1 695	425	4 286	1 569	1 993
<i>Provision for losses — specific</i>	1 911	960	489	220	(625)
— general	79	147	275	1 500	1 500
<i>Foreign exchange charges</i>	2 989	3 504	7 644	2 400	1 913
<i>Net income/(loss) — operational loans etc.</i>	(3 284)	(4 186)	(4 122)	(2 551)	(795)
<i>Income — capital investments^(b)</i>	6 008	6 932	6 991	7 630	7 243
<i>Less overhead (apportioned)</i>	364	444	527	721	962
<i>Net income — capital investments</i>	5 644	6 488	6 464	6 909	6 281
<i>Operating profit (before tax)</i>	2 360	2 302	2 342	4 358	5 486
<i>Less taxation</i>	282	377	231	787	345
<i>Net operating profit</i>	2 078	1 925	2 111	3 571	5 141
<i>Extraordinary profits</i>	225	52	426	3 075	3 200
<i>Net profit</i>	2 303	1 977	2 537	6 646	8 341
(a) Includes rebateable dividends (s.46)	356	232	492	1 263	2 915
(b) Includes rebateable dividends (s.46)	1 231	1 331	1 336	1 244	1 149
	1 587	1 563	1 828	2 507	4 064
(c) Includes profit from sale of operational investments	1 199	170	2 339	675	561
(d) 'Gross up' additional value of (a)	303	198	419	1 076	2 463

CHAPTER 30: HOUSING LOANS INSURANCE CORPORATION

A. BACKGROUND

30.1 The Housing Loans Insurance Corporation (HLIC) was established in 1965 under the Housing Loans Insurance Act to meet what was then seen as a 'gap' in the market for mortgage insurance cover for lenders wishing to lend outside normal lending limits. At the time it was first proposed to establish HLIC, mortgage insurance was not readily available in Australia.

30.2 HLIC is by far the largest mortgage insurer in Australia: in 1979-80 it accounted for over 60% of all new loans insured. Its market share has tended to fluctuate, regaining lost ground sharply in the last two years from a low point in 1977-78.¹ Further details are shown in Tables 30.1 and 30.2.

30.3 Besides the Commonwealth-owned HLIC, mortgage insurance is offered by several private mortgage insurers, the major three (accounting for most privately written mortgage insurance) being:

- Mortgage Guaranty Insurance Corporation of Australia (MGICA), which was incorporated in 1965;
- Australian Mortgage Insurance Corporation (AMIC), which commenced business in 1971; and
- AFG Insurances, which was established in 1973.

TABLE 30.1: MORTGAGE INSURERS: NET PREMIUM INCOME^(a)

Year ended 30 June	1976		1977		1978		1979		1980	
	\$'000	%	\$'000	%	\$'000	%	\$'000	%	\$'000	%
HLIC	4 883	54.9	3 837	47.5	4 665	46.0	8 298	56.0	10 196	60.6
MGICA	2 808	31.5	2 727	33.7	3 291	32.4	3 947	26.7	3 974	23.6
AMIC	892	10.0	1 079	13.4	1 771	17.4	2 205	14.9	2 407	14.3
AFG	321	3.6	443	5.4	426	4.2	357	2.4	261	1.5
Total	8 904	100.0	8 086	100.0	10 153	100.0	14 807	100.0	16 838	100.0

(a) Gross premium income less reinsurance, stamp duty, premium refunds etc. As mortgage insurers charge one-time premiums on long-term risks, net premium income received in any one year is brought to account over several years (usually about ten). That portion which is brought to account in any given year is treated as 'earned' income, with the balance being treated as 'unearned' income.

Source: Annual Reports and data provided by mortgage insurers.

1 For further background information, see Interim Report, paragraphs 18.34-38 and Appendix 12.

TABLE 30.2: MORTGAGE INSURERS: VALUE OF MORTGAGES INSURED^(a)

Year ended 30 June	1976		1977		1978		1979		1980	
	\$m	%	\$m	%	\$m	%	\$m	%	\$m	%
HLIC	1 041	63.3	1 044	61.0	1 050	56.1	1 429	59.6	1 690	63.7
MGICA	425	25.9	431	25.2	522	27.9	611	25.5	590	22.3
AMIC	122	7.4	160	9.4	222	11.9	289	12.0	332	12.5
AFG	56	3.4	76	4.4	76	4.1	70	2.9	39	1.5
Total	1 644	100.0	1 711	100.0	1 870	100.0	2 399	100.0	2 651	100.0

(a) Includes residential and non-residential business.

Source: Annual Reports and data provided by mortgage insurers.

30.4 The announcement by the Government in July 1979 of its intention to sell HLIC to private interests stimulated public debate on its role and functions. In May 1981 the Government reaffirmed its intention to sell HLIC. Submissions to the Committee have commented on the implications of HLIC's operations, and its sale, for:

- the availability of mortgage insurance;
- the degree of competition;
- the cost of mortgage insurance;
- the development of a secondary mortgage market;
- the stability of private mortgage insurers;
- building societies; and
- the position of trustees in relation to HLIC-insured mortgages.

30.5 The first part of this chapter addresses the issues associated with the possible sale of HLIC. The Committee then examines several matters connected with HLIC's competitive position which bear on its future role and operations in the event that the sale does not proceed.

B. SALE OF HLIC: THE ISSUES

(a) Market Gap

(i) Availability of Mortgage Insurance

30.6 Fears have been expressed that the sale of HLIC would lead to a reduction in the availability of high loan-to-valuation housing finance. This, it is said, would accentuate the 'deposit gap' problem as well as reduce the aggregate flow of funds to housing; there are also fears that it might raise premiums, especially outside the major urban centres.

30.7 The Committee does not believe that the sale of HLIC would create an **availability** problem in this segment of the market. This is because:

- mortgage insurance is likely to remain a highly competitive field;
- the major private insurers have been significant insurers of high ratio loans (see Table 30.3) and have given assurances that the private mortgage insurance industry will continue to insure high ratio loans on reasonable terms and conditions; and

- there is no logical reason for insurers to vacate a segment of the market that, with premiums set on a purely commercial basis, would be profitable in the long run.

TABLE 30.3: LOANS IN EXCESS OF 90% OF VALUATION AS A PROPORTION OF TOTAL LOANS INSURED (%)

<i>Year ended 30 June</i>	1976	1977	1978	1979	1980
HLIC	11.7	9.0	12.7	16.2	16.3
MGICA	14.6	13.7	16.6	26.3	22.5
AMIC	14.7	11.0	14.4	17.8	16.3
AFG	15.0	15.0	15.0	10.0	3.0

Source: Data provided by mortgage insurers.

(ii) Competition

30.8 HLIC competes with private mortgage insurers in insuring lenders against loss on loans for owner-occupied and rental housing, the purchase of land for home construction, and land development and construction of housing estates.² (However, unlike private mortgage insurers, HLIC does not insure mortgages over industrial property, shopping centres or office blocks.)

30.9 The Committee notes that HLIC has reduced premiums four times since 1965, generally leading the market.³ Thus there is no doubt that HLIC has contributed substantially to the present high — some feel excessive — degree of competition in the mortgage insurance industry.

30.10 Some submissions have argued against the sale of the HLIC on the grounds that it will reduce the level of competition.

30.11 There is little doubt that the sale of HLIC to private interests would lead to some change in the existing competitive climate. However, this should occur even if HLIC were not sold, as the Committee recommends below that if HLIC remains under government ownership, it should be put on an equal competitive footing with its private counterparts.

30.12 The Committee is of the view that if HLIC were sold, competition would not be reduced to an inappropriate degree and indeed there might even be **increased** competition over the longer term. Its reasons are as follows:

- The Treasurer is well aware of the implications of the sale of HLIC to any of the existing operators, and it has not been suggested that HLIC should be liquidated. This implies that the number of substantial participants will not be reduced.
- It is possible that the presence of HLIC may be inhibiting the entry of additional private insurers into the mortgage insurance field because of competitive advantages thought to accrue from its government ownership.

² Loans may be partially or wholly insured, with such insurance extending to all risks or only to losses arising from physical damage. The lender is typically insured for repayment of both principal and accrued interest as well as the costs normally associated with a mortgagee sale, e.g. unpaid rates, sales commission, legal expenses and cost of repairs.

³ It also absorbed stamp duty into its expenses when made liable for this in 1977, effectively reducing premiums by a further 7%; however, in 1979–80 it increased the effective cost of mortgage insurance by between 5 and 7.5% by passing on the stamp duty payable on insurance contracts.

- As a number of substantial financial groups are understood to have shown interest in the purchase of HLIC, further entrants to the market **after** the sale of HLIC cannot be ruled out.
- Uncertainty about the regulatory framework within which mortgage insurers will be operating in future may have been an obstacle to new entry in the past — a situation which should be rectified if proposals discussed in Part III of Chapter 20 were implemented.
- A number of the Committee's recommendations in other areas will impinge on the shape of the market for mortgage insurance and are likely to maintain competitive pressures in the market. For example, the lifting of bank interest rate ceilings should result in a less conservative lending approach by banks and may therefore encourage greater resort to mortgage insurance by them as a way of reducing risk. If premiums were unduly high, reflecting insufficient competition, the banks would undoubtedly find ways of dealing with this — if necessary by establishing their own mortgage insurance business. Similarly, if permanent building societies were permitted to operate nationally, the greater geographical spread of their assets would enhance their capacity to self-insure, which would encourage mortgage insurers to keep their premiums down.

(iii) Cost of Mortgage Insurance

30.13 HLIC's present operations are not evenly spread geographically, a particular feature being its support for lending outside the main centres of population. HLIC's pricing policy has contributed to this uneven spread. HLIC charges a flat rate for each loan-to-valuation category irrespective of location. It believes that the setting of separate regional rates would add significantly to its administrative costs, and is not warranted in the light of its underwriting experience.

30.14 As the premiums of MGICA are also set on a national and those of AMIC on a state basis, the sale of HLIC in itself is unlikely to raise the **cost** of mortgage insurance in higher risk areas. Even if mortgage insurers, including a privately owned HLIC, were to adopt a differential pricing policy, HLIC's underwriting experience suggests that any additional cost would probably not be significant in relation to total mortgage costs: a relatively low premium would still secure a high ratio loan.⁴

30.15 The Committee also notes that private mortgage insurers claim to have insured many loans in regional and country areas since the mid 1960s. They have made it clear publicly that they will continue to insure such loans in the future where these meet normal lending criteria.

(iv) Implications for the Secondary Mortgage Market

30.16 Some submissions have suggested that the role of HLIC should be extended to include the functions of a secondary mortgage agency, i.e. as a trader in mortgages. Others feel that the government guarantee inherent in HLIC-insured mortgages is essential for the development of a secondary mortgage market; they point to the supportive role played by government in the United States in the development of such markets.

⁴ For example, on a loan of \$50 000, representing 90% of valuation, mortgage insurance represents 1.1% of the cost of purchasing a home (excluding interest) with a once-only premium over the full term of a mortgage of \$600 or \$24 per annum on a typical 25-year loan. For a similar loan, representing 80% of valuation, the cost is only \$200 or \$8 per annum on a 25-year loan.

30.17 The suggestion of a government-backed secondary mortgage agency is discussed in Part II of Chapter 37, where it is concluded that such an agency is not required. Even if a need were established, the Committee does not consider that it would be appropriate for HLIC to perform this role, as this would excessively concentrate its risk exposure; it would expose HLIC not only to the **insurance** risk but to the risk associated with **holding** mortgages.⁵

30.18 The effective government backing for HLIC-insured mortgages has undoubtedly contributed to the gradual development of a small privately sponsored secondary mortgage market in these mortgages over the past few years. However, the Committee considers that, if HLIC's connection with government were to be severed, the expansion of this market would not be significantly impeded.⁶

30.19 The existence of a rapidly growing market in conventional or privately insured mortgages in the United States in competition with a market in FHA-insured mortgages is clear evidence that a secondary mortgage market need not be confined to government-backed paper, though the latter may carry a slightly lower yield.

30.20 The Committee believes that market confidence in private mortgage insurers will continue to grow over time, which should be sufficient to underpin the development of a secondary market in privately insured mortgages.

30.21 It does not see any significant benefits flowing to investors generally from HLIC involvement in mortgage insurance. HLIC-insured mortgage-backed securities, being effectively government guaranteed, may tend to be viewed as simply another type of government security, possibly higher yielding. Given the minimum size of transactions, it is likely that the main buyers of mortgage-backed securities will continue to be corporate or institutional investors rather than the average individual investor.

30.22 Nor does the average home buyer benefit by lower costs or greater availability of funds,⁷ as the mortgages currently being traded are exclusively of the short-term, fixed-interest variety utilised by more affluent home buyers and property investors. Many of the mortgages being traded are secured against property bought for rental purposes, a fact recognised in the 1979 HLIC annual report. The predominant kind of housing mortgage, with its credit foncier system of repayments, variable interest rates and uncertain maturities, has not to date been attractive to Australian investors in secondary mortgages.

(b) Stability of Private Mortgage Insurers

30.23 Doubts have been raised, by the Insurance Commissioner and others, about the prudential standards private mortgage insurers would maintain in the

5 In this connection, it is relevant that government-owned mortgage agencies in the United States such as Government National Mortgage Association and Federal Home Loan Mortgage Corporation do **not** insure mortgages, though both trade in them (only those insured by the Federal Housing Authority (FHA) and the Veterans Administration in the former case). This is understood to reflect concern about the concentration of risk that would otherwise be involved.

6 Nor would the market in securities backed by existing HLIC-insured mortgages be disrupted by the sale of HLIC, as the Treasurer has given an undertaking that all such mortgages will remain subject to a government guarantee.

7 However, it should be noted that, by attracting investors who would not otherwise invest in mortgages, the availability of HLIC-backed mortgages increases the overall availability of funds for housing and thus constitutes a disguised bias in the pattern of financial flows within the economy.

absence of government ownership of HLIC. This view is based on the claim that HLIC, by virtue of its dominance and government guarantee, has given a lead on prudential standards which the rest of the industry has tended to follow in order to obtain a reasonable share of business.⁸

30.24 The Committee has difficulty accepting this line of argument. It notes that:

- If there were concern about the prudential standards of mortgage insurers, the solution is to set appropriate requirements under the Insurance Act, not to rely on HLIC as a pace-setter.
- To the extent that the presence of HLIC has had the effect at times of keeping premiums below an appropriate level having regard to risk, it may in fact have had a destabilising impact on private mortgage insurers.⁹
- The private mortgage insurers have indicated that they are concerned to continue sound underwriting and lending practices (e.g. adequate checks on a borrower's capacity to repay a loan) in the housing finance market, but that the pressure of competition from HLIC makes this difficult. It has been suggested that the recent sharp increase in claims (see Table 30.4) and the deterioration in underwriting experience (see Table 30.5)¹⁰ could have been indicative of inadequate lending standards, at least in some states, given the premium rates in force.

TABLE 30.4: MORTGAGE INSURERS: CLAIMS INCURRED

Year ended	1976		1977		1978		1979		1980	
	\$'000	%	\$'000	%	\$'000	%	\$'000	%	\$'000	%
30 June										
HLIC	385	44.9	703	47.5	1 221	44.6	2 604	46.9	3 591	54.4
MGICA	432	50.3	697	47.1	1 090	39.8	1 731	31.1	1 841	27.9
AMIC	41	4.8	64	4.3	180	6.6	686	12.3	1 097	16.6
AFG	—	—	17	1.1	248	9.0	538	9.7	69	1.1
Total	858	100.0	1 481	100.0	2 739	100.0	5 559	100.0	6 598	100.0

Source: Annual Reports and data provided by mortgage insurers.

TABLE 30.5: MORTGAGE INSURERS: UNDERWRITING PROFIT/LOSS (\$'000)

Year ended	1976	1977	1978	1979	1980
30 June					
HLIC ^(a)	1 455	1 093	863	201	150
MGICA ^(a)	255	323	(435)	(964)	(858)
AMIC ^(a)	88	141	215	(251)	(472)
AFG ^(b)	88	182	(194)	(44)	21

Sources: (a) Mortgage insurers' Annual Reports.
(b) Data provided by AFG.

- 8 The question of the regulation of mortgage insurers is referred to in paragraphs 30.49–50 and discussed in detail in Part III of Chapter 20.
- 9 Private mortgage insurers claim that HLIC, especially more recently, has not priced its premiums for the higher risk business (over 90% of valuation) at rates commensurate with the risk. They also claim that HLIC dominates mortgage insurance of commercial housing because it does not differentiate between commercial and owner-occupied housing in setting premiums, with the result that rates on the former are below those which should prevail having regard to risk.

TABLE 30.6: HOUSING LOAN MORTGAGES INSURED^(a)

Year ended 30 June	1976		1977		1978		1979		1980	
	\$m	%	\$m	%	\$m	%	\$m	%	\$m	%
Building societies	1 165.4	87.6	1 124.3	86.7	1 373.9	86.3	1 711.6	83.3	1 873.8	82.2
Banks	135.0	10.1	115.5	8.9	130.1	8.2	200.0	9.7	191.9	8.4
Mortgage management companies	8.2	0.6	9.7	0.7	5.8	1.0	28.2	1.4	7.7	3.4
Other	2.8	1.7	46.6	3.6	71.2	4.5	114.1	5.6	135.4	6.0
Total	1 331.4	100.0	1 296.1	100.0	1 591.0	100.0	2 053.9	100.0	2 278.8	100.0

(a) Covers residential, as distinct from 'commercial', housing only.
Source: Department of Housing and Construction.

(c) Impact on Building Societies

30.25 Certain building societies have argued strongly for retention of HLIC as a government-owned corporation. As indicated in Table 30.6, the bulk of insured house mortgages emanates from building societies.

30.26 These societies see HLIC mortgage insurance as contributing to public confidence in their long-term viability. They consider this to be particularly important because of the official protection available to bank depositors by virtue of the Banking Act.

30.27 While the Committee acknowledges the security that HLIC can be said to offer building society depositors in this regard, it believes that a stable, soundly based, privately owned mortgage insurance industry, coupled with private deposits insurance arrangements or effective prudential oversight, should effectively underpin public confidence in building societies.

30.28 Building societies have also expressed concern about the likely effect of the sale of HLIC on the availability of high ratio loans and the development of a secondary mortgage market. Both of these questions have already been examined.

(d) Position of Trustees

30.29 Certain trustee companies have also expressed concern about the sale of HLIC, as trustee legislation in Victoria, Queensland and South Australia specifically stipulates that only mortgages insured by HLIC qualify as authorised trustee investments.

30.30 It is understood that these trustee companies would be less apprehensive about the sale if mortgages insured by private mortgage insurers were also authorised as trustee investments. This is the situation already applying in some states. The Committee does not express a view on the desirability or otherwise of such action beyond indicating its support, in principle, for moves toward uniformity in the range of authorised trustee investments throughout Australia (see Chapter 21). It does not, however, believe that this issue has a significant bearing on whether HLIC should remain a government-owned institution.

(e) Conclusions

30.31 Since the establishment of HLIC, a substantial market in mortgage insurance has developed. The Committee is of the view that the sale of HLIC is unlikely to reintroduce a market gap. In particular, it **should not**:

- lead to a reduction in the availability of high loan-to-valuation housing finance, housing finance for non-urban areas or aggregate funds for housing generally;
- inappropriately reduce competition in the mortgage insurance market; indeed over the longer run it may result in a greater level of competition;
- lead to a significant increase in the cost of mortgage insurance when related to the total servicing costs of a mortgage loan;
- impede the development of an economically sound secondary mortgage market;
- lead to a lowering of prudential standards among private mortgage insurers;

10 Notwithstanding that the three private insurers incurred underwriting losses in 1978-79 and two of them again in 1979-80, overall profits were achieved, arising from the incidence of income from investments.

- affect public confidence in permanent building societies or cause any other major disruption to financial markets.

30.32 Indeed, putting the matter more strongly, the Committee believes that the retention of HLIC as a government institution might inhibit the continued development of a dynamic private market in mortgage insurance.

30.33 The Committee also believes that HLIC is not the appropriate vehicle for the provision of ongoing subsidies, if any, to non-urban areas or housing generally. This view is based on doubts about the cost-effectiveness of such an approach¹¹ as well as competitive neutrality considerations.

30.34 At the same time, given the overall size of the industry, it believes that the continued independent operation of HLIC as a separate, **privately owned** entity is desirable to maintain a competitive market in mortgage insurance.

30.35 It is the Committee's judgment, and accordingly it *recommends* that:

- (a)** The Government should proceed with its declared intention to sell HLIC.
- (b)** HLIC should *not* be sold to one of the larger existing mortgage insurers.

C. COMPETITIVE NEUTRALITY

30.36 If the Government were to decide not to proceed with the sale of HLIC, for the present time, it is important that competition between it and private insurers should be 'fair'.

30.37 HLIC's enabling legislation was amended in 1977 to require it to pay Commonwealth and State taxes and service capital, with the intention of placing it on a more equal footing with its competitors. Despite this, it has been claimed that HLIC continues to have certain competitive advantages relative to private mortgage insurers. These complaints have centred on:

- the higher costs of private mortgage insurers associated with their need to reinsure;
- the existence of a government guarantee and, more generally, the benefits arising from government ownership; and
- the cost advantage to HLIC of being exempt from the requirements of the Insurance Act.

(a) Reinsurance

30.38 The Mortgage Insurers Association of Australia, representing the major private mortgage insurers, has claimed that if HLIC were subject to the same reinsurance costs as private insurers, its profits would have been materially affected. As noted in Appendix 12 of the Interim Report, HLIC has taken out some reinsurance on risks relating to catastrophe. It does not, however, reinsure its normal business. HLIC's policy in this regard is based on the requirement, under s.26 of its Act, that its premiums and other charges shall be at the lowest possible rates having regard to its need to secure revenue sufficient to meet all its expenditure and to make a reasonable return on its capital. Given its capital, reserves, unearned premiums, borrowing powers and its government guarantee,

¹¹ See Chapter 36.

HLIC believes it would not be meeting this requirement if it were to reinsure its general business.

30.39 Although the act of reinsurance imposes an expense, it also has an offset — the recovery of a proportion of claims. Nevertheless, it seems clear that HLIC has a significant advantage in not having to reinsure its general business.

30.40 The Committee *recommends* that **HLIC's insurance risks should be reinsured on a basis comparable to that of private mortgage insurers or an appropriate amount be paid annually to the Commonwealth.**

(b) Government Ownership/Guarantee

30.41 It is widely believed that HLIC and the private mortgage insurers do not compete on an equal footing, basically due to HLIC's government guarantee, but more generally because of the benefits associated with government ownership.¹²

30.42 The Committee is of the view that the government guarantee, or at least the fact of government ownership, does confer a marketing advantage on HLIC. This is clear, for example, from the submission of one major building society which places particular emphasis on the security associated with having all its mortgages insured by HLIC. (Similarly, the emphasis placed on the importance of HLIC-insured mortgages by some operators in the secondary mortgage market is indicative of the market's perception of the importance of the government link.) The Committee does not believe that abolition of the formal guarantee would be sufficient to remove this marketing advantage — an advantage comparable with the gain in 'borrowing status' enjoyed by other GFIs (see Chapter 26). It therefore favours the charging of an appropriate fee to neutralise the advantage.

30.43 The Committee *recommends* that **HLIC should pay an appropriate fee to offset the competitive advantage associated with its government ownership and guarantee.**

30.44 Two further issues to be considered are whether HLIC:

- is adequately capitalised relative to the capitalisation of its private sector competitors; and
- earns a comparable profit after tax and pays a comparable rate of dividend.

30.45 Other things being equal, one would expect HLIC's capital (including reserves), as a proportion of total assets, to be at least comparable to that of its private sector competitors. However, as indicated in Table 30.7, HLIC's capital, as a proportion of total assets, is currently less than that of AMIC and substantially less than that of MGICA. The difference was less marked five years ago. The equity component of all the companies measured fell during that five-year period.

30.46 Comparison of profit return on capital and reserves is further complicated by the fact that HLIC does not reinsure its normal business. Nevertheless, the return by HLIC on its funds employed (as shown in Table 30.7) more than stands the basic test. For the five years reviewed, HLIC's return is generally considerably better than that of its competitors, especially more recently. In making the

12 One incidental benefit of government ownership needs a mention here. The Committee has been informed that at least one government-owned lending institution places all of its mortgage insurance business with HLIC. The institution concerned has confirmed that this business is directed solely to HLIC because they are both owned by the Federal Government. However, the volume of mortgage insurance written is not substantial for either the lender or HLIC and has been declining in recent years.

comparison, the Committee has excluded from net operating profit items of an abnormal or extraordinary character; these particularly refer to profit on the sale of investments.

TABLE 30.7: MORTGAGE INSURERS: CAPITAL AND PERFORMANCE^(a)

<i>Year ended 30 June</i>	1976	1977	1978	1979	1980
	<i>Capital^(b)/Total assets (%)</i>				
HLIC	54.9	40.7	38.7	32.7	29.0
MGICA	58.6	56.3	50.4	45.7	43.1
AMIC	50.7	42.8	36.4	33.2	32.5
	<i>After-tax operating profits as % of capital^(c)</i>				
HLIC	(d)	18.2	15.7	13.1	15.4
MGICA	11.9	10.7	6.9	5.0	5.2
AMIC	11.1	17.3	20.2	8.6	5.1
	<i>Dividends as % of after-tax operating profit</i>				
HLIC	(e)	29.7	47.5	72.8	58.1
MGICA	47.6	49.2	72.8	102.8	39.5 ^(f)
AMIC	44.5	42.9	37.7	74.0	—

(a) Separate data for mortgage insurance not available for AFG Insurances.

(b) Comprises capital and reserves.

(c) After-tax profits have been adjusted to exclude abnormal and extraordinary items, including profits from the sale of investments.

(d) HLIC was not liable for tax prior to 1 July 1976.

(e) HLIC did not pay a dividend prior to 1976-77.

(f) Interim dividend only; final dividend deferred to 1980-81.

Source: Annual Reports and data provided by private mortgage insurers.

30.47 Again, because of the different capital structures it is not appropriate to compare dividend rates of HLIC and its competitors. However, the Committee has measured the 'pay out' ratios (dividends as a percentage of net operating profit, excluding extraordinary items) and these are shown in Table 30.7.

30.48 Consistent with the principles set out in Chapter 26, the Committee **recommends** that:

- (a) **The capital of HLIC should be reviewed with the object of bringing its capital/total assets ratio into line with that of private mortgage insurers.¹³**
- (b) **HLIC should be expected to earn a rate of return on capital comparable (after charges for reinsurance and the government guarantee) to that of private mortgage insurers and to pay a comparable rate of dividend.**

(c) Insurance Act Requirements

30.49 The private mortgage insurers have indicated that they would be amenable either to appropriate regulation under the Insurance Act or to self-regulation. They are prepared to observe higher prudential standards provided these also apply to HLIC. However, they only see self-regulation as being feasible if HLIC were sold. This issue is taken up in Chapter 20.

30.50 Whichever course is followed, the Committee **recommends** that **HLIC should be required to meet the same prudential standards as private mortgage insurers.**

¹³ As discussed in Chapter 26, an alternative would be to phase in additions to HLIC's capital over time. Another, less desirable, alternative would be to impute HLIC's capital and reconstruct its accounts before applying an industry-based profit performance and rate of dividend test.

CHAPTER 31: STATE GOVERNMENT INSURANCE OFFICES

A. THE NEED FOR SGIOs

31.1 Government Insurance Offices (SGIOs) operate in each state and the Northern Territory; most have been in existence for many years. An outline of the legislative and competitive framework within which they function is included in Appendix 12 of the Interim Report.

31.2 SGIOs predominantly underwrite classes of compulsory insurance, notably workers' compensation insurance and third party motor vehicle insurance, but also have a significant share of household and motor vehicle comprehensive insurance. SGIOs are also increasingly writing life insurance in some states, in competition with long-standing private sector operators.

31.3 In terms of its proposed tests for commercial GFIs (see in particular Chapter 26) the Committee questions whether, on broad efficiency grounds, the continued existence of SGIOs is warranted. They are not seen as being needed to fill a 'commercial market gap'. At prices related to cost, private sector organisations seem quite ready to match the range of insurance facilities provided by SGIOs. Nor are SGIOs seen as necessary to ensure an adequate competitive environment in respect of many of their insurance activities. In fact, there is some evidence that their ownership by government has given them an unfair competitive advantage in a number of respects, with distorting effects on the structure of insurance markets. **All this suggests that there is a strong case on efficiency grounds for the sale or winding up of existing SGIOs.**

31.4 Nonetheless, the Committee recognises that state governments attach considerable weight to the social role being filled by SGIOs in the general provision of insurance, particularly those classes of compulsory insurance in respect of which normal market premiums are considered inappropriate.

31.5 The Committee, of course, in no way questions the right of governments to make such social judgments, but it prefers methods of intervention which have minimal detrimental effects on the efficiency of the financial system.

31.6 As regards the most cost-effective method, the Committee clearly prefers (for the reasons set out in Chapter 36) a direct subsidy to the intended beneficiary. Where this is not practicable, it would next prefer the channelling of assistance through existing **commercial** institutions. The Committee does not generally favour the continuing operation of SGIOs for the purpose, although it recognises that a case can sometimes be made for directing certain limited classes of business through government-owned insurance offices (e.g. see paragraph 31.14).

31.7 If governments choose to retain SGIOs, the question of competitive neutrality becomes critical. That issue is the subject of the balance of this chapter.

31.8 The tests of economic viability and operational efficiency are not canvassed by the Committee. It records, nevertheless, the need for these tests to be applied to SGIOs which continue to perform any commercial functions.

B. COMPETITIVE NEUTRALITY: THE ISSUES

31.9 The Committee attaches importance to competitive neutrality because, to the extent that SGIOs compete unequally in their commercial activities, they will impact detrimentally on the structure and efficiency of the insurance industry.¹

31.10 It has been put to the Committee that SGIOs currently have a competitive advantage over their counterparts in the private sector by virtue of:

- preferential access to some areas of insurance business;
- government ownership/guarantees;
- freedom from the requirements of Commonwealth insurance and other legislation; and
- freedom from certain taxes and charges.

(a) Preferential Access to Insurance Business

31.11 Submissions have identified various elements of preferential access which are seen as giving SGIOs an unfair competitive advantage.

(i) Business with the Public

31.12 It is claimed that, for social or other reasons, SGIOs have tended to set non-commercial rates for certain classes of insurance, and have been given exclusive selling rights, e.g. in relation to workers' compensation insurance in Western Australia's mining industry.

31.13 Such action may be influenced by a range of considerations, including:

- a desire to subsidise certain sections of the population;
- a realisation that legislative compulsion alone may not ensure complete coverage: the more expensive is such insurance, the greater the incentive to evade it;
- a belief that it is socially desirable to concentrate business in the hands of SGIOs for the ultimate protection of the insured; and
- the view that the market is not operating efficiently and that premiums are inappropriately high as a consequence.

31.14 As already argued (see paragraph 31.6), wider social objectives would generally be more appropriately met through subsidies paid directly to the recipient, leaving him to purchase the service on a commercial basis from private insurers. However, it is recognised that many policyholders may have more regard for price than for the strength and stability of the insurer in deciding where to place their business — in which case third parties (e.g. the occupants of 'the other car' or an employee in an industrial accident) could still face loss in the event of the insurer collapsing.

31.15 It has been suggested that if governments wish to further social aims by

¹ This impact may be particularly significant at a time when there is generally considered to be excess capacity within the general insurance industry.

controlling premiums or through other arrangements which have the effect of concentrating the writing of certain classes of business with a public agency, then such an agency should not write **other** classes of insurance in competition with private insurers. The complaint is that monopolised or rate-controlled business gives SGIOs a base from which to launch into other services and also helps to attract other business.²

31.16 The Committee has not been able to evaluate fully these arguments. It is of the opinion however that, consistent with the general principles of competitive neutrality espoused throughout the Report, the scope for advantage in their commercial operations arising from compulsory insurance should be minimised to the extent practicable.

31.17 Accordingly, it suggests that, to enable the competitive position of SGIOs to be properly assessed on an ongoing basis, **the 'commercial' insurance activities of SGIOs should be recorded separately from those activities in respect of which, for 'social' or other non-commercial reasons, governments may wish to maintain an SGIO monopoly or premium rates below those obtaining in a free market.**

(ii) Government Business

31.18 Criticism has been levelled at the practice in some states of requiring government departments and instrumentalities to insure with the relevant SGIO.³

31.19 The Committee has been advised by the NSW Government that such directions are more a case of government deciding to act as its own insurer than of giving the SGIO preferential access to particular insurance business. Indeed, in Queensland, with the exception of motor vehicles where the SGIO does the underwriting, the State is self-insurer of its property.

31.20 There can be no grounds for objecting to a direction that a group of public instrumentalities be covered by the one policy with an SGIO (or for that matter a private insurance company) if this reduces the cost of cover in aggregate. This is no different to a private company negotiating cover for all its establishments and risks in the one policy.

31.21 On the other hand, a direction to government organisations or contractors involved in government contracts that they **must** negotiate cover with SGIOs, even though there may be cheaper alternatives, would be undesirable on competitive neutrality grounds (quite apart from the possible cost to the taxpayer).

31.22 Accordingly, the Committee believes that competitive neutrality requires that, **where government organisations are required to take out insurance, such business should, as far as practicable, be put to public tender so that private insurers are given the opportunity to compete.** In taking this stance, the Committee is in no way questioning the right or desirability of the Government to carry self-insurance.

2 For example, the 1979 *Annual Report* of the Victorian Insurance Commissioner referred to the comprehensive motor vehicle insurance business which the State's Insurance Commission had attracted by virtue of its monopoly of compulsory third party insurance.

3 In some states (e.g. New South Wales and Tasmania) the requirement relates to all insurable risks. In others, it relates only to certain classes of business (e.g. the Government Workers' Compensation Fund in Western Australia) or takes the form of a traditionally favoured position in handling certain business of government departments (e.g. workers' compensation insurance in Victoria).

(b) Government Ownership/Guarantee

31.23 Submissions from the insurance industry have emphasised the competitive advantage that accrues to the SGIOs by virtue of their government guarantee. They are generally of the view, however, that the benefits obtained from the guarantees cannot be readily quantified and that it might not be practicable to neutralise fully their effects.

31.24 Although SGIOs operate under a government guarantee, most are understood to make reinsurance arrangements.⁴ As well, state governments have indicated that SGIOs are expected to operate on a profitable and efficient basis. It would appear, therefore, that state governments usually seek to ensure that the guarantee is never called on.

31.25 As evidence that SGIOs do not have a competitive advantage, state governments have pointed to the fact that their premiums are generally in the middle of the range of those offered by private insurers and that they are subject to special constraints and requirements. They suggest that any residual advantage is not quantifiable.

31.26 Nevertheless, the Committee is of the view that government guarantees do give SGIOs a marketing advantage, although this is seen as flowing largely from government ownership rather than from the explicit guarantee per se. While the Committee acknowledges that various requirements imposed on SGIOs, including the need for prudent management, mean that their ability to lower premiums and increase their market share is impaired, many people seeking insurance may be prepared to pay a higher premium to obtain the security associated with SGIO insurance. Accordingly, the Committee believes that the marketing benefits to SGIOs of government guarantees should, as far as possible, be offset by requiring them to pay an appropriate fee. (At the same time, as mentioned later, the Committee does not consider it appropriate for SGIOs to be subject to discriminatory obligations or investment constraints.)

31.27 The Committee concludes that **SGIOs should pay an appropriate fee to offset the marketing advantage associated with their government ownership.**

31.28 The existence of a government guarantee is also said to bestow a competitive advantage because it implies a lesser need for capital and consequently lower servicing costs. Conversely, it has been claimed that the lack of capital tends to inhibit the development of SGIOs because it places them in the position of having to rely on profits to build up reserves, and to adopt more cautious investment and underwriting policies so as to avoid recourse to state government financial support under the guarantee. It is acknowledged that these factors may have had a restricting effect on operational flexibility and pricing policies but the rate of growth of SGIOs in recent times does not suggest that lack of capital has been a constraining factor on their development.

31.29 The Committee notes that SGIOs have built up their reserves over the years and thus effectively now have a capital base. It has not endeavoured to assess whether this capital base is comparable with that of private sector competitors, because of the problems inherent in differentiating between the commercial and non-commercial activities of the SGIOs.

4 The only state where there is no explicit guarantee is Western Australia, where the SGIO is a government department and as such is the direct responsibility of the Government.

31.30 The Committee does not express any judgment as to whether, on balance, SGIOs have benefited from having a lower capital base, but points out that the conditions of competitive neutrality require that **SGIOs, in respect of their commercial non-life business, should:**⁵

- **aim to maintain a capital/liabilities ratio similar to that of private insurers; and**
- **be expected to earn a rate of return on that capital comparable to that of private insurers and to pay a comparable rate of dividend.**

31.31 The Committee acknowledges the difficulties in determining precisely the calculations involved. It further acknowledges that these difficulties are compounded by the poor underwriting (as distinct from the investment) results recently experienced by many insurers, not only in Australia but in many other countries.

(c) Exemption from Commonwealth Legislation

31.32 SGIOs are exempt from the Commonwealth Insurance Act and the Life Insurance Act. There are constitutional reasons for this: the insurance power (section 51(xiv)) prevents the Commonwealth from legislating in respect of state insurance. SGIOs are also exempt from the provisions of the Trade Practices Act.

31.33 It has been claimed that exemption from the Insurance and Life Insurance Acts means that SGIOs are not subject to the solvency requirements required of their private sector competitors. However, the Committee understands that, in general, SGIOs endeavour to meet the Insurance Commissioner's solvency requirements, and the Life Insurance Commissioner's Minimum Valuation Basis is used to determine whether the actuarial liability of life policies is complied with or exceeded.

31.34 It must be recognised that all insurance companies have difficulties in assessing their liabilities in respect of 'long-tail' business, i.e. business such as third party and workers' compensation where the actual liabilities may not be ascertainable for some years after the annual maturity of the policy and are thus of an indeterminate amount.

31.35 Nevertheless, it seems that SGIOs may derive competitive advantage from the fact that some of their other business (e.g. compulsory third party insurance) is conducted on an unfunded basis⁶ (supported by government guarantee).

31.36 While recognising that there may be practical difficulties, the Committee believes that, in the interests of competitive neutrality, **SGIOs should be required to comply with solvency and other requirements of legislation to which their private sector competitors are subject.**

31.37 While SGIOs are exempt from the provision of the Trade Practices Act the Committee understands that they generally observe the spirit of the Act in their operations.⁷

⁵ The Committee notes that in respect of their life insurance operations, SGIOs are competing mainly with mutual organisations which do not have a capital base.

⁶ Unfunded business is business for which no specific provision, or only a very inadequate provision, is made for outstanding claims.

⁷ In the case of at least one SGIO, however, recipients of housing loans are required to take out life insurance in addition to insuring their houses with it.

(d) Taxation and Related Considerations

31.38 The industry's concern with regard to taxes, fees and charges is that an SGIO's costing of insurance may not reflect the full range of such expenses for which a private insurer is liable, so allowing it to undercut its competitors.

31.39 The Committee understands that, although not liable for Commonwealth company tax, every SGIO pays an equivalent amount into state revenues. In general, SGIOs also pay most state taxes (e.g. payroll tax, land taxes, fire brigade levies and stamp duties) although there are exceptions: in some states, for instance, the SGIO is exempt from stamp duty on transfers of marketable securities, conveyances of real property etc. where the transactions are undertaken on their own account. As well, SGIOs have a general exemption from sales tax on vehicles and equipment.

31.40 In the interest of competitive neutrality, the Committee believes that **SGIOs should be required to pay all taxes, fees and charges (or their equivalents) for which private insurers are liable.**

(e) Investment Practices

31.41 The management and powers of investment of SGIOs are regulated by state legislation. In some cases the investment powers are not specified, being left to managerial discretion; in practice, however, state governments have effective powers to determine the scope and direction of SGIOs' investments.

31.42 There can be no question that at least some SGIOs have consistently been used as a source of funds for state instrumentalities. As indicated in Table 31.1, government-owned insurance underwriters, which primarily comprise SGIOs, held 44.5% of their assets in public securities in 1979; in contrast, private sector underwriters held only 10.9% in this form.

TABLE 31.1: DIRECT UNDERWRITERS: COMPOSITION OF ASSETS^(a) (%)

Assets	1975		1979	
	Private	Public	Private	Public
Fixed assets	9.8	7.9	8.9	8.9
Public securities	6.0	45.0	10.9	44.5
Shares	18.3	1.5	16.5	2.8
Debentures and notes	11.0	9.9	20.3	9.7
Deposits and loans	26.5	27.9	25.0	25.8
Current assets	28.1	7.8	18.2	8.3
Intangible assets	0.3	—	0.2	—
Total	100.0	100.0	100.0	100.0

(a) At book value.

Source: *Sixth Annual Report of the Insurance Commissioner, 1980.*

31.43 The costs of such portfolio constraints in terms of investment income forgone might be seen as providing a *quid pro quo* for state government guarantees and other advantages. The Committee acknowledges that these investment restrictions may offset, in part or in whole, the competitive advantages of SGIOs, although it is not possible to arrive at an exact balance.

31.44 However, in the light of the Committee's stress on competitive neutrality, and consistent with its views on captive markets (Chapter 10) and on the undesirability of seeking to balance burdens and privileges, the Committee considers that **SGIOs should not be subject to restrictions or requirements to which their private counterparts are not subject; in particular, they should be free to invest in those areas which, in their judgment, offer the best risk/return combinations.**

COMPETITIVE STRUCTURE

- Ch. 32** Competitive Structure: Financial Intermediaries
- Ch. 33** The Structure and Efficiency of Securities Markets and Patterns of Share Ownership

CHAPTER 32: COMPETITIVE STRUCTURE: FINANCIAL INTERMEDIARIES

A. THE ANALYTICAL FRAMEWORK

32.1 This chapter focuses on the conditions of competition among financial intermediaries and the extent to which the institutional structure impacts on the functional efficiency of the financial system.

32.2 As indicated in Chapter 1, an efficient system of financial intermediation must satisfy certain performance standards. The required standards are:

- operational efficiency: are the operations of intermediaries being conducted at least cost?¹
- allocative efficiency: are financial resources (which in turn are claims on real resources) being put to the most productive use?
- dynamic efficiency: is the system reasonably adaptable to changes in the economic climate, technology and market preferences?

32.3 These performance standards are likely to be more fully met when the financial institutional structure is characterised by:

- (i) high levels of competition — particularly price competition; this is usually achieved when:
 - there are large numbers of independent participants;
 - the market is not dominated by a few institutions (i.e. there is low market concentration);
 - there are no barriers to entry other than 'natural' commercial ones²; and
 - there are no collusive agreements between the participants designed to restrict competition.
- (ii) competitive neutrality — the market will work most efficiently if:
 - participants have an equal opportunity to compete for business and equal access to information; and
 - the incidence of regulation and taxation is neutral, i.e. it impacts in a consistent way.
- (iii) diversity of choice — a desirable competitive structure should include an appropriate range and mix of institutions offering a full spectrum of financial services and a wide choice of risks; this is usually — but not always — associated with high levels of competition.

1 In terms of resource input for a given product output.

2 For example, if established enterprises are enjoying economies of scale, they will have a 'natural' advantage over newcomers for a period.

32.4 While the Committee attaches great importance to the achievement of these competitive standards, there is a need to balance the aim of competitive efficiency against other aims of public policy. To illustrate:

- Free entry is vital to competitive efficiency; at the same time, indiscriminate expansion of numbers may temporarily lead to uneconomic market fragmentation and threaten the viability of some institutions, with possible repercussions for general confidence in the system. Here the conflict is principally between efficiency and stability; the Committee acknowledges that there may at times be prudential justification for moderating the level and pace of new entry, although such circumstances would be very rare.
- Efficiency considerations require that less successful, non-viable institutions be allowed to leave the industry without official hindrance. However, to minimise problems for stability, it is important that procedures exist for the orderly exit of such institutions.
- In the application of monetary and prudential policy, there may be administrative economies from the Government's viewpoint in dealing with fewer rather than larger numbers of financial businesses; yet effective competition often depends on there being a reasonable number and range of business units. This conflict between competition and administrative simplicity would be less important in the market-oriented policy environment which the Committee proposes.
- The fact that banks are subject to closer regulation than other intermediaries performing comparable financing functions represents a clear departure from competitive neutrality, but the establishment and development of a wide range of non-banks has permitted greater diversity of choice. Nonetheless, it should be possible to secure appropriate diversity of choice without the costs imposed by the lack of neutrality.
- Even in a highly competitive market, the degree of access to finance by some groups — low income households, risky small businesses etc. — may fall short of what society regards as acceptable. Such conflicts between allocative efficiency and social equity may only be resolved at the political level, but the Committee has expressed views throughout this Report (and particularly in Chapters 36–42) about what might be the appropriate methods of assisting particular groups.
- Many of the issues which arise in the context of deregulation of the financial system reflect a concern about the short-run consequences of changes which many see as beneficial in the longer term. The Committee shares this concern. Policy changes, including those bearing on competitive balance, should be implemented in ways which minimise transitional disturbance and provide appropriate forewarning of inherent uncertainties. Here again there is a need to balance efficiency in its several aspects against stability in financial markets.

32.5 Competitive efficiency must therefore be pursued within the constraints imposed by other valid objectives of public policy.

32.6 The competitiveness of the financial environment can be assessed by examining:

- competitive performance (over time, inter-sectorally, internationally), with reference to such criteria as cost structures, intermediation margins, range of facilities, and profitability;

- institutions offering such low risk/high liquidity savings facilities (e.g. banks) have been constrained by official restrictions on interest rates and portfolio structure;
- those investment facilities that are not constrained by interest rate controls, e.g. the cash management funds, certificates of deposit, finance company debentures etc., are not used by many small savers — either because of limits on minimum subscriptions/transactions or because the perceived risk is considered too great for them⁷;
- there is no adequate low risk hedge against inflation available to the small investor; and
- while Australian Savings Bonds offer many of the characteristics required by the risk-averse small saver it may not have quite the liquidity characteristics sought by some of these investors.

32.28 Only to a minor extent could these problems be attributed to deficiencies or imperfections in the operation of financial markets. Some of the limits on minimum transactions — but by no means all — may fall into this category, but there are already indications that the limits are becoming less restrictive as the market becomes more competitive.⁸ The main problem appears to have been not the market but government regulation, and its restrictive effect on the capacity of banks to compete actively for household savings. In such a regulatory environment competition has manifested itself in various forms of non-price competition such as the proliferation of branches; this has distorted household sector choices, as well as reducing the returns available to bank depositors.

32.29 Turning to the household sector as a user of funds, the Committee believes that, while there is generally intense competition in the market for personal loans, there may be a 'gap' in the medium-risk category.⁹ This too is in large part a product of regulation. The effects of regulation can also be seen in the market for housing loans, where interest rate controls have tended to create a situation of excess demand. In such a market there has been little incentive to innovate in mortgage lending terms and conditions.

32.30 The Committee's proposed program of deregulation should help to remove many of the distortions now existing in the markets for household deposits and loans.

32.31 Later in this chapter the Committee notes the high degree of market concentration among institutional lenders to the household sector and discusses a few of the implications.

(iii) Business Sector

32.32 Business enterprises with surplus funds to invest — normally in moderate to large amounts — undoubtedly have a wide range of highly competitive outlets to choose from.

7 It must be recognised that even in the kind of financial system envisaged by the Committee, the banks will still remain the main depository for many risk-averse savers. This is because the banks will remain a special category for prudential policy (see Chapter 19).

8 For example, the trading banks have been gradually reducing the minimum amount acceptable on term deposits. Again, it is interesting to note that the second cash management trust launched in Australia in June 1981 has a minimum subscription of \$2000 whereas the first trust required a minimum initial subscription of \$5000.

9 For example, the leading finance companies are typically lending at interest rates 5 to 7 percentage points higher than those available from banks.

32.33 On the borrowing side, the picture is more uneven. Markets serving medium to large, high grade business borrowers are generally highly competitive and innovative. There are a large number of institutional participants, entry to the market is relatively free, and there is no reason to presume any lack of operational efficiency. As well, large businesses have the capacity to gain direct access to the capital market (both domestic and overseas) and are not dependent on institutional intermediaries. The only qualification that needs to be made is that government regulation, such as the 30/20 rule and the restrictions on small bank overdraft interest rates, have often worked to the disadvantage of business borrowers.

32.34 On the other hand, the loan market for small or high risk business enterprises is somewhat less competitive. A fundamental reason is that government regulation has tended to distort the supply of funds to small business and high risk ventures. The nature and form of these regulations are discussed in Chapter 38.

32.35 Apart from the influence of government regulation, it has been argued that the Australian market for relatively high risk venture capital is lacking in scope and generally uncompetitive in relation to the corresponding markets in other advanced countries.

32.36 The Committee discusses this criticism in Chapter 38: while acknowledging the absence of a formal institutional framework for venture capital, it is not clear that the larger non-finance business houses have let good opportunities pass for want of support. Nonetheless, in a small, capital-scarce country with a wide geographic distribution of human and natural resources and an attractive array of alternative investment opportunities, it is possible that there are impediments to successful entrepreneurial activity arising in some areas of the financial markets.

(iv) Overview

32.37 Any views about whether Australian financial intermediaries are adequately competitive must involve an element of judgment. Hard evidence on the degree of competition is very difficult to come by. One reason is that it is difficult even to define the 'market' or 'industry', e.g. the level of competition within the banking 'industry' is considerably affected by competition from non-banks. The Committee has nevertheless looked at some obvious indicators such as the numbers involved, their market behaviour, margins charged, profitability, ease of entry and levels of concentration. The issue of concentration is discussed separately later.

32.38 On the basis of the discussion above, the Committee would make the following observations:

- financial intermediation, taken as a whole, has become substantially more competitive, versatile and innovative than it was ten or twenty years ago; there are more institutions, and traditional lines of demarcation have been eroded;
- the level of competition is not, however, uniform throughout the financial system; some markets (e.g. wholesale business finance) are more price competitive than others (e.g. small household sector deposit facilities);
- deficiencies in competition are largely a product of regulation;
- while there have been over the years many examples of restrictive agreements within institutional groups (such as banks, life offices, building societies and

stock brokers), many of these have disappeared as a result of the intervention of the Trade Practices Commission and others are under challenge or review.

(b) Other Aspects of Competitive Structure

32.39 The Committee has also examined the extent to which the present system stands up to the tests of competitive neutrality and diversity of choice.

32.40 In various parts of the Report, attention has been drawn to the unequal impact on financial intermediaries of certain forms of government intervention, e.g. monetary controls, prudential regulation, special arrangements with the Reserve Bank, differential taxation, entry barriers, or the direct participation of government-owned enterprises.

32.41 Apart from the effects of government intervention, non-neutrality may arise if individual institutions or groups of institutions are thought to have disproportionate market power, arising from their size, financial resources,¹⁰ status etc. One aspect of 'neutrality' is discussed in Section C(b) dealing with concentration of ownership and control.

32.42 Part I of the Interim Report surveyed the changing structure and operation of the financial system and pointed to the wide and ever-increasing diversity of institutions, markets, instruments and services. Since the Report was issued, the pace of innovation has, if anything, accelerated — and with it the diversity of choice available.

32.43 While this is the broad picture, the Committee has already noted the limited range of choice available in the provision of cheque account and foreign exchange facilities. It should also be recognised that the small size and geographical dispersion of the Australian market impose some constraints on the range of facilities that might be available.

32.44 Finally, in this review of the competitive structure of financial markets, there is a need to point out that an adequate flow of information is an essential ingredient if competition is to function effectively. Without a well-informed market, the benefits of competition can be lost. While the Committee has identified some impediments in the flow and transmission of information (e.g. in the areas of small business and corporate reporting), it is satisfied that overall the range of information available is adequate. This issue is covered in Chapters 21 and 44.

C. FUTURE STRUCTURE

32.45 In assessing the future competitive structure, the Committee has focused on the following key issues:

- Are the levels of competition which can be expected to emerge from the implementation of the Committee's recommendations likely to be consistent with an 'efficient' and stable financial system? If not, what form should public policy take?
- Is the implementation of the Committee's recommendations likely to result in an undesirable concentration of ownership and control of the financial system?

10 This could arise, for example, out of the excessive use of financial strength by large overseas groups and others in 'buying' market shares, with little regard for short-term profitability. The longer term outcome of this may be reduced competition.

- As it is proposed that some official intervention in the system be retained, is this intervention likely to be reasonably even-handed in its incidence on the competitive balance between participants?

32.46 The remainder of this chapter seeks to place these three issues in the broad context of the Report as a whole.

(a) Future Levels of Competition

32.47 The Committee has no precise picture in mind of the financial institutional structure which will emerge once the changes it has proposed have been implemented and existing participants have had time to adjust. However, the detail of the institutional structure can be regarded as incidental provided certain performance objectives are met. In summary, these objectives are:

- 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.

32.48 The Committee has proposed changes which will promote such a structure, although it is under no illusion that the financial system which evolves will always operate perfectly. As argued throughout this Report, any competitive deficiencies will generally be short-lived so long as there is effective freedom of entry.

32.49 The dominant theme underlying the entire package of the Committee's recommendations is that, in the long run, the community as a whole will be better off (i.e. the efficiency with which resources are allocated throughout the community will be improved) if financial markets are allowed to operate more freely and with less direct government intervention — subject to there being effective competition (as well as observance of basic prudential standards).

32.50 One area where there is a degree of public unease about the present and possible future competitive climate is banking, especially against the background of the recently announced mergers.¹¹

32.51 Four key factors will dictate the future level of competition in this area. These are:

- the structure of the banking industry (numbers of participants, extent of co-operation between them, degree of concentration etc.);
- the extent to which government regulation will continue to inhibit competition among banks;
- the availability of close substitutes for facilities provided by banks; and
- the conditions of entry.

32.52 The Committee has indicated that, in its opinion, the present market

¹¹ The banks expect that the mergers will lead to greater operational efficiency and improved international competitiveness. It is not a judgment which the Committee can reasonably assess, because it has not sought to be in possession of the relevant kind of detail about banks' operations.

structure may not be fully conducive to an adequate level of competition among banks. It has also argued that government regulation (especially of interest rates and advances) has been severely hindering competition — although recent policy changes have reduced this problem to some degree. Implementation of the Committee's program of deregulation will remove this key barrier to competition; for example, banks will be free to pay interest on current accounts, which can be expected, in turn, to have a significant effect on the level and nature of competition in the provision of money transfer services.

32.53 In regard to competition from substitutes, the banks currently offer a composite service which is perceived by the market to have two distinctive elements:

- a high level of official protection for depositors; and
- unique rights to provide cheque payment and other basic money transfer facilities, including foreign exchange dealing.

32.54 Both are — in varying degrees — the product of government intervention. Although changes proposed by the Committee will facilitate the participation of non-bank financial institutions in the provision of domestic payments system services, implementation of the Committee's recommendations will essentially preserve these unique characteristics of banking. There will, therefore, be a continued need to ensure that the banking industry *per se* is fully competitive.

32.55 Against this background, the Committee looked closely at the fourth factor mentioned above as influencing the competitive environment, viz. the conditions of entry into banking. It has concluded that it would be desirable for policy to be more accommodating to new bank entry in four respects:

- trading banks in future should not be expected necessarily to provide the full range of services and facilities presently associated with such banks;
- they should be allowed flexibility in capital structures (e.g. co-operative institutions, and institutions owned by a group of non-banks, should be eligible for authorisation);
- the Banks (Shareholdings) Act should be abolished; and
- foreign banks should be progressively admitted, having regard to the special potential they offer for competition.

32.56 As well, the Committee is of the view that the criteria for entry should not involve discretionary judgments as to the optimum number of participants from an efficiency viewpoint.

32.57 The Committee has also indicated in Chapter 23 that it envisages much freer indirect participation by non-banks in the provision of payments facilities.

32.58 In summary, the Committee is confident that with the adoption of its recommendations, a strongly competitive environment will in due course become firmly established and artificial market imperfections will be of limited significance.

32.59 The Committee recognises that even with a greater level of competition, limited segments of markets may seem 'neglected' simply because the potential market is unknown, too small or too risky to warrant provision being made on reasonable terms and conditions. Often, this is not a market imperfection at all; it may for example reflect the overall scarcity of capital in relation to available investment opportunities or simply the presence of 'externalities'. Nonetheless, the Committee can readily accept that from time to time free market participants

may collude to restrict competition or may be slow to respond to unusual or high risk or slow-yielding but essentially commercial investment opportunities. (There are, of course, limits on the pace at which the economy can adjust to change.) The Committee therefore sees a need for appropriate government authorities to review the workings of the market.

32.60 Against this background and consistent with its view in Chapter 2, the Committee *recommends* that the Reserve Bank should undertake regular reviews of the overall functioning of the financial system, in the context of which it should diagnose and report on any structural problems that appear to exist and any barriers to effective competition, especially government-induced barriers.

32.61 The main regulatory body in the area of competition is, of course, the Trade Practices Commission. A major aim of the Commission is to develop and strengthen competition in private enterprise as a means of achieving greater economic efficiency.¹² The Trade Practices Commission will clearly have an important role to play in maintaining effective competition in financial markets.

32.62 While the Committee attaches considerable importance to the maintenance of a strongly competitive environment, it also sees a need to ensure that due regard is taken of any conflicts between stability and competitive efficiency. This might require greater involvement by those industry authorities that are concerned with prudential regulation (Reserve Bank, Life Insurance Commissioner etc.) in the relevant examinations of the Trade Practices Commission.

32.63 Involvement of the regulatory authorities might take one of the following forms:

- a senior representative of the appropriate industry authority might be seconded to sit with the Trade Practices Commission (and could be permitted to make a minority report);
- the Commission might be required to invite submissions from the relevant industry authority and to take explicit account of the views expressed in arriving at its final judgment; or
- the examination of industry practices which restrict competition might be undertaken by the relevant industry authority, but with one or more Commissioners from the Trade Practices Commission being seconded to facilitate a consistent approach to competition policy.

32.64 The Committee favours the second of these alternatives; it would enable greater weight to be given to stability considerations, but at the same time it would involve least change to present arrangements and would preserve the fullest degree of consistency in competition policy.

32.65 The Committee *recommends* that the Trade Practices Act should be amended to provide that the Commission, when examining the conduct or practices of particular groups of financial intermediaries, seek submissions from the relevant industry authority and take explicit account of these submissions in arriving at its judgment.

32.66 Equally, of course, the authorities must ensure that any government

¹² See Chapter 18 of the Committee's Interim Report for additional detail.

regulation and intervention is so structured as to minimise the possibility of encouraging or supporting anti-competitive behaviour.

32.67 Finally, the competitive effects of 'self-regulation' need to be considered. It is undoubtedly a more flexible approach to regulation and permits account to be taken of evolving market behaviour, but the Committee recognises that it may not always be compatible with effective competition. Where this is likely to be a problem, the Committee suggests that self-regulation should be supported by arrangements which provide scope for government intervention to override action by the self-regulatory body, where such intervention is considered to be in the public interest. In effect, this would involve a system of co-regulation. (See further discussion in Chapter 21.)

(b) Concentration of Ownership and Control

32.68 A number of groups have expressed concern to the Committee about the trend towards greater concentration of ownership and control of the financial system, and the likelihood that this trend might accelerate in a more deregulated environment.

32.69 The fears expressed take two distinct forms:

- that a particular group or category of institutions (e.g. 'banks' or 'life insurance companies') may assume a position of undue dominance in the financial system; this may be called 'group dominance';
- that a small number of large institutions may dominate the financial system; this may be called 'individual firm dominance'.

32.70 These two issues must be kept separate as they could have quite different economic and social implications. For example, a substantial increase in the overall importance of banks in the financial system would probably generate little public concern if the market structure were such that any individual bank held only a small share of banking business; it might, however, be less readily acceptable if three or four banks effectively held the market between them.

32.71 Fears of **group dominance** have promoted public policy intervention in a number of countries. For example some countries (such as South Africa and Canada) have acted either to prohibit entirely the involvement of banks in life insurance business (and vice versa) or to limit such involvement. The Committee has received submissions recommending similar restraints in Australia. Many of these submissions point to the dangers of excessive 'economic power' and express concern that the banks would have an unfair competitive advantage in a deregulated environment.

32.72 The Committee does not believe there are any valid economic arguments against the involvement of banks in life or general insurance, or vice versa,¹³ subject to the setting of appropriate prudential requirements. The provision by banks of a wider range of financial services — including insurance — may be of benefit to their clients, and may offer some marketing and technical economies. Similar comments apply in the case of the involvement of life offices in banking or banking-type activities.

¹³ In Chapter 19, the Committee proposes a notification process whenever a single shareholder acquires a substantial shareholding in a bank or increases an existing substantial shareholding, with scope for the Reserve Bank to require divestment where this is in the public interest.

32.73 This assumes, of course, that intermediaries compete on a basis of equality. If the authorities believe there is a real danger that one group may — e.g. through its special relationship with the authorities — have an unfair competitive advantage, the answer should be not to ‘compartmentalise’ the system by regulation but rather to remove the source of the competitive advantage, where this arises from official intervention. The Committee believes that conditions closely approximating competitive neutrality between the various intermediaries will exist if its package of recommendations is adopted (see next section).

32.74 It does not therefore favour any restrictions, other than prudential, on the participation by non-bank institutions in banking or other areas of finance; (indeed, the functional approach to prudential regulation outlined in Chapter 19, involving the setting of consistent prudential requirements for banks and other DTIs, and the Committee’s recommended abolition of the Banks (Shareholdings) Act should facilitate such participation in the longer term). Similarly, the Committee sees no need to restrict banks’ participation in non-banking (except — possibly — in the case of authorised dealers).¹⁴

32.75 Thus, the Committee does not recoil (on efficiency grounds) from the idea of allowing banks (if they wish) to engage in some ‘investment banking’ activities, along the lines of their European counterparts, so long as satisfactory prudential controls are in place. The fact that banks (or life offices) as a group will be participating in every area of the financial system need not cause concern so long as individual institutions do not have excessive market power. Group dominance is not seen as a problem *per se*.¹⁵

32.76 The question of **individual firm dominance** raises much more difficult issues for the Committee.

32.77 In many sectors of the Australian financial system, there has been a high and generally rising level of concentration in the hands of a few large institutions.

- The four largest trading banks account for about 71% of all trading bank assets. The recently announced bank mergers will raise this figure to 87%. The comparable ratio ten years ago was 66% and twenty years ago it was 64%. Similar concentration ratios and trends are evident for savings banks.
- The four largest life insurance companies account for about 76% of the total assets of the life insurance industry — the same ratio as ten years ago and slightly lower than in 1960.
- On an equity-weighted basis, the four largest banks and life offices, when consolidated with their affiliates, account for over 40% of the assets of all financial institutions.¹⁶ The recently announced bank mergers will raise the figure to almost 50%.

14 In Chapter 9 it is argued that there are special factors which justify some short-term restriction on banks’ equity interest in dealers, but even here the Committee advocates freedom of entry in the long run.

15 The relative growth of different groups of institutions is discussed in Chapter 3 of the Interim Report.

16 For a discussion of the approach adopted see Interim Report, paragraph 6.28 et seq. It should be noted that one of the four major banks is government-owned.

- There is a significant degree of interlocking of directorships among financial institutions which are not otherwise closely related.¹⁷

32.78 The Committee recognises that there are dangers in an approach to measuring concentration which focuses exclusively on nominal industry groups. The relevant focus is financial markets and in most instances the range of participants that do business with any particular 'sector' embraces a range of institutional groups.

32.79 Table 32.1 contains broad estimates of the extent of concentration of assets in respect of four broadly defined 'sectoral' markets for loan finance: housing, consumer (non-housing), rural, and ('wholesale') corporate finance. It can be seen from the table that (on a consolidated basis) the largest five lenders account for about 43%, 56%, 67% and 40% of all institutional loans to these four sectors respectively; and the largest ten 58%, 71%, 90% and 52% respectively. When the proposed bank mergers are completed the corresponding figures will be higher. It should be stressed that the figures are indicative only — as the coverage of available statistical collections is not complete. Nonetheless the evidence suggests a high level of institutional concentration in some loan markets (especially consumer and rural finance).

TABLE 32.1: SECTORAL FINANCING — DECEMBER 1980^(a)

	<i>Largest five lenders (\$b)</i>	<i>% of total</i>	<i>Largest ten lenders (\$b)</i>	<i>% of total</i>	<i>All lenders (\$b)</i>
<i>Institutional basis</i>					
Loans for housing	9.6	(38)	13.1	(52)	25.1
Other consumer loans	5.6	(43)	8.0	(63)	12.8
Non-government loans to the rural sector	2.1	(67)	2.8	(90)	3.1
Loans to the corporate sector	8.9	(27)	13.5	(40)	33.4
<i>Consolidated group basis^(b)</i>					
Loans for housing	10.9	(43)	14.5	(58)	25.1
Other consumer loans	7.2	(56)	9.1	(71)	12.8
Non-government loans to rural sector	2.1	(67)	2.8	(90)	3.1
Loans to the corporate sector	13.4	(40)	17.4	(52)	33.4

(a) Figures are indicative only; it has not been possible to eliminate all inter-group lending particularly in the category 'loans to the corporate sector'; nor is the coverage of available statistical collections complete.

(b) Figures of subsidiaries and parent companies which fall into different institutional groups are aggregated.

Source: Reserve Bank of Australia. The figures are based on both published and unpublished information.

17 For example, as at 1979, the 76 directors of the eight largest independent financial institutions in Australia held 40 directorships in other unaffiliated financial institutions. As well they held 130 directorships in non-financial companies.

The interlocking of directorates between competing or semi-competing financial institutions is prohibited in many countries (e.g. USA) because it has the potential to diminish competition: the directors act as 'common messengers' and this can reinforce any propensity to adopt 'parallel behaviour' on prices, innovation etc. It can also confer competitive advantage in the form of superior market intelligence. Interlocking directorships involving financial and non-financial corporations are viewed by some writers as a means by which financial institutions may gain access to otherwise unavailable intelligence or obtain favoured access to markets. Others regard it as natural that large financial institutions and other companies would be seeking the same kind of board members and see no reason to view these connections with suspicion. These issues have not been explored by the Committee.

32.80 While exactly comparable figures from other countries are not available, levels of concentration in Australia appear to be at the upper end of the spectrum by world standards — at least in respect of banking.¹⁸

32.81 The concern of some people about concentration of power in a few large institutions stems mainly from three considerations:

- possible adverse effects on the competitive structure of financial intermediation, with implications for allocational efficiency;
- alleged differences in investment and lending policies as between large and small institutions (e.g. in respect of housing, small business, resource development etc.); and
- a more general social and political concern about concentration of financial power in the hands of a small group of directors and managers.

32.82 To assess the validity of these concerns, certain key questions need to be answered:

- assuming no barriers to entry are imposed by governments on other than prudential grounds, are there natural economic barriers to the entry of new participants (such as economies of scale or high establishment costs)?
- to what extent are present levels of concentration an impediment to competition?
- is the lending and investment behaviour of large institutions markedly different from that of small institutions?

32.83 The Committee has not found it possible to make firm judgments on these questions.

32.84 The first question is important because, if new participants can establish themselves on a viable, competitive basis within a short time, freedom of entry will provide a built-in safeguard against any abuse of monopoly power. However, if there are economies of scale, there will be a tendency for the industry to become concentrated. In that situation there may be some loss in competitive strength — which would have to be weighed against the technical efficiency gains from large-scale operation.

32.85 The available evidence suggests¹⁹:

- there are moderate economies of scale in some aspects of banking, particularly in the management of the payments mechanism;
- there is weaker evidence of economies of scale in the operations of building societies and, on overseas experience, credit unions; and
- there is no convincing evidence on the existence or otherwise of economies of scale in other forms of financial intermediation.

32.86 At the same time, it is of interest to note the consistent trend, especially in the 1970s and in recent years, towards consolidation and amalgamation,

¹⁸ Drawing on a number of sources — such as a study of 'Banking Systems Abroad' by the London based Inter-Bank Research Organisation; OECD, *Financial Statistics* (various issues); together with a study by K. T. Davis and M. K. Lewis ('Economies of Scale in Financial Institutions' in *AFSI Commissioned Studies and Selected Papers*, Part 1, AGPS, Canberra, 1981) — the Committee has derived a strong impression that the dominance of the four largest banks in the Australian financial system is high compared with most other developed countries.

¹⁹ This evidence is surveyed in K. T. Davis and M. K. Lewis, 'Economies of Scale in Financial Institutions', *op. cit.* Of course, technological change may make past experience less relevant.

particularly amongst banks and building societies. While it is possible that many of the large institutions in Australia have reached a scale of operation where few additional economies are available they may nevertheless have a significant competitive advantage over small newcomers, at least initially.

32.87 In judging the extent to which economies of scale act as a barrier to entry, two points need to be noted. Firstly, new small institutions often feel able to compete effectively with established 'giants' in at least some areas, e.g. witness the recent establishment of the Australian Bank. This must suggest that — in respect of some activities at least — technical economies of scale are not prohibitive and that there are offsetting managerial or 'marketing' advantages from small-scale operations.

32.88 Secondly, economies of scale are unlikely to deter established large institutions from seeking to diversify their activities into new areas. This is another reason why the Committee favours the breaking down of entry barriers between different groups of intermediaries, and why it favours allowing existing intermediaries unrestricted freedom to diversify — preferably through new entry rather than through takeover — subject to prudential considerations. A large life office, for example, should not be inhibited from seeking to obtain some of the marketing or operational economies of a large scale operation by acquiring a substantial interest in banking. Nor should a bank be inhibited from spreading its activities into insurance.

32.89 The second, and related, question raised above — the relationships between concentration and competition — also involves an element of judgment. Many have argued that, other things being equal, the more an industry is dominated by a few large institutions the less likely they are to compete aggressively on prices and the more likely they are to engage in collusive or other restrictive practices.

32.90 On the other hand, high levels of market concentration are not necessarily inconsistent with effective competition; especially where entry to the market is unrestricted.²⁰ So long as there are no official barriers to entry, the mere threat of new entry will act as a strong incentive for established firms to remain efficient and competitive.

32.91. Simple numerical assessment of numbers and relative size of participants is only one dimension of the issue, and concentration ratios and indexes are often a poor guide to the extent of monopoly or competition. To assess the degree of competition, there is a need to look closely at the market conduct and performance of participants as well as the composition of the participants. It is significant, for example, that evidence to the Committee shows that, among finance companies and permanent building societies, there have been significant shifts among institutions in the 'top 10' — i.e. the relative importance of specific institutions has changed over time.²¹ With freer entry conditions in the future, there is every likelihood that further shifts in 'ranking' will occur, and that competition between intermediaries will be sustained at high levels.

20 The Committee has examined the findings of a number of studies on the relationship between market concentration and prices for banking services. In all cases only a weak relationship was detected. (*Journal of Finance*, March 1981.)

21 Information supplied to the Committee by the Australian Association of Permanent Building Societies and the Australian Finance Conference.

32.92 The third question posed in paragraph 32.82 above raises some important and sensitive issues²²; it is also one of the most difficult for the Committee to resolve. The Committee was able to form an impressionistic judgment on the basis of three sources of information:

- a study of the published AMP share portfolio;
- a questionnaire survey of the investment policies of a sample of large and small life insurance companies; and
- a study by a consultant to the Inquiry of the institutional ownership patterns of a sample of Australian corporations.²³

32.93 A summary of the main findings is in Appendix 32.1. In brief, they suggest that there is a fair degree of diversity among financial institutions in their approach to equity investments and lending policies — and this diversity cuts across size characteristics, i.e. there are almost as many differences among large institutions as there are between large and small institutions. As would be expected, there is a general tendency for institutions to invest in larger sized companies, which have established records of profitability and a ready market for their shares. Both large and small institutions tend to shun equity investments in unlisted or very small listed companies (\$2m or less in capitalisation). However, a quite diverse group of institutions are prepared to hold the stock of middle-sized (non-mining) companies (those with a capitalisation in the range \$5m to \$25m).

32.94 The study of share ownership patterns commissioned by the Committee found that a number of institutions were prepared to acquire the shares of relatively small companies in search of greater potential returns. This was considered sufficient to ensure that the needs of smaller businesses were not unduly overlooked. It was also thought, to lessen the risk, that a 'two-tier' share pricing structure might emerge — e.g. a situation where price-earnings ratios for, say, the top 100 companies were disproportionately high relative to those of other listed companies on the Stock Exchange.

32.95 Nor is it clear from the evidence that the largest institutions have a lesser predilection to invest in the shares of small/medium companies than the second-ranking (smaller) institutions, although it is possible to see a slight tendency in this direction. Similarly, there is no clear pattern with loan finance.

32.96 It is true that the smaller institutions — sometimes by reason of their very size — pursue a different overall investment strategy from the larger institutions, e.g. their investment in property is proportionately much smaller. (See Table 33.7, Chapter 33.) But it is not possible to draw from this fact any inferences about the impact of concentration on the allocative efficiency of the financial system.

32.97 On balance, the Committee's view is that — especially if its recommendations are substantially adopted — there is no present cause for concern regarding the effects of concentration levels on **competition**, the pattern of funds flows or the development of a two-tier pricing structure.

32.98 Against this background and the broad institutional base of the financial system, the Committee has elected for changes which:

22 For example, fears have been expressed that increased concentration might interfere with the flow of funds to small business and housing.

23 P. H. Davies, 'Equity Finance and the Ownership of Shares', *AFSI Commissioned Studies and Selected Papers*, Part 3, AGPS, Canberra, 1981.

- encourage new entry and discourage co-operation between participants of a kind which limits competition; and
- allow competitive market processes to guide the evolution of the system in the period ahead.

32.99 Nonetheless, the Committee recognises that freedom of entry may not ensure that levels of concentration are always consistent with the public interest. Beyond a certain point, mergers and amalgamations involving the large institutions could well mean a net loss of efficiency for the financial system. In so far as large institutions have different investment preferences from small institutions, high levels of concentration may also produce an allocation of funds that is socially or politically unacceptable. Finally, there may be a legitimate social concern about the degree of concentration of financial power in a few hands.

32.100 If governments, for one reason or another, wish to take pre-emptive action to control the trend to, or the effects of, higher concentration, there are broadly five types of policy instruments available to them:

- (a) direct regulation or control of lending investment patterns and interest rates to ensure that the allocation of funds is in accordance with the public interest;
- (b) statutory limitations on the ownership structure of financial intermediaries — such as is provided under the Banks (Shareholdings) Act and s. 39(11) of the Life Insurance Act and the restrictions on individual holdings in trustee companies under state trustee legislation;
- (c) the kinds of notification and divestment processes recommended for share acquisitions in banks (on prudential grounds) in Chapter 19;
- (d) the use of government institutions to inject additional competition; and
- (e) the use of the Trade Practices Act to prevent an individual institution from acquiring a dominant position in the market and, in the process, substantially lessening competition.

32.101 The Committee has already indicated unambiguously its stance on lending and interest rate controls. It believes that such an instrument is inappropriate and would create many more 'by-product' distortions than any it might correct.

32.102 The Committee has also argued against the use of legislation such as the Banks (Shareholdings) Act. See Chapter 19.

32.103 There may be a limited role for option (c); option (d) has a little more to offer in special circumstances.²⁴ Generally, however, the appropriate instrument is the Trade Practices Act.²⁵ This is the approach commonly used in most of the developed countries.²⁶

32.104 Irrespective of the levels of concentration, the Committee favours positive and resolute government intervention to ensure adequate disclosure and

24 (c) would only be applicable where there are licensing arrangements. Some discussion of option (d) is to be found in Chapters 23 and 27.

25 It is noted that significant amendments were made to the Act following the Swanson Committee report in 1977.

26 USA: Federal Trade Commission;
UK: Monopolies and Mergers Commission;
West Germany: Bundeskartellamt.

accountability by directors and managers of financial institutions to their members and shareholders (see Chapter 21).

(c) Neutrality of Regulatory/Tax Incidence

32.105 The demand for greater evenness in the incidence of regulatory burdens and privileges has been a consistent theme of many submissions to the Inquiry. It is a principle which the Committee has strongly endorsed.

32.106 The restoration of competitive neutrality between groups of intermediaries will tend to ensure that funds are transmitted through the most efficient channels, and will strengthen the capacity of the system to adapt to changes in technology and market conditions. Differential regulation has also impeded the free movement of funds between sectors and the removal of these impediments will provide greater neutrality in respect of access of borrowers to loan funds.

32.107 The Committee has proposed many specific changes which can be expected to establish a more neutrally competitive financial system. If these proposals are adopted:

- authorisation as a bank will be more freely available, subject to appropriate prudential requirements;
- even though banks will continue to have exclusive rights to issue cheques, the banking system will be more competitive in this area and individual banks will compete for the right to provide chequing account (and other payment system) facilities indirectly to the customers of non-banks;
- banks will not have exclusive rights of access to central bank liquidity support facilities;
- generally, monetary policy will rely more on open market operations, and financial institutions will be freed from direct controls on interest rates, asset structures and lending policy which have worked to segment markets;
- government-owned institutions will compete on a more equal footing in commercial markets; and
- the tax system will impact less unevenly on the flow of funds.

32.108 As well, the Committee's proposals in Chapter 19 will permit a more consistent application of prudential regulation. The trend towards diversification of the services provided by financial intermediaries reinforces the need for a functional approach to regulation, and the Committee's recommendations are directed towards this end, e.g. the development of a national framework for the prudential regulation of certain non-bank deposit-taking institutions.

32.109 Another important recommendation of the Committee which will work towards competitive neutrality is that financial intermediaries should be able to change their status and primary area of operation and become subject to different prudential requirements if they see this course as desirable from a competitive viewpoint. The consequences of uneven regulation can be mitigated to a certain degree if intermediaries can take such action.

32.110 The Committee has also proposed a more uniform approach to reporting and disclosure standards (see Chapter 21).

32.111 The degree to which the Committee's recommendations will succeed in

achieving competitive neutrality is a question that must of necessity involve an element of subjectivity.

32.112 The Committee recognises, for example, that some will see continuing unevenness in the extent of official responsibility to protect the depositors of banks. On the other hand, the 'price' of this official responsibility is more stringent prudential requirements. As well, monetary policy will, even under our proposed approach, impact a little more heavily on banking groups. It is recognised that this may not ensure perfect 'balance'. However, if non-banks believe they are disadvantaged vis-a-vis banks, it should be open to them to seek recognition as a bank, demonstrating their capacity and willingness to observe the same high prudential standards.

INVESTMENT CHARACTERISTICS OF INSTITUTIONAL INVESTORS

1 This Appendix summarises the main findings of three separate investigations into the investment characteristics of institutional investors:

- a study¹ on the institutional ownership patterns of a sample of middle and small-sized Australian companies;
- an assessment of the replies to a Secretariat questionnaire sent to a sample of small and large life offices;
- a Secretariat study of the AMP's published share portfolio.

THE STUDY OF INSTITUTIONAL OWNERSHIP

2 Two samples of listed companies were selected:

- a group of forty-five medium-sized companies, ranging in market capitalisation from \$5.9m to \$26.5m;
- a group of forty-one small companies with market capitalisation of under \$2m.

3 The composition of the top twenty shareholdings in each of these two groups was examined, and compared with the ownership patterns of the 98 largest companies.

4 The following Tables 32A.1 to 32A.4 (reproduced from that study) show respectively:

- the institutional groups included in the top twenty shareholdings;
- the proportion of the shares in each sample held by the five largest life offices;
- the proportion of shares in each sample held by medium-sized life offices;
- the proportionate ownership of shares in each sample held by 'other financial institutions'.

5 From the study it appears that:

- Amongst financial institutions, there appears to be considerable diversity of approach to the equity market. Understandably, with the top fifty companies accounting for 57.5% of total market capitalisation,² the most common pattern is for resources to be concentrated on the larger companies which have established records of profitability and ready marketability.
- Partly reflecting the unavailability of stock, institutional investments in very small companies (under \$2m capital) are relatively insignificant, but this is true irrespective of the size of the institution; a quite diverse group of institutions are prepared to hold the stock of middle-sized, non-mining companies (\$6m to \$26m).
- While there is the present diversity of management policies there seems little ground for concern regarding the existence of a two-tier pricing structure. However, the continuing reduction in the numbers of institutions by merger and takeover, as well as the growth of managed superannuation funds, could conceivably create problems of this sort in the future.

1 For a full discussion of this study see Chapter 4 of P. H. Davies, 'Equity Finance and the Ownership of Shares', op. cit.

2 Source: The Stock Exchange of Melbourne Limited, *Annual Report*, 1980.

TABLE 32A.1: SIZE OF COMPANY V. SHARE OWNERSHIP: TOP TWENTY

	<i>Middle group</i>		<i>Small group</i>	
	<i>No.</i>	<i>% agg. MV</i>	<i>No.</i>	<i>% agg. MV</i>
<i>Corporations & Institutions</i>				
Bank nominees	28	1.8	9	2.3
Life companies	121	9.9	7	.5
General insurance	44	2.1	1	.1
Super funds	73	3.5	10	1.1
Non-bank nominees	28	1.5	30	1.9
Trustee companies	27	.7	4	10.2
Non-profit organisations	5	.1	1	2.3
Private companies	206	13.2	174	15.9
Listed industrial coys	37	7.3	15	4.6
Listed investment coys	44	1.4	15	1.5
Listed mining coys	5	.1	3	.1
Finance coys	8	.6	—	—
Trade-related coys	21	2.8	19	4.9
Management-related coys	19	3.8	16	8.0
Totals	666	48.8	304	53.4
<i>Persons</i>				
Management	78	5.4	128	12.2
Other	159	3.9	384	13.6
Totals	237	9.3	512	25.8
Grand Totals	903	58.1	816	79.2

Notes:

The column headed 'No.' is the number of holdings in the specified category. The '% agg. MV' is the percent of that category's holding of the aggregate market value of each sample.

'Management-related' companies and 'persons' refers to holdings in the names of directors or relatives.

'Trade-related' companies refers to holdings by companies in the same industry deemed to be for non-investment purposes.

'Non-profit organisations' includes charities and educational institutions.

Source: P. H. Davies, op. cit.

TABLE 32A.2: SIZE OF COMPANY: SHAREOWNERSHIP OF LARGE LIFE OFFICES

		<i>Top 98</i>	<i>Middle group</i>	<i>Small group</i>
Agg. MV of sample	(\$)	22.9b	595m	55m
Av. MV of sample coys	(\$)	234.3m	13.2m	1.3m
		%		
AMP		3.9	2.7	—
% of sample coys		81 (79)	40 (18)	—
National Mutual		1.5	2.4	—
% of sample coys		65 (64)	55 (25)	—
MLC		1.5	1.1	—
% of sample coys		67 (66)	31 (14)	—
CML		0.9	0.4	—
% of sample coys		65 (64)	20 (9)	—
T & G Mutual		0.5	0.2	.02
% of sample coys		49 (48)	7 (3)	2.0

Notes:

The table shows the percent of aggregate market value of each sample held by the listed institutions. The second line in each case shows the percent of companies in each sample held by the institutions with number of holdings in brackets.

The column headed 'Top 98' is based on Crough's (1980) sample of the top 98 companies by market capitalisation.

Source: P. H. Davies, op. cit.

TABLE 32A.3: SIZE OF COMPANY: HOLDINGS OF MEDIUM-RANKING INSTITUTIONS

Percentage of aggregate value of sample, and number of holdings (in brackets)

	<i>Top 98</i>	<i>Middle group</i>	<i>Small group</i>
City Mutual	.35 (47)	.4 (6)	—
Manufacturers Mutual	.16 (38)	—	—
Prudential	.25 (38)	—	—
Perpetual Trustee	.40 (36)	.23 (6)	.20 (2)
Aust. Foundation Invest.	.11 (27)	.23 (4)	—
NRMA	.10 (28)	.14 (4)	—
Mercantile Mutual	.06 (21)	1.6 (22)	.25 (5)
Nauru Phosphate	.10(18)	—	—

Note:

Amongst this group, Mercantile Mutual stands out as diverging from the industry pattern with holdings in more 'middle' companies than AMP and slightly less than National Mutual. Mercantile Mutual had five holdings in the Small Group and was the largest holder of such stock amongst all institutions.

Source: P. H. Davies, op. cit.

TABLE 32A.4: SIZE OF COMPANY: HOLDINGS OF OTHER FINANCIAL INSTITUTIONS

Percentage of aggregate value of sample, and number of holdings (in brackets)

	<i>Middle group</i>	<i>Small group</i>
AMEV	.05 (3)	—
APA	.01 (1)	—
Argo Investments	.29 (12)	—
AUI	.06 (3)	—
Co-op Insurance	.10 (4)	—
Colesanco Super Fund	.12 (6)	—
Commercial Union	.17 (4)	—
Eagle Star	.02 (2)	—
Heinz Noms (super fund)	.05 (4)	—
Legal and General	.06 (2)	—
Milton Group	.23 (7)	.18 (4)
NRMA	.14 (4)	—
NS Life Group	.35 (7)	.09 (1)
RACV	.07 (2)	—
Royal Insurance	.06 (2)	—
Scottish Amicable	.20 (6)	—
SGIO (Qld)	.63 (4)	—
United Insurance	.03 (2)	—
Vicins (NZI super fund)	.10 (4)	—
Whitefield	.10 (1)	.09 (2)

Note:

It can be seen that a quite diverse group of institutions are prepared to hold the stock of middle size companies. Of the 'small' group only Milton has more than one holding — it may be noted that this investment company has links with Mercantile Mutual. Argo Investments is conspicuous for the number of its middle size holdings.

Source: P. H. Davies, op. cit.

REPLIES TO SECRETARIAT QUESTIONNAIRE

6 Because of the confidential nature of some of the replies given to the Secretariat questionnaire, it was necessary to process the responses on an aggregative basis.

7 The main findings are:

Equity

- Life offices undertake very little investment in unlisted equities.
- The larger life offices indicated that the size of the company was an important factor in their investment decisions, but rigid guidelines were not usually laid down. Some life

offices invest fairly significant amounts in small listed companies including a few 'speculative' ones.

- Most of the medium and smaller life offices have no formal requirements on size of the company in which they will invest. Most reply that each individual proposal is judged on its merit. There is some suggestion that they are unlikely to go beyond the 'better performers' (larger and established businesses).
- As to be expected, only the larger life offices have a noticeable direct investment in resource development projects. This is not to say that the smaller life offices have no indirect involvement through shares in resource companies.

Loans

- Nearly all institutions normally set a minimum size of loans but there is no obvious relationship between the minimum level set and the size of the institution.

General

- The proportion of funds invested in or lent to small business (\$2m or under in capitalisation) and housing is relatively small — commonly around 5% — but the proportion bears no relationship to the size of the institution. If anything, in the limited sample surveyed, the large life offices appear to be proportionately more heavily committed in these areas.

EXAMINATION OF AMP'S PORTFOLIO

- 8 The Committee has examined the share portfolio of the largest life office, the AMP.
- 9 The main findings are:
 - It has no significant share investments in companies with a capitalisation below \$5m; it has only 0.4% of its share portfolio invested in companies with a capitalisation of under \$10m; and 2.3% of its portfolio in companies with a capitalisation of under \$20m. By contrast, companies with a capitalisation of under \$10m account for 3.7%³ of the capitalisation of all companies listed on the Sydney Stock Exchange, and those of under \$20m account for 7.9%.
 - The society's share investments in companies with a market capitalisation below \$20m is largely confined to industrial stocks. These companies account for 1.5% of the combined market capitalisation of all listed stocks, whereas they account for 2.3% of AMP's share portfolio. The AMP can thus be said to be 'overweighted' in its holding of under \$20m industrial stocks. The under \$10m industrials account for 0.4% of AMP's portfolio and they represent 0.3% of total market capitalisation.

3 Many of these companies would be speculative mining companies.

CHAPTER 33: THE STRUCTURE AND EFFICIENCY OF SECURITIES MARKETS AND PATTERNS OF SHARE OWNERSHIP

33.1 This chapter focuses primarily on the stock exchanges as **secondary** securities markets — their role, liquidity characteristics, stockbroking arrangements and general efficiency. However, the efficiency of stock markets bears directly on the ability of companies to raise funds in primary markets and on the price of those funds. The chapter therefore also examines listing requirements in the light of this interrelationship. (There is further discussion of primary markets in Chapter 38.) Other related issues discussed include the effect of changing patterns of share ownership on the efficiency of the stock market and the role of credit rating systems.

A. INTRODUCTION

33.2 The basic role of a stock exchange is to provide a market for the trading of securities by bringing buyers and sellers together.

33.3 In Chapter 1, three aspects of efficiency — allocative, operational and dynamic — were identified.¹

33.4 A stock market is efficient in an **allocative** sense where share prices accurately reflect the relative returns companies can offer investors. This will only happen where:

- the information available is adequate to permit a full evaluation of the risk and return to be made; and
- prices rapidly reflect all available information.

33.5 In such a market, companies will be able to raise equity funds on terms reflecting the risk-adjusted returns they can offer investors; and inefficient users of resources will be vulnerable to takeovers — although whether this is always an efficient means of resource allocation is open to question.²

33.6 A stock market is **operationally efficient** where the costs of transactions or of raising funds from the public are minimised.

33.7 A stock market is **dynamically efficient** where there is constant innovation

1 See also Peter H. Davies 'Equity Finance and the Ownership of Shares', in *AFSI Commissioned Studies and Selected Papers*, Part 3, AGPS, Canberra, 1981; Davies refers to informational efficiency. This is an aspect of allocative efficiency, and accordingly it is discussed briefly here in that context.

2 For a discussion of this issue, see Davies, *op. cit.*, Chapter 11.

and adaptation so as to meet the changing needs of those seeking to raise funds and those wishing to invest.³

33.8 The **overall efficiency** of the stock market (i.e. where the desire of savers to maximise the risk-adjusted return on their investments is consistent with minimising the cost to companies of raising equity finance) is most likely to be achieved where the following conditions are fulfilled:

- There are sufficient buyers and sellers to ensure a liquid and competitive market in the shares of listed companies; i.e. a market where investors can readily adjust their share portfolios without unduly disturbing the price of the securities concerned. This aspect of stock market efficiency is discussed in Sections B and C of this chapter.
- All participants have timely access to relevant and reliable information. This aspect is principally discussed in Chapter 21.
- Transaction costs are set by the free interplay of competitive market forces. The extent to which this condition is met is discussed in Sections D and E of this chapter.
- There is freedom of entry. This bears directly on operational efficiency and is discussed in Section E of this chapter.

B. THE LIQUIDITY OF THE STOCK MARKET

33.9 As noted in the preceding section, an important condition for an efficient stock market is that shares can be bought and sold in reasonable volume without causing sharp price fluctuations.⁴

33.10 When a company's shares are marketable (or 'liquid') the cost of new equity funds to the company is generally lower. This is the main advantage derived from listing.

33.11 Table 33.1, which updates Table 7.2 of the Interim Report, provides an international comparison of the liquidity of stock markets as indicated by turnover as a percentage of market capitalisation. Such comparisons must be treated cautiously because of the differing national characteristics of markets and investors. However, it is clear that the liquidity of most stock markets has improved in recent years after the weaker trend evident in the first half of the 1970s.

33.12 Table 33.2 disaggregates the turnover/capitalisation ratios for the mining and oil, and industrial sectors for the Melbourne Stock Exchange. The table shows that the improvement in the liquidity of the Australian share market in the last few years has not been confined to the mining and oil sector.

33.13 Another indicator of the liquidity of the market is the bid-ask spread. The evidence, while confirming that the Australian market is less liquid than the New

3 Davies discusses the costs of 'going public' in Chapter 11 of his report. In drawing attention to what he sees as the excessive costs of listing and to 'negligible experimentation in the methods of issuing equity to the public', he highlights an aspect of dynamic efficiency.

4 Market liquidity may be defined in several different ways. The two most common are the turnover/capitalisation ratio and the spread between buyer and seller prices. Low spreads are characteristic of markets with many informed participants and a high turnover of securities.

TABLE 33.1: VALUE OF TURNOVER AS A PERCENTAGE OF MARKET CAPITALISATION: SELECTED EXCHANGES

<i>Year ended 31 Dec.</i>	<i>New York</i>	<i>Tokyo</i>	<i>London</i>	<i>Brussels</i>	<i>Canada</i>	<i>Australia^(a)</i>
1970	18.1	54.9	14.1	9.1	9.2	12.5
1971	21.0	70.9	17.0	12.3	10.8	6.4
1972	19.7	63.0	19.3	12.6	14.6	9.7
1973	18.8	34.3	18.4	15.2	13.9	7.8
1974	16.4	32.1	24.5	12.6	9.8	6.9
1975	20.3	38.2	26.3	13.5	10.5	6.3
1976	20.6	49.5	18.7	15.8	14.5	6.8
1977	19.3	40.8	20.4	11.5	13.0	7.6
1978	24.5	52.6	16.9	10.9	18.6	8.4
1979	26.4	52.2	18.0	18.3	12.0	9.5
1980	35.2	51.1	20.5	18.0	14.3	14.8

(a) Figures for Australia are for year ending 30 June.

Source: Capital International Perspective, Geneva; AASE.

TABLE 33.2: VALUE OF TURNOVER AS A PERCENTAGE OF MARKET CAPITALISATION: MELBOURNE STOCK EXCHANGE

<i>Year ended 30 June</i>	<i>1975</i>	<i>1976</i>	<i>1977</i>	<i>1978</i>	<i>1979</i>	<i>1980</i>
Mining and oil	3.6	3.8	4.0	4.1	5.8	9.0
Industrial	2.7	3.1	3.6	3.7	4.2	5.9

Source: The Stock Exchange of Melbourne Limited, *Annual Report*, 1980.

York Stock Exchange, does not show significant changes in the spread over the period 1950–1980.⁵

33.14 In the light of the above evidence, the Committee concludes that there has been no long-term decline in the liquidity of the stock market in Australia. The decline in liquidity in the first half of the 1970s would seem to have been due primarily to cyclical factors.

33.15 Irrespective of recent trends, it is interesting to consider what scope there might be for increasing the liquidity of the Australian stock market, having regard to the greater liquidity apparent in at least some overseas markets. The role of ‘market makers’ is relevant here. One suggestion is that Australia should develop a **jobbing** system, comparable to that which operates in the UK, as a means of enhancing the liquidity of the market.

33.16 However, it should be noted that, in contrast to the situation in the United Kingdom, brokers in Australia are permitted to act as principal provided this fact is disclosed to the other party and no brokerage is charged.⁶ This dual role performed by brokers would seem to provide adequate scope for ‘market making’; the Committee sees no need for government intervention to create a jobbing system in Australia.

33.17 The Committee also believes that implementation of certain recommendations elsewhere in this Report will tend to enhance the liquidity of the share market in the future:

⁵ Davies, *op. cit.*, Chapter 13.

⁶ Sydney Stock Exchange, Rule 3.1.

- the recommendations for the removal of the 30/20 rule and other portfolio controls should allow equity investment to compete more equally with other forms of investment;
- the introduction of an integrated tax system would ease the tax burden on dividends for low income investors, while rectification of the anomalous treatment of realised losses under s. 26AAA would remove a bias against equity investments; and
- some of the suggestions made in Sections D and E of this chapter should also encourage a larger turnover in shares.

C. INDIVIDUAL INVESTORS AND THE STOCK MARKET

(a) Introduction

33.18 In this section two closely related questions are examined — the declining role of the individual investor and the increasing importance of the institutional investor.

33.19 When referring to the activities of the ‘individual investor’ the Committee has in mind not only the direct investments of individuals but also those made through trusts, family companies, nominee companies etc., where individuals retain continuing responsibility for the way their funds are invested.

33.20 The distinction between individuals’ direct and intermediated investments in the share market is an important one. Institutions hold shares on behalf of individuals, but through the process of intermediation the ultimate owners lose direct control over the allocation of their funds. To the extent that the investment behaviour of institutions differs from that of individual investors, any tendency towards the institutionalisation of savings and share ownership could have significant implications for the pattern of funds flows and the overall efficiency of the financial system.

33.21 The Committee has examined:

- the available data (including some provided by the consultancy which the Committee commissioned on this subject) in order to determine the trends which have occurred in share ownership;
- the factors responsible for these trends;
- some of the implications for the pattern of funds flows; and
- whether there is a role for government in encouraging the individual investor.

TABLE 33.3: OWNERSHIP OF SHARES, NOTES OR UNITS (DECEMBER 1980)

<i>Participation by age group</i>		<i>Participation by income group</i>		<i>Participation by sex</i>	
18-24	4.1%	Under \$10 000	6.8%	Male	8.0%
25-39	6.7%	\$10 000-14 999	5.2%	Female	7.7%
40-54	8.1%	\$15 000-19 999	12.7%		
55+	11.5%	\$20 000-24 999	9.0%		
		Over \$25 000	26.3%		
Average	7.9%	Average	7.9%	Average	7.9%

Source: McNair Anderson survey, op. cit.

33.22 In addressing itself to these issues, the Committee's concern is with the changing relative importance of individuals and institutions as shareholders; it is not concerned with the concentration of shareholdings among a few large institutions. This latter issue is discussed in Chapter 32.

(b) Trends in Share Ownership

33.23 On the basis of various studies commissioned, the Committee estimates that between one-half and three-quarters of a million people currently own shares in Australia⁷ — and that an average of 5.3 stocks is held per shareholder.⁸

33.24 Table 33.3 sets out the age, income and sex characteristics of individual shareholders. The 'share participation rate' refers to the number of shareholders in a particular group expressed as a percentage of the total number of people in that group.⁹ It is clear that the incidence of shareholding increases with age.¹⁰

33.25 On the basis of these results, it might be argued that, if those presently in the younger age groups were to continue to retain the same participation rate as they grow older, the number of individual shareholders would decline in the future. While such an outcome is possible, particularly given the growth in saving through superannuation funds, it is equally conceivable that younger people will invest more in shares as they grow older and their commitments ease. Indeed, the fact that the population is expected to 'age' slightly in the next decade may point to a rise in the overall share participation of the population.

33.26 The table also shows (not surprisingly) that the participation rate is much higher in the highest income group than in any of the other groups and smallest in the two lower income groups. It is interesting to note, however, that the participation rate is higher in the lowest income group than in the second lowest. This may reflect income splitting or the fact that many shareholders are retired and have a low measured income.¹¹

7 See Davies, *op. cit.*, Chapter 5; and McNair Anderson Report 'Investments and Savings, Australia, December 1980', AFSI, *Commissioned Studies and Selected Papers*, Part 4, AGPS, Canberra, 1981. Using data obtained from the 1975-76 ABS Consumer Finance Survey, Davies estimates the number of shareholders in Australia at 590 000 or 6.4% of the adult population. The McNair Anderson survey indicates that 785 000 people (7.9% of the adult population) owned or jointly owned shares, notes or units (in unit trusts) in December 1980. The difference between these figures can be explained by the timing and sampling methods of the two surveys, and the fact that the McNair Anderson survey question was not restricted to shares and involved some double counting of shares which were jointly owned.

8 This compares with three to four stocks per shareholder in the United States and six in the United Kingdom. (See Davies, *op. cit.*, Chapter 4.) Davies concludes from this that individuals' shareholdings are insufficiently diversified for such investment to be regarded as 'efficient'. While this may be true, it does not mean that individuals' investments overall are insufficiently diversified.

It should be recognised that individuals' shareholdings may form the riskiest part of a widely diversified portfolio — including housing, bank deposits and government paper. It is difficult, however, to assess the overall degree of diversification achieved by individual investors without knowing more about the dispersion of shareholdings, the types of shares held, the risk preferences of the investors, the characteristics of other assets held etc.

9 The figures derived from the survey relate to shares, notes and units; it is assumed here that the patterns revealed would broadly apply to shares alone.

10 Davies reports a similar result from the 1975-76 survey.

11 A similar result (based on weekly income groups) is reported by Davies, Chapter 5. He also shows that share ownership tends to be higher among professional and technical workers than among other occupational groups.

33.27 In order to examine trends in share ownership, the Committee arranged for some surveys of public companies to be carried out. First, a sample of companies was surveyed to determine how the number of shareholders has changed over time. These findings, and some additional material collected by earlier investigators, indicate that, although the number of shareholders tended to increase in the 1950s and 1960s, it declined (in absolute terms) in the 1970s for three-quarters of the companies in the sample. A recent Statex study also showed a declining trend in individual shareholdings.¹² There were signs of a reversal of the trend for some companies in the last two or three years.¹³

33.28 To obtain a more complete picture of developments in patterns of shareholdings in a typically large Australian corporation, a detailed analysis was carried out of the share register of BHP. This involved identifying the individual shareholders on the register even if their holdings were in the names of family companies etc., an objective which was achieved by asking for relevant information from a sample of shareholders whose nature was not obvious from the entry in the register. It was also necessary to obtain information on the composition of bank nominee holdings; this is set out in Table 33.4.

TABLE 33.4: BENEFICIAL OWNERSHIP OF BHP SHARES HELD BY BANK NOMINEES (1979) (%)

	<i>Residents</i>	<i>Non-residents</i>	<i>Total</i>
Institutional & corporate	29.0	65.0	94.0
Persons	3.8	2.2	6.0
	<u>32.8</u>	<u>67.2</u>	<u>100.0</u>

Source: Davies, *op. cit.*, Chapter 6.

33.29 Table 33.5 sets out the beneficial owners of shares in BHP in 1970 and 1979. It is clear from this table that there has been a decline in the **proportion** of BHP shares held by individuals (even if the holdings of private investment companies and trustee companies are added to those of 'persons'). Two other major conclusions are:

- the proportion of shares held by institutions (life offices, general insurance companies and superannuation funds) increased from 15.7% in 1970 to 24% in 1979; and
- the proportion of shares held by non-residents (at 21.8%) has increased slightly over the period 1970–79.

33.30 The same broad trends are also evident in the aggregate data set out in Table 33.6. This indicates that households and unincorporated enterprises have generally been heavy net sellers of shares throughout the 1970s.¹⁴ Institutions have been net buyers of shares throughout the period. There are also indications that overseas investors have been purchasing equities extensively over the postwar period, especially in recent times.

12 'Investors Left out in the Cold', A. Jury, *Australian Business*, 13 August 1981.

13 Davies, *op. cit.* Davies also presents evidence to show that the percentage of shares held by the top twenty shareholders has increased since 1953–54. Davies suggests that, as bank nominee holdings in the top twenty tend to be collections of quite fragmented holdings, the trend towards greater concentration may be overstated by these figures.

14 The figures for the household sector are calculated as a residual in the flow of funds accounts on which this table is based. Therefore, they can be taken only as indicative of general trends.

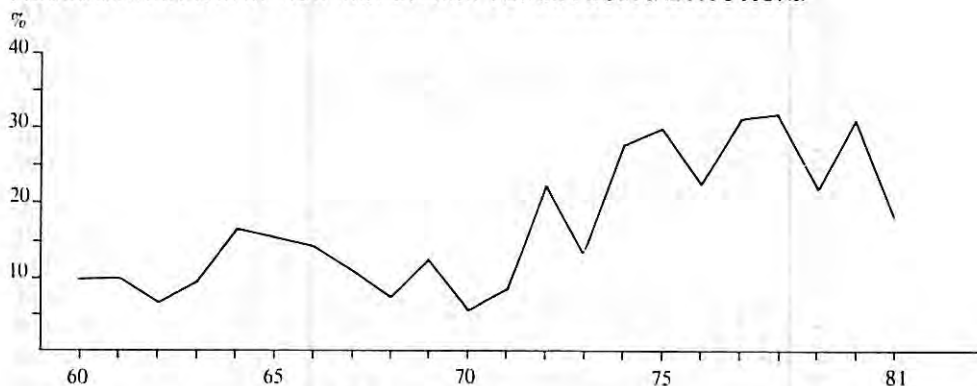
TABLE 33.5: BENEFICIAL OWNERSHIP OF BHP SHARES (%)

Holder	Proportion held		Resident		Non-resident	
	1970	1979	1970	1979	1970	1979
	Bank nominees	2.0	4.7	1.6	—	0.4
Non-bank nominees	3.2	1.7	2.8	1.2	0.4	0.5
Life offices	6.1	9.5	5.6	8.4	0.5	1.1
General insurance companies	1.2	1.6	0.7	0.8	0.5	0.8
Superannuation funds	8.4	12.9	8.3	12.4	0.1	0.5
Non-profit institutions	0.2	0.2	0.2	0.2	—	—
Companies (undefined)	9.2	13.2	4.1	4.3	5.1	8.9
Public companies	5.4	1.5	2.2	1.3	3.2	0.2
Private investment companies	7.0	9.5	6.9	9.3	0.1	0.2
Trustee companies	5.4	2.9	3.4	2.9	2.0	—
Persons	51.9	42.3	44.9	37.4	7.0	4.9
Total	100.00	100.00	80.7	78.2	19.3	21.8

Source: Davies, *op. cit.*, Chapter 6.

33.31 A similar trend is evident in the pattern of new equity capital raisings by Australian companies. Figure 33.1 indicates that the percentage of the total raised from institutions increased over the 1970s.

FIGURE 33.1: SOURCE OF NEW MONEY: NEW FUNDS FROM INSTITUTIONS



Source: ABS Catalogue No. 5628.0

33.32 Comparable trends have occurred in other countries. For example:

- In the United States the incidence of share ownership (as measured by the ownership survey of the New York stock exchange) increased through the 1950s and 1960s — from 4.2% of the population in 1952 to 15.1% in 1970. It then fell to 11.9% in 1975, but the 1980 survey showed some recovery to 13.6%. However, the median size of the portfolio was less than half that of the 1975 survey, suggesting that total share holdings of households may still be declining.¹⁵

¹⁵ See Davies, *op. cit.*, Table 4.3.

TABLE 33.6: ACQUISITION OF SHARES IN AUSTRALIAN COMPANIES: BY SECTOR

Year ended 30 June	Life offices and pension funds		Non-Life insurance companies		Other financial enterprises		Corporate trading(b) enterprises		Households(a)		Rest of world		Total	
	\$m	%	\$m	%	\$m	%	\$m	%	\$m	%	\$m	%	\$m	%
1967	104	43.9	29	12.2	38	16.0	—	—	-71	-30.0	137	57.8	237	100.0
1968	100	35.1	27	9.5	12	4.2	—	—	-279	-97.9	425	149.1	285	100.0
1969	201	29.1	46	6.7	106	15.3	—	—	-161	-23.3	499	72.2	691	100.0
1970	200	29.0	32	4.6	125	18.1	—	—	50	7.2	283	41.0	690	100.0
1971	149	24.0	84	13.5	31	5.0	—	—	42	6.8	316	50.8	622	100.0
1972	196	35.1	-33	-5.9	101	18.1	—	—	108	19.4	186	33.3	558	100.0
1973	339	50.9	-3	-0.5	192	28.8	—	—	-213	-32.0	351	52.7	666	100.0
1974	259	60.4	160	37.3	154	35.9	—	—	-85	-19.8	-59	-13.7	429	100.0
1975	103	27.8	-85	-23.0	76	20.5	—	—	278	75.1	-2	-0.5	370	100.0
1976	329	54.2	30	4.9	207	34.1	—	—	-105	-17.3	146	24.1	607	100.0
1977	540	60.9	78	8.8	147	16.6	—	—	155	17.5	-34	-3.8	886	100.0
1978	418	56.9	56	7.6	186	25.3	—	—	-45	-6.1	119	16.2	734	100.0
1979	567	139.7	365	89.9	274	67.5	—	—	-849	-209.1	49	12.1	406	100.0
1980	846	67.1	36	2.9	617	48.9	—	—	-970	-76.9	732	58.0	1 261	100.0

(a) The figures for households have been derived as residual.

(b) The take-up of shares by corporate trading enterprises has been assumed to be zero. Although these companies do hold shares in financial enterprises, available information suggests that increases in holdings have been small.

Source: Reserve Bank of Australia.

- The Wilson Committee reported that, whereas in 1957 the proportion of shares owned by individuals in the United Kingdom was 66% and by institutions 21%, the 1979–80 figures were 32% and 52% respectively.¹⁶

(c) Some Explanations of the Trends

33.33 The trends outlined in the previous section may be regarded as a shift by individuals from direct to indirect investment in equities. Individuals derive a number of advantages by investing in shares indirectly:

- they obtain a stake in a diversified share portfolio and, therefore, a risk/return combination which may be more suitable to their needs than can be obtained by investing directly in a small portfolio of stocks;
- they may make ultimate savings in transactions costs, particularly where a portfolio is actively managed; and
- they enjoy the convenience, and in many instances the rewards, of having their funds professionally managed, even if these are comparatively small.

33.34 Although individuals may face heavy ‘front end’ costs, and may lose some discretionary power regarding the deployment of their funds, indirect investment through institutions provides the only means for some small investors to invest in a diversified share portfolio.

33.35 The Committee notes that, under the French ‘*Loi Monory*’ scheme, a tax concession was given for purchases of shares, but that most investors chose to take this concession by investing through special mutual investment funds rather than by directly purchasing shares.

33.36 An important reason for the decline in direct share investment has been the increasing volume of ‘contractual’ savings. Many individuals are virtually ‘captive’ savers for their retirement through insurance companies and superannuation funds. There are also substantial tax advantages involved in investing through institutions — in particular, superannuation funds. This point is touched on below and is discussed in greater detail in Chapter 15.

33.37 It is reasonable to assume that some of the funds invested in shares through institutions would not have been directly invested in equities if individuals had retained control of the funds themselves. Table 33.3 indicates that households with incomes below \$20 000 tend not to hold shares. Since these households frequently contribute to life insurance and superannuation funds, it is quite possible that the switch to indirect investment has actually **increased** the amount invested in shares.

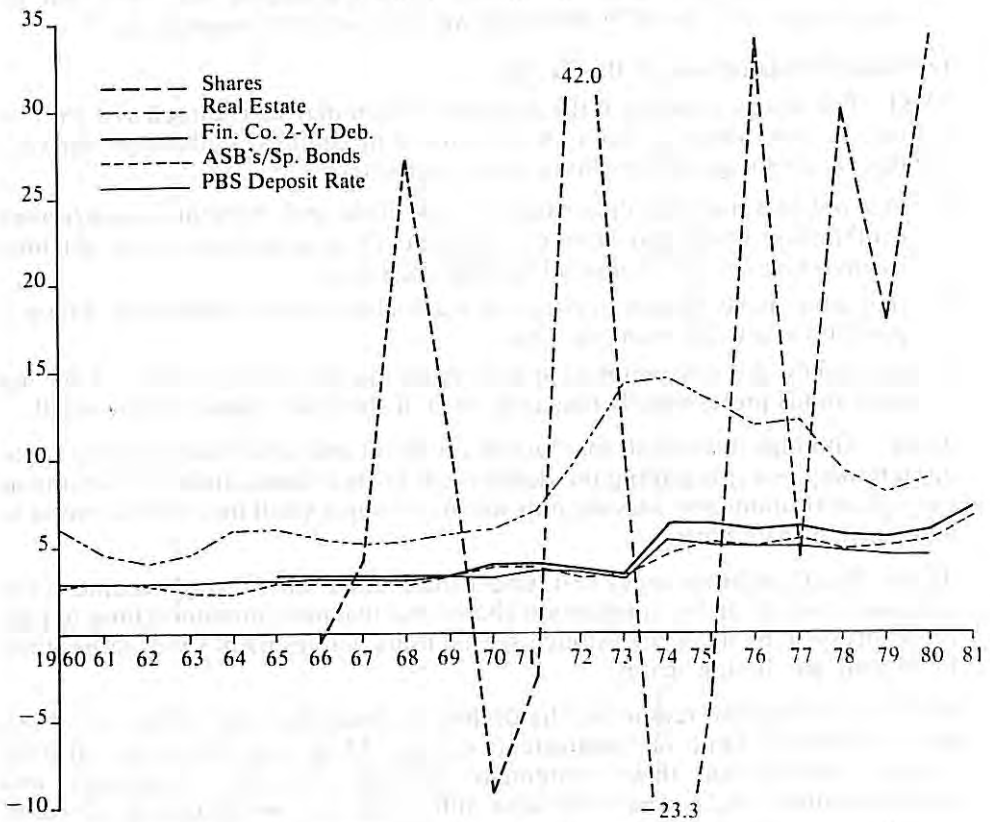
33.38 In addition, it must be recognised that in the uncertain economic climate of the 1970s, the risk/return characteristics of shares have not been as attractive as those possessed by other investments available to the individual investor — in particular, certain classes of real estate.

33.39 The nature of this problem is indicated by Figure 33.2, which shows the after-tax return on shares and other selected household investments.

33.40 It is clear that the return on shares showed a high degree of **variability** in the period covered by Figure 33.2. The uncertainty arising from this source was

16 *Report of the Committee to Review the Functioning of Financial Institutions*, HMSO, London, June 1980, Chapter 4, paragraphs 250–251.

FIGURE 33.2: AFTER-TAX RATES OF RETURN ON SELECTED HOUSEHOLD INVESTMENTS (%)



Source: RBA Statistical Bulletin

Aust. Assoc. Permanent Building Soc.

AFSI — Stutex Study

Department of Housing and Construction. Based on methodology used by R.J. Filmer and R. Silberberg, and reported in their paper 'A Model of the Australian Housing Sector,' published in *Housing Economics: Papers Prepared for National Housing Economics Conference 1978*, Australian Government Publishing Service, Canberra 1980. For further information contact the Department of Housing and Construction, Canberra.

augmented by the effect of inflation and economic stagnation.¹⁷ It is likely that the risk perceived to be attached to shares increased substantially over this period, leading many investors to favour other assets.

33.41 The major alternative for many investors was real estate in general and housing in particular.¹⁸ As Figure 33.2 shows, the after-tax return on real estate (housing) has been markedly less variable over the 1970s than the return on shares. Moreover, during most of this period the return to investment in these

17 The same factors may have caused an increase in the liquidity preference of investors. This would lead them to favour short-term government paper or deposits over share investment.

18 This point is discussed in some detail in Davies, *op. cit.*, Chapter 8.

fields has been higher than that obtained on shares. This was partly due to the particular tax treatment:

- owner-occupiers are not taxed on the imputed rental value of their dwelling; and
- both shares and real estate often escape taxation of any capital gains; however, by taxing profits made on the sale of assets held for a short time, s. 26AAA impacts more directly on shares than on real estate. Inflation has moved many Australians into higher tax brackets; this will have made the capital gains associated with investment in housing more attractive to them.

33.42 The Committee does not know of any completely satisfactory published series on the return on investment in housing. The one shown in Figure 33.2 was obtained from the Department of Housing and Construction. In the view of the Committee, it may have underestimated the return on home ownership for the following reasons:

- the price series used is a 'cost of construction' series which underestimates the capital gains made on housing; in particular, it takes partial account only of the important contribution made by the increasing value of land in a number of areas¹⁹; and
- the series is the return on the purchase price of a dwelling and does not indicate the gains which can be made from a geared investment.

33.43 It is clear from this discussion and from other evidence — such as the high yields produced by property trusts — that on a risk/return basis, investment in housing has been more attractive than direct purchase of shares in the 1970s.

33.44 Furthermore, there have been important demographic influences encouraging the purchase of housing rather than shares. During the late 1960s and early 1970s, the population composition arising out of the postwar baby boom caused an increase in household formation and, therefore, in the demand for housing. For the same reasons, people have had an inducement to save with housing finance institutions in order to secure eligibility for loans.

33.45 Based on the experience of the 1970s, it appears that investors have become more responsive to return differentials (adjusted for risk) on different assets, particularly over a period when inflation has been a factor working towards a widening of these differentials.²⁰ On this assessment, the withdrawal of individual investors from the share market has largely reflected the greater perceived attractiveness of other avenues of investment, particularly real estate.

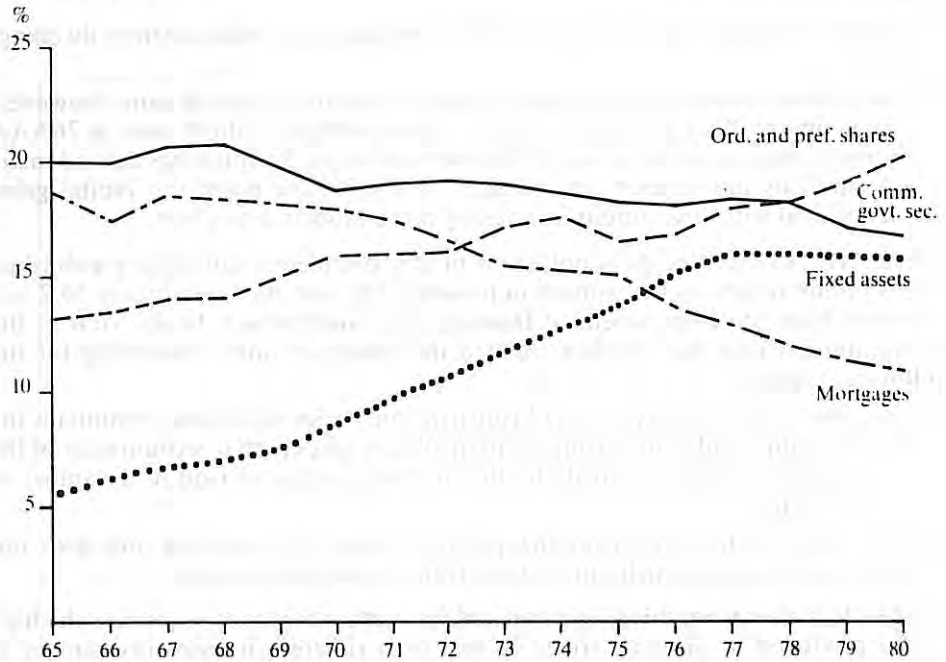
33.46 One factor in the decline in the number of individual shareholders may be the higher unit brokerage rates paid on small transactions. As well, there is some evidence that, in periods of buoyant share prices, potential new small investors have been turned away by some stockbrokers.

33.47 By contrast with individual investors, the composition of the portfolio of the large institutions — life offices and superannuation funds — has swung sharply in favour of shares over recent years. This is illustrated in Figure 33.3. Mortgage

¹⁹ See Davies, *op. cit.*, Chapter 8.

²⁰ The greater fluidity in funds flows in recent years is reflected in the initial success of Australian Savings Bonds and, more recently, of cash management trusts, as well as in the renewed attraction of fixed-term deposits offered by banks.

FIGURE 33.3: LIFE OFFICES AND PENSION FUNDS: SELECTED ASSETS AS A PERCENTAGE OF TOTAL ASSETS



Source: RBA Statistical Bulletin

lending and government security holdings have grown much more slowly than investments in shares and fixed assets (principally property investments).²¹

33.48 Equities are more attractive to institutions than individuals for the following reasons:

- they can more effectively reduce the risks associated with share investment by holding a diversified portfolio;
- there are economies in dealing in large parcels resulting in a lower transaction cost per share;
- life offices receive an s. 46 rebate on dividends received; and
- superannuation funds receive ‘favoured’ tax treatment on their investment income, including investment in shares.²²

(d) Implications of the Trends

33.49 Some fears have been expressed about the effect of increasing institutional dominance on the efficiency of the share market and on the availability of funds to certain classes of business.

²¹ However, the pattern has been distorted, particularly in recent years, by the increasing proportion of life office and superannuation fund assets that has been brought to account at market values. This has had the effect of substantially decreasing the values of all fixed-interest securities and dramatically increasing the value of shares held.

²² See Chapter 13 of the Interim Report and Chapter 15 of this report for details of taxation provisions in respect of superannuation.

33.50 Some commentators have expressed concern that institutions may be too conservative in their choice of investments, because of portfolio restrictions and their perceived 'trustee' responsibilities. It is also suggested that they prefer to deal in large parcels of shares and seek to avoid taking dominant equity positions for fear of being 'locked in' and becoming involved in the day-to-day management of companies; they therefore tend to confine themselves to the shares of only the larger, well-established companies, neglecting the shares of smaller or new businesses — even where they offer a higher risk/reward combination.

33.51 In order to evaluate these claims, the Committee has sought some information from a sample of life offices. The impression gained from the replies received, as well as from a related study of institutional ownership patterns, (see Appendix 32.1) is that **in respect of listed shares** there is no uniform tendency for life offices to confine their share investments to larger, well-established companies.²³ To the extent that a number of life offices do follow such a policy, however, a contributing factor may be the reluctance of substantial shareholders in smaller listed companies to sell their shares.

33.52 It is also evident that life offices, as a general rule, do not invest significant amounts in **unlisted companies**. It is possible that the higher risk involved, the difficulty of obtaining information to evaluate these investments²⁴ and the limited secondary markets for such shares might have been contributing factors. These problems apply at least as much to individual investors.²⁵

33.53 Another concern is that institutions focus too narrowly on the market for existing shares and rights issues arising therefrom, and thus make insufficient contribution to new company floats. The Committee has seen no clear evidence of any such behaviour by institutional investors.

33.54 A common concern of the 1970s has been that savings might not be aggregated on a sufficient scale for large-scale resource projects to be financed domestically. There is some evidence that institutions have been increasingly willing to diversify into large-scale resource development projects (often with foreign partners). Through their increasing participation in large investment projects, they have done much to meet a deficiency in this area of finance.

23 The Committee has also examined the share portfolio of the largest life office, the AMP. It has only 0.4% of its share portfolio invested in companies with a capitalisation of less than \$10m and 2.3% of its portfolio in companies with a capitalisation of less than \$20m. By contrast, companies with a capitalisation of less than \$10m account for 3.7% of the capitalisation of all companies listed on the Sydney Stock Exchange, and those of less than \$20m account for 7.9%.

While this suggests that the AMP does favour larger, well-established companies, the figures need to be interpreted carefully. The AMP's share investments in companies with a market capitalisation below \$20m is largely confined to **industrial stocks**. Thus, while these account for 2.3% of the AMP's share portfolio, such stocks account for 1.5% of the combined market capitalisation of all listed stocks. The AMP can therefore be said to be 'overweighted' in its holding of 'under \$20m' industrial stocks. The 'under \$10m' industrials account for 0.4% of AMP's portfolio whereas they represent 0.3% of total market capitalisation.

24 Unlisted companies are not subject to the more stringent reporting requirements that listing entails.

25 Whether the availability of capital to unlisted companies is adequate in an economic sense is a complex question and cannot be assessed separately from the competing needs of other sectors, the risk and return from such investments and the risk preferences of the community as a whole. The Committee recommends in Chapter 38 that, if governments wish to provide assistance to small businesses, it might take the form of taxation relief for subscriptions to small business investment companies.

33.55 In summary, there is no strong evidence to suggest that the institutionalisation of share ownership *per se* necessarily works to the disadvantage of the smaller, newer (but not necessarily unproved) listed companies. More generally, institutions are likely to have greater capacity to offset risks by diversification than individuals. A quite separate issue is whether small, newer businesses are disadvantaged by the **concentration** of assets among a few large institutions. This issue is discussed in Chapter 32.

33.56 It is also argued that there is insufficient diversity among institutions with respect to their investment strategies, with a consequent 'famine or flood' in the availability of capital to particular areas in the economy. By implication, this process is thought to generate large price distortions, structural strains in labour and product markets, and the neglect of some areas of investment.

33.57 Although there are insufficient data to form a definite judgment on this question, such evidence as is available suggests that the concerns are largely unfounded. Life offices, superannuation funds, unit trusts etc. are not homogeneous in size and activity, and respond differently to changes in the range of investment opportunities.²⁶ The investment objectives and strategies of individual institutions can be very different; this is illustrated in Table 33.7, which shows the broad composition of the portfolios of ten small life offices on the one hand and the industry in general on the other.

TABLE 33.7: COMPARISON OF THE ASSETS DISPOSITION OF TEN SMALLER LIFE OFFICES (%)

<i>Assets</i>	<i>Ten offices</i>	<i>Industry</i>
Shares	21.8	18.7
Property	5.6	24.5
Total equity	27.4	43.2
Government paper	39.1	32.3
Other fixed interest securities	33.5	24.5
Total fixed interest securities	72.6	56.8

Source: Davies, *op. cit.*, Chapter 7.

33.58 The Wilson Committee in the UK gave some attention to this issue and also decided that there was little evidence to support the view that institutions as a group pursue uniform investment policies.²⁷

33.59 On a more general level the behaviour postulated by critics (conservative investment patterns, undue emphasis on large, well-established companies, narrow focus on existing shares etc.) implies that institutions do not seek to maximise the rate of return on their investments. Given the high degree of competition among funds' managers, it seems inconsistent both with theory and with their recent behaviour to suggest that institutions as a whole are unresponsive to relative returns.

²⁶ For a discussion of the different investment strategies adopted by funds of different sizes in recent years see the *Business Review Weekly*, 6-12 June 1981, pages 38-9.

²⁷ This lack of uniformity also means that the level of concentration among institutions can have a significant influence on the allocation of funds. The issue of concentration is discussed in Chapter 32.

33.60 Beyond these arguments bearing on the allocative efficiency of the stock market, there is also the contention that the growing institutional presence has damaged the technical, operating efficiency of the share market. One such view is that institutions, because they are reluctant to turn over their shares, create a thin market which damages market liquidity.

33.61 It is true that large institutions may be discouraged at times from selling for fear of the impact on prices. They are to some extent 'locked into' large shareholdings, especially in medium and small companies. However, experience during the later 1970s has been that institutions are often very active share traders. Indeed, being professional funds managers, they are likely to review their portfolio more frequently than individual investors.

33.62 Section B of this chapter examined the trend in stock market liquidity and concluded that there was no evidence of a long-term decline; prima facie, this suggests that the growing institutional presence in the share market has not had a sustained adverse effect on its liquidity.

33.63 Therefore, on the basis of both *a priori* reasoning and empirical observation, the Committee is inclined to doubt that institutionalisation of share ownership *per se* damages the **liquidity** of the share market. In addition, the fact that a large proportion of the funds invested in shares is under the control of professional fund managers may enhance the efficiency and stability of the share market. Professional investors are less likely to allow share yields to move too far out of line with returns on other investments.

33.64 The Committee is aware, however, that overseas attitudes on the optimum method of managing portfolios are in a state of flux and that, if some of the approaches being tested in other countries were adopted in Australia, the increase in the relative importance of institutions may lead to a reduction in both the technical and allocative efficiency of the stock exchange. Two more or less polar examples can be mentioned:

- it has been suggested that institutions can gain most of the benefits of diversification by holding a small number of carefully selected shares;
- on the other hand, it has also been argued that a relatively passive investment policy based on the purchase, and long-term retention, of a very wide and fully representative group of shares provides a return which is at least as high as a policy of active portfolio management, because the latter involves substantial transactions costs.

33.65 If Australian institutions — which at present generally pursue policies midway between these extremes — were all to adopt either of these approaches, the conclusions of this section may no longer be valid.

33.66 In considering all of these arguments, it must be remembered that overseas investors are currently playing an increasingly important role in Australian share markets (see Tables 33.5 and 33.6); the evidence suggests that their periods of highest activity and the pattern of their investments do not necessarily correspond with those of domestic institutions. Indeed, it would be surprising if they did because many of the factors to which overseas investors react (international economic conditions, exchange rate expectations etc.) have much less influence on local investors.

33.67 To sum up, therefore, the Committee can see no basis for public concern about the **efficiency** implications of the long-term trend towards

institutionalisation of share ownership – i.e. the substitution of institutions for individuals as owners of corporate shares.

(e) Role of Government

33.68 Nevertheless, the Committee recognises that the Government may have reasons for wishing to see greater individual participation in equity investment – **in addition to, rather than in lieu of**, institutional participation. For example, it may see it as a means of easing some degree of public concern about the high level of concentration of share ownership and the absence of clear lines of accountability in some cases.

33.69 A desire to encourage greater individual share buying may also stem from judgments about the desirability of direct community participation in the ownership of Australian corporations and resources – what is sometimes called ‘people’s capitalism’ or shareholder democracy. Specifically, it is felt that sectional conflicts can be reduced through a wider dispersion of shareholdings. This is an important social issue, but, as noted on many other occasions, the Committee’s terms of reference do not extend to an evaluation of such issues.

33.70 Small individual investors undoubtedly face some problems in entering the share market directly – higher brokerage costs, minimum transaction size, a limited ability to research intended investments fully, and an inability to achieve adequate diversification within a limited investment budget. In general, these are not market imperfections but rather reflect difficulties inherent in any small transactions; indirect investment via an institution is one evolutionary response by the system to the problem. However, those of the Committee’s recommendations elsewhere in this Report which may enhance the liquidity of the market should facilitate greater involvement by individual investors.

33.71 Some countries have introduced taxation arrangements which offer positive encouragement to individuals to invest in shares:

- in the United States the first US\$200 of dividend income to an individual is non-taxable;
- in Canada, the first Can\$1000 of interest and dividend receipts are excluded from taxable income;
- New Zealand offers a tax rebate on dividend income for taxpayers whose taxable income is less than \$NZ8000. The maximum rebate allowed is \$NZ400;
- In France, the ‘*Loi Monory*’ scheme introduced in July 1978 allowed each household to deduct from taxable income their new net investment in the shares of French companies, up to a ceiling of F5000 per year (approximately \$A800), with higher limits where there are dependent children. The scheme was operative for new net investments made during the period 1978–1981. With certain exceptions, such as for pensioners, their share investments had to be held for at least four years. As the highest personal tax rate in France is 60%, the maximum allowable deduction was therefore F3000 (\$A500). This concession is being reviewed by the new French Government which took office in 1981.

33.72 These overseas schemes must be considered in the light of the particular policy circumstances and objectives relevant to each individual country. For example, the main objective of the ‘*Loi Monory*’ scheme, apart from encouraging wider ownership, was to foster the development of the stock market in order to

encourage French companies to reduce their relatively high debt/equity ratios and their heavy dependence on short-term debt. As the Committee notes in Chapter 34, neither of these appear, at this stage, to warrant special government intervention in Australia.

33.73 The Committee recognises that under the present 'classical' system of corporate taxation, many potential shareholders in the lower and middle income ranges might be **discouraged** from investment in equities. In Chapter 14, the Committee recommended that an integrated system of company and personal taxation be adopted to remove these inherent disincentives to lower income investors. The recommendation goes further in the pursuit of this objective than the partial tax integration schemes currently operating in some countries; for example Canada, the United Kingdom and West Germany. It is, however, designed to achieve a more **neutral** tax system; the aim is **not** to build a **bias in favour** of individual investors.²⁸

33.74 The Committee is unconvinced of the need, *on efficiency grounds*, for government measures to discriminate in favour of direct share investments by individuals. The *social* considerations are a matter for judgment by government.

33.75 Institutions are expected to be sensitive to community values and aspirations in respect of their investment policies. It should be recognised, however, that the community cannot demand a 'social orientation' in institutional investment policies and at the same time expect to reap the full benefits of a competitive and efficient institutional structure. Nonetheless, the fact that the obligations of contractual savings institutions are long-term in character, and their members come from a very wide cross-section of the community, enables these institutions to adopt a broad, longer term investment perspective, subject to the need to achieve a satisfactory and equitable distribution of returns to all their members.

D. BROKERAGE RATES

33.76 Having regard to the implications of transaction costs for the overall efficiency of the stock market, the Committee now turns to discuss brokerage rates. These rates are currently determined by the Council of the Australian Associated Stock Exchanges (AASE); the method of fixing brokerage rates is currently under consideration by the Trade Practices Commission.

33.77 Earlier in this chapter, the view was expressed that an important pre-condition for maximising the overall efficiency of the stock market is that transaction costs should be set by the free interplay of competitive market forces.²⁹ Those who favour retaining the present approach to the fixing of rates need therefore to establish that there are advantages which outweigh the potential loss of the benefits of competition.

33.78 Various arguments have been advanced against the introduction of competitive brokerage rates. These include concern for:

28 The suggestion that the Government might encourage small investors by providing assistance to a unit trust type of national investment fund is discussed in Chapter 35.

29 The Committee endorses, for example, the competitive approach to the determination of underwriting fees — although it is perhaps significant that other financial institutions have played a role in this area. No other such influences exist in respect of broking services.

FIGURE 33.4: U.S. COMMISSION RATES AS A % OF PRINCIPAL

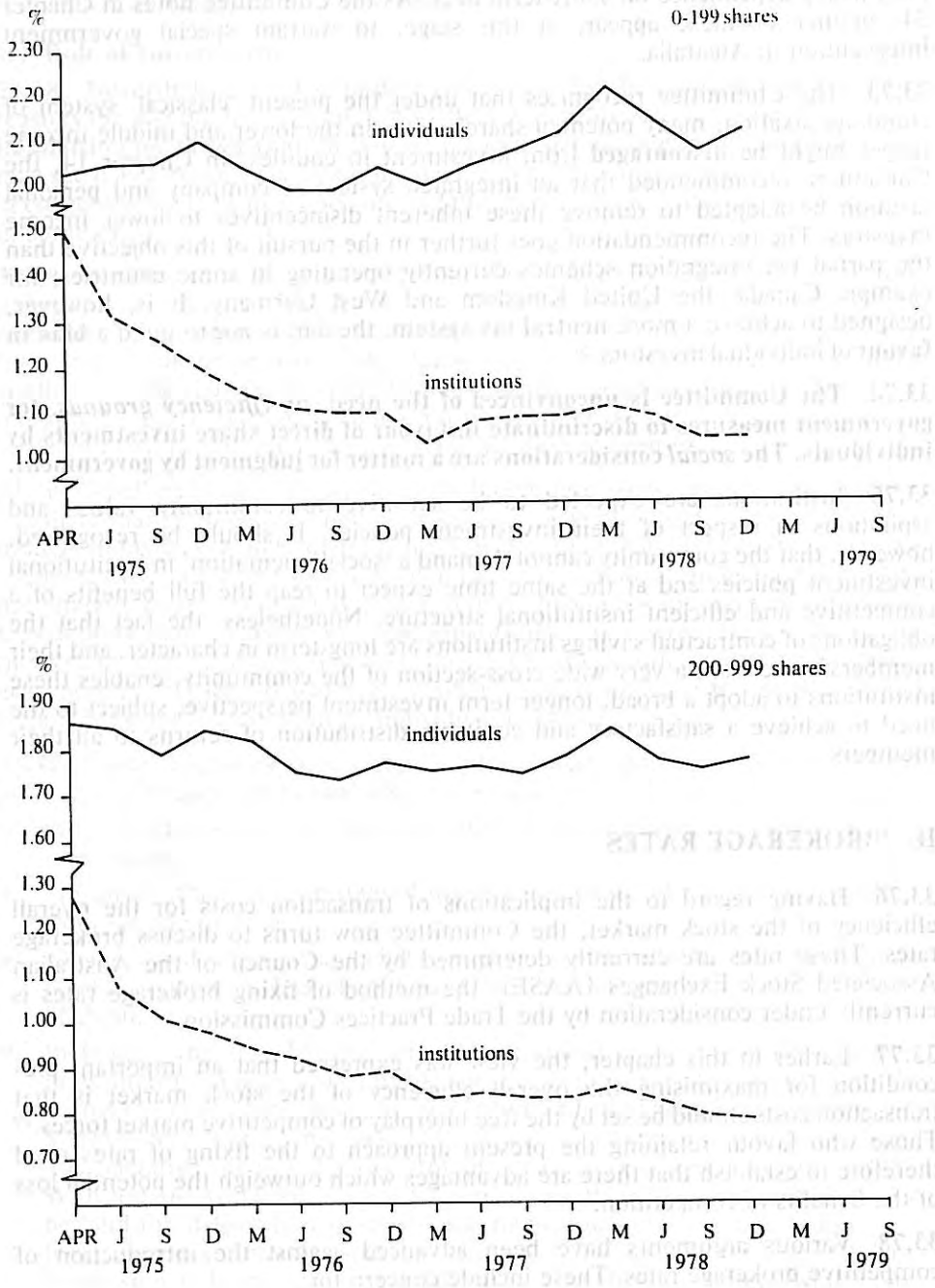
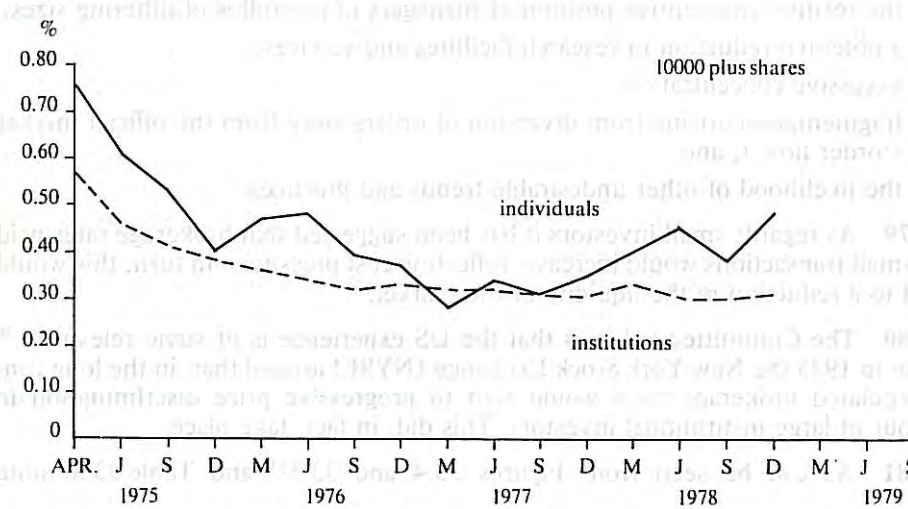
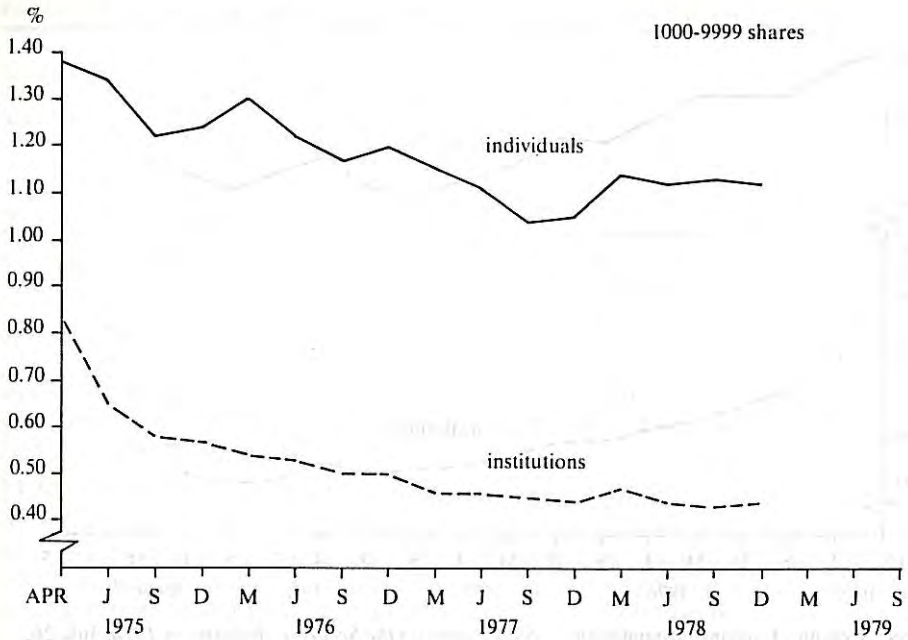
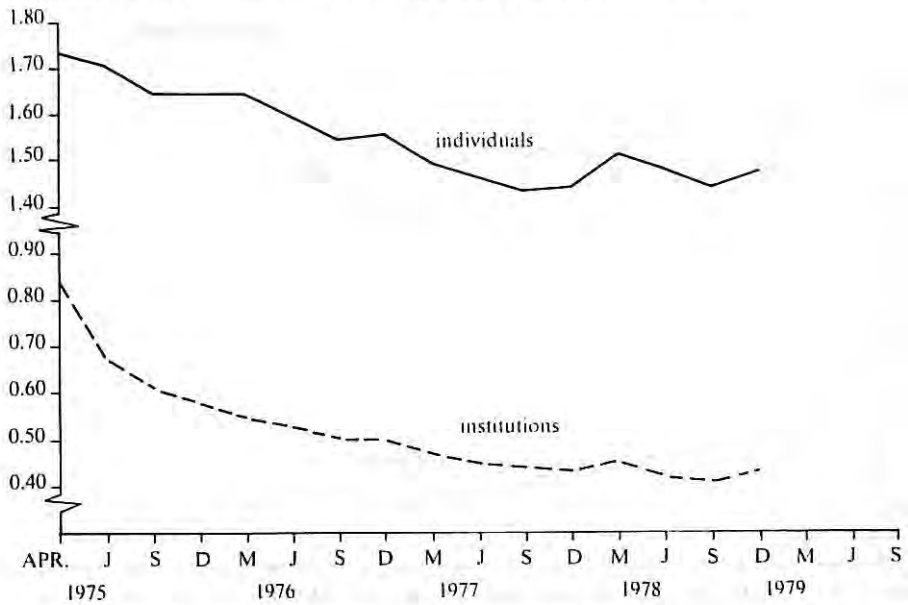


FIGURE 33.4 (continued)



Source: Securities and Exchange Commission. Staff Report on the Securities Industry in 1978, July 26, 1979

FIGURE 33.5 U.S. COMMISSION RATES AS A % OF PRINCIPAL: AVERAGE



Source: Securities Exchange Commission — *Staff Report on the Securities Industry in 1978*, July 26, 1979

- small investors;
- the relative competitive position of managers of portfolios of differing sizes;
- a potential reduction in research facilities and services;
- excessive concentration;
- fragmentation arising from diversion of orders away from the official market ('order flow'); and
- the likelihood of other undesirable trends and practices.

33.79 As regards small investors it has been suggested that brokerage rates paid on small transactions would increase, reflecting cost pressures. In turn, this would lead to a reduction in the liquidity of the market.

33.80 The Committee believes that the US experience is of some relevance.³⁰ Prior to 1975 the New York Stock Exchange (NYSE) argued that, in the long run, deregulated brokerage rates would lead to progressive price discrimination in favour of large institutional investors. This did, in fact, take place.

33.81 As can be seen from Figures 33.4 and 33.5³¹ and Table 33.8 quite

30 In the following discussion, the Committee has referred in some detail to the US experience since brokerage rates were deregulated on 1 May 1975. While it acknowledges that there are significant differences in the way that stock markets operate in the United States, and that the US markets are substantially larger than the Australian stock markets, the US experience should still give a broad indication of what might be expected to happen in Australia if brokerage rates were deregulated.

31 While the series on which these figures is based is only available to the end of 1978, figures provided in the SEC *Staff Report on the Securities Industry in 1979*, published in July 1980, indicate that the trend remained substantially unchanged.

TABLE 33.8: EFFECTIVE COMMISSION RATES — NYSE MEMBER FIRMS

(% change between April 1975 and end 1979 in commissions as % of principal value)

<i>Number of shares</i>	<i>Individual investors</i>	<i>Institutional investors</i>
less than 200	2.5	-28.0
200- 999	-7.0	-38.3
1 000-9 999	-21.0	-50.6
10 000 or more	-40.8	-50.9
All trades	-17.9	-54.8

Note: The reduction in brokerage rates is overstated inasmuch as the April 1975 rates included research whereas the 1979 rates were solely for share transactions, a separate charge often being made for research.

Source: 'Survey of Commission Charges on Brokerage Transactions'; SEC, *Staff Report on the Securities Industry in 1979*, July 1980.

significant reductions occurred in the effective commission rates payable by institutions and the larger individual investors. The smaller individual investor, however, paid more.³²

33.82 In the light of the US experience, the Committee concludes that, as a consequence of brokerage deregulation, managers of large portfolios are likely to gain an advantage over managers of small portfolios. As well, it is probable that small transactors will pay more under competitive brokerage rates for a 'fully serviced' transaction than they do now. There is no solution to this — unless it is attended to as a social matter (see paragraphs 33.68-74). It is simply (and as previously noted) that small transactions (whether it be in stockbroking or in any other activity) cost relatively more to 'fully service' than large transactions. One would expect the more sophisticated of the small transactors to use discount brokers³³: as a consequence, their brokerage costs would be lower. In any event, a competitive environment should ensure that charges for 'fully serviced' small transactions are kept reasonable. (It may be that the less sophisticated small investors would prefer fixed rates, especially if these were subject to the influence of an independent authority.)

33.83 Moreover, periodic reports in Australia of the difficulty of small investors gaining access to stockbrokers at times of buoyant share activity suggest that fixed rates do not always benefit such investors. A similar situation apparently existed in the United States prior to the introduction of negotiated brokerage rates; two surveys of investor attitudes between 1970 and 1973 showed that the principal cause of individual investors' disenchantment with equity investment was the preference of brokers for dealing with institutional intermediaries.³⁴ Between 1969 and 1972, the percentage of NYSE firms indicating a willingness to deal with all classes of individual investors declined from 83% to 50%.³⁵

32 In interpreting Figures 33.4 and 33.5 and Table 33.8, it should be noted that the average value per share is considerably higher in the USA than in Australia.

33 Discount brokers offer an order execution service only, their commissions being about 50% of those charged by brokers offering the full range of services. In 1979 there were about 100 discount brokers, accounting for about 8% of the retail brokerage market.

34 It is relevant that, despite the increase in brokerage rates on small transactions, there was a marked recovery (from 11.9% to 13.6%) between 1975 and 1980 in the incidence of share ownership in the population as a whole. While there is no sound basis for concluding that this recovery was associated with the deregulation of brokerage rates, it suggests that higher brokerage rates on small transactions were not a discouraging factor.

35 'Report on the Consequences of the Elimination of Fixed Stock Exchange Commission Rates and Restrictions on Stock Exchange Membership in the United States', D. R. Ratner, pages 4, 7 and 10. Appended to Submission by AMBA to the Trade Practices Commission, June 1981.

33.84 As regards research, it is claimed that negotiable brokerage rates might force member firms to reduce the resources they allocate for this facility. The US experience is not clear but it seems that many individual investors have been prepared to pay for and obtain research material following the introduction of negotiated brokerage rates. Moreover, research material may now be more effectively disseminated than was the case before 1975.

33.85 Even if less research were undertaken, this would not necessarily be detrimental — though if the decline in research were to be concentrated on smaller companies, the liquidity of the market in the shares of those companies could be affected.

33.86 Following deregulation of brokerage rates, only those brokers offering the 'best' research service will continue to provide it. Unbundling of research would also enable investors to evaluate the cost-effectiveness of undertaking their own research or having the brokers do it for them.³⁶

33.87 As regards concentration, it is claimed, in particular, that the smaller firms servicing the smaller investors will disappear; residual firms will grow larger (by survival and merger) and these will tend to service only the institutional and larger groups. It is further claimed that small independent brokers in the smaller states will find it hard to survive and that, as a result, investors in those states will have to pay more for broking services than their counterparts in Sydney or Melbourne, and are unlikely to be offered a comparable range of broking and stock exchange services. A further claimed effect of such a structural change in the stockbroking industry is that stock exchanges in states other than NSW and Victoria will cease to exist, so that public companies in these states will have difficulty raising capital.

33.88 The Committee does not share these fears. Before brokerage rates were deregulated in 1975, the NYSE put forward similar arguments, suggesting that competitive commission rates would lead to the failure of many stockbroking firms, particularly small and regional firms. This view hinged primarily on the assumption that there were substantial economies of scale. There were also fears that competitive brokerage rates might encourage large firms with substantial resources to adopt 'predatory pricing' policies, i.e. to reduce brokerage rates below cost so as to put smaller firms out of business, after which prices would again be raised to 'normal' levels.

33.89 The post-1975 experience of the New York Stock Exchange has not borne out this line of thinking. The most recent comparable data indicate that, of firms conducting business with the public:

- the largest twenty-five firms increased their share of the industry's gross revenue from 56% in 1977 to 61% in 1979 and their share of total assets from 73% to 77% over the same period;
- however, the rates of increase were well below those in the period 1972 to 1974, when the top twenty-five firms increased their share of gross revenue from 44% to 53% and their share of total assets from 57% to 71%.³⁷

36 To the extent that there are benefits from centralisation of some basic research, it should be — and is being — carried out by the stock exchange itself.

37 SEC, *Staff Report on the Securities Industry in 1979*, op. cit., page 11. However, it should be noted that securities commission accounted for only 34% of the aggregate gross revenue of the 2532 reporting firms in 1979. It is also of interest that the smallest stockbroking firms (those with assets of less than \$1m) obtain a considerably higher gross revenue from securities commissions than do large firms.

33.90 The US experience also suggests that the ability of small stockbroking firms to compete has not been impaired:

- discount brokers were described by the SEC in 1979 as 'one of the most profitable and fastest growing segments of the brokerage industry';
- the profit margin of firms with a gross revenue of \$7.5 million or less in 1979 averaged 15.9% compared with 12.4% for larger firms; and
- the return on capital of firms with a total capital of less than \$10 million amounted to 26.2% compared with 23.0% for larger firms.³⁸

33.91 Nor is there any *a priori* reason for believing that in a free market environment large Australian brokers will have an overwhelming competitive advantage over small brokers. Looking at brokers' cost structure, the Rae Committee³⁹ noted that salaries were consistently the largest single expense item, accounting for between 38% and 44% of all expenses of the members of the six exchanges between 1966 and 1971. As well, other significant variable costs included communications charges, interest charges and travelling expenses. The apparently high level of variable to total costs suggests that there may not be substantial economies of scale.

33.92 Similar impressions may be gleaned from a study of comparative profits in the Australian stockbroking industry. In 1979-80, net operating profit as a percentage of revenue, for the ten largest firms on the Sydney Stock Exchange, was somewhat below the average for all member firms.⁴⁰

33.93 Given the relative profitability of small firms, and bearing in mind the low fixed costs required to enter the industry, the Committee believes it is unlikely that large firms in Sydney and Melbourne would be able to dominate the industry at the expense of stockbroking firms in the smaller states. It follows that the demise of stock exchanges in these states is unlikely.⁴¹

33.94 As regards the matter of 'order flow' (see paragraph 33.78), the Committee records the concern expressed by brokers and some investors about possible fragmentation and the ultimate liquidity of the market. At present, brokers are required to bring all orders below a certain size (\$500 000) to the Stock Exchange floor. By so doing, they may only obtain one commission in any transaction. If brokerage rates were subject to negotiation, stockbrokers would

38 SEC Staff Report; *op. cit.*, page 59.

39 The Senate Select Committee on Securities and Exchange.

40 The following detailed breakdown provided by the Sydney Stock Exchange relates to 1979-80; a similar pattern is evident in the three preceding years. The figures relate to member firms of the Sydney Stock Exchange only and may not be representative of the industry as a whole. Care should be exercised in interpreting the data because of broker accounting procedures and practices.

<i>Broking firms ranked by revenue</i>	<i>Net operating profit as % of revenue</i>
1-10	29.8
11-20	42.3
21-30	26.0
31-48	48.0
Average	33.3

41 It should be noted that the development of a computerised national market for listed securities is likely to enhance the role of stockbrokers in the smaller states, by encouraging more active participation by investors and national listing by smaller state-based companies, ensuring the longer term viability of stockbroking firms in these states.

have a greater incentive to bypass the floor or, if trading rules were effectively enforced, to give up their membership of the Exchange and deal off 'change. This would have possible implications for the fragmentation of securities markets and related information flows.

33.95 The Committee understands that NYSE firms must initially take their orders of shares in listed companies to the relevant specialist on the floor. He has the right, subject to a predetermined maximum number, to take the shares to satisfy orders at or better than the 'crossing price' nominated by the member firm. The member firm may then cross the balance of the shares off the floor.

33.96 This rule applies only to shares in companies which were listed on the NYSE prior to May 1979. All other shares may be crossed 'off market' without exposing them to the auction process so long as the volume and price is reported to the consolidated tape. (The consolidated tape system was instituted by the Congress as part of its policy to introduce a centralised market system for the US.)

33.97 Table 33.9 shows the total of all shares traded **on the floor** of the NYSE from 1972 to 1980. From that table it will be noted that the total shares traded declined between 1972 and 1974 but in the post-deregulation period 1975-1980 they increased steadily.

TABLE 33.9: NEW YORK STOCK EXCHANGE —
SHARE VOLUME

<i>Year</i>	<i>millions</i>
1972	4 138.2
1973	4 053.2
1974	3 517.7
1975	4 693.4
1976	5 360.1
1977	5 273.8
1978	7 205.1
1979	8 155.9
1980	11 352.3

Source: New York Stock Exchange, *Fact Book*, 1981.

33.98 The Committee was unable to obtain figures which indicated the volume of US trading **not** conducted on the floor of the US Exchanges. However, bearing in mind the NYSE crossing rules referred to above, the following extract from the NYSE 1981 Fact Book may be of some relevance:

With the continued expansion of block positioning, off-floor **members'** transactions again exceeded specialists' dealings. Off-floor **members'** volume rose 46% to 3.2 billion shares, accounting for 53% of all member trading and 14.1% of all reported purchases and sales.

33.99 It is clear from the above that some fragmentation of the market has occurred. Whilst the volume of shares traded 'on floor' has grown, the volume 'off floor', at least in respect of members' own transactions, has grown more rapidly. In the absence of information about the total volume of 'off floor' transactions the Committee could not form a positive conclusion as to the extent of the fragmentation and any relevance it might have to the general question of deregulation. The Committee is uncertain also as to the relevance to Australia of the NYSE experience with order flows.

33.100 Further arguments against deregulated brokerage rates involve such

considerations as the unlimited liability of members, constraints on dealings as principal etc., and the suggestion that these offer some *quid pro quo* for the present rate-setting system. In other chapters⁴², the Committee expresses the view that it does not favour giving any group of intermediaries privileges to compensate them for perceived burdens.

33.101 The particular matter of unlimited liability of members, however, is dealt with later in this chapter in the discussion on incorporation.

33.102 The Committee does not consider that the disciplines on brokers, when dealing as principal, impose unreasonable constraints — given the need for an ethical and confident relationship with their clients.

33.103 It may well be argued that the deregulation of brokerage rates will contribute to enhanced efficiency in that:

- there is evidence that fixed brokerage rates have, on occasion, generated revenue for stockbrokers quite unrelated to costs and have thus operated to the disadvantage of investors⁴³;
- fixed brokerage rates allow cross-subsidisation of activities of brokers (e.g. provision of financial advice in takeovers) where there is competition with others in the securities industry; this is not consistent with competitive neutrality and can be a source of inefficiency;
- lower rates will generate greater turnover by investors,⁴⁴ although (for reasons expressed earlier) not necessarily a more liquid market; and
- the product of research undertaken by stockbroking firms will be disseminated more cost-effectively, as apparently has been the case in the US since 1975.

33.104 It is argued that the dependence of brokers on commissions is greater in Australia than in the United States, where brokers are effectively able to cross-subsidise their brokerage activities by virtue of their ability to invest clients' funds to earn income for themselves.⁴⁵ In Australia, such funds must be held in trust accounts.

33.105 The Committee acknowledges the effect of this on the level of brokerage rates in Australia. However, it does not believe this provides sufficient justification for retaining the present method of determining brokerage rates.

33.106 The Committee concludes that, on the evidence available to it, a qualified case has been made, on efficiency grounds, for the deregulation of brokerage rates. The qualification principally arises from the possibility that deregulation would excessively fragment the market for securities. The

42 See especially Chapter I.

43 In its submission to the Trade Practices Commission in June 1981, AMBA documented the costs to investors and companies of fixed brokerage rates in connection with Part C takeovers, pages 9–10. In such cases, brokerage charges would clearly be considerably lower if they were negotiable — not least because they would not include a 'research' component, in most instances.

44 Academic work in the US indicated that a 12% reduction in brokerage rates would tend to generate a 3% increase in turnover. See H. R. Stoll, *Regulation of Securities Markets: An Examination of the Effects of Increased Competition*, New York University, 1979, page 50.

45 The relevance of such action can perhaps be gauged from the fact that between 1975 and 1979, commission income of nine large securities firms in the US, examined by the SEC, declined from 49.5% to 39.2% of gross revenue while interest income rose from 17.5% to 32.5%.

Committee appreciates that there are other considerations which need to be taken into account. The TPC Inquiry will, no doubt, fully allow for these.⁴⁶

E. BARRIERS TO ENTRY

33.107 Each of the six stock exchanges is registered as a company. The Exchanges elect a Council, which may include members from outside the industry, as the governing body of the Australian Associated Stock Exchanges (AASE). The exchanges themselves remain autonomous but matters with a national character are co-ordinated through the AASE.

33.108 The Securities Industry Act prohibits the establishment of a stock market other than a stock market of an approved stock exchange. Approval is given by the Ministerial Council once it is satisfied that certain conditions exist in relation to its business rules and listing requirements (s. 37 and 38).

33.109 The Committee has received no complaints on the existing procedures to establish a stock market and is unaware of any problems associated with the existing procedures.⁴⁷ Accordingly, it is not proposed to consider further this aspect of market entry.

33.110 Rules for admission to membership of the exchanges are broadly similar, although not uniform, among the exchanges but only the Sydney Stock Exchange retains a system of membership seats, the others having a system of licensing. Prerequisites for membership of the Sydney Stock Exchange⁴⁸ include that the candidate shall have:

- been employed for not less than four years (in aggregate) in the stockbroking business with one or more members of a recognised stock exchange;⁴⁹
- passed such examinations as may be considered necessary;⁴⁹
- a sound financial position; and
- a suitable character.

33.111 The application for membership is submitted to a Committee (elected annually by ballot by the general body of members) of the exchange which has absolute discretion in deciding the suitability of a candidate before submitting the application to a ballot of the full membership. (See Appendix 33.1.)

33.112 Persons are admitted to membership on the basis that they are to operate in partnership.⁵⁰ The exchange rules permit non-members to enter into partnership with members. Apart from minor variations in age and financial requirements, the system of admission is similar for each of the exchanges.

46 The Committee has not specifically examined the question of fixed brokerage rates applying in the case of members of the Sydney Futures Exchange. However, as noted earlier in this Report, the Committee's general view is that operational and allocative efficiency are most likely to be achieved in a freely competitive environment.

47 While there may not be any 'unreasonable' barriers associated with existing requirements for the establishment of a stock exchange, another quite separate issue is whether the Australian market is large enough to bear the cost of additional exchanges. Transactions can, of course, be made freely by parties off the stock exchange.

48 A short summary of the membership rules of the other exchanges is provided at Appendix 33.1.

49 The exchange may grant exemption from either or both of these requirements.

50 Sole traders are permitted on the Brisbane Exchange.

33.113 In addition, members and non-member partners of stock exchange firms are required to obtain licences either to act as investment advisers or dealers. These licences are issued subject to prudential requirements set by the Corporate Affairs Office of each state.⁵¹

33.114 The existing entry requirements and procedures necessary to obtain membership of the stock exchanges, and in particular the lack of provision in the exchanges' business rules for the admission of corporations to membership, have been criticised as being too restrictive, and are currently under examination by the Trade Practices Commission. These criticisms take on particular significance because of the statutory endorsement the entry requirements receive via the Securities Industry Act:

- the restriction on the use of the title of 'stockbroker' or 'sharebroker' to members or partners in a partnership that is a member firm of a stock exchange (s. 133);
- the restriction on establishing or providing a stock market that is not the stock market of an approved stock exchange (s. 37 and 38);
- the limitation that only member firms may trade on the floor of the exchange (SSE Rule 6.1 in conjunction with s. 38)⁵²; and
- the provision empowering the Court to order observance of enforcement of business (or listing) rules of a stock exchange (s. 42).

33.115 There are three related issues which need to be considered:

- whether existing entry barriers are unduly restrictive;
- whether stockbroking firms should be permitted to incorporate and admit outside shareholders; and
- if so, what restrictions, if any, should be placed on their ownership.

33.116 It has been put to the Committee that the existing arrangements regarding entry to stockbroking are operating satisfactorily, that the number of stockbrokers is sufficient to ensure adequate competition, that objective criteria for membership exist, and that those persons who have the requisite qualifications and experience are not prevented from becoming members.⁵³

33.117 Although the Committee has not seen any evidence that reasonable applications for membership have been refused in recent years, it is concerned that the present arrangements lend themselves to **potential** abuse. It notes that, as membership of the exchanges is regulated by member brokers themselves and

51 See Interim Report — paragraphs 17.66–73 — and Information Booklet No. B1 — *Securities Industry Act, 1975 Licensing Requirements*, Interstate Corporate Affairs Commission, February 1979. In summary, licences are required for dealers, dealers' representatives, investment advisers and investment representatives. Brokers must ensure that any liquid funds requirement specified by their Exchange or Corporate Affairs Commission in respect of the firm of which they are partners is met; in addition, stockbrokers must, as part of the licence condition, maintain personal solvency and lodge an annual personal statement of affairs with the relevant Corporate Affairs Commission.

52 This is particularly relevant because of the provision in the Share Acquisition Code that an accepted method of carrying out a takeover should be by standing in the market on the floor of the exchange.

53 The AASE has stated that no exchange has refused any application for membership during the past ten years. It should be noted, however, that the Committees of several of the Exchanges retain absolute discretion to refuse to submit a candidate's application to ballot.

there is no right of appeal against an exchange's decision, there is a risk that the level and pace of entry may at times be incompatible with the public interest.

33.118 In Chapter 21, it is argued that the authorities should have the power to require changes to the business rules of the Stock Exchanges (as distinct from the present power to disallow business rules). Implementation of this recommendation — together with appropriate supervision — should ensure that the entry requirements do not operate unreasonably to exclude eligible persons from membership of an exchange.

33.119 The Committee therefore *recommends* that:

- (a) **The authorities should keep existing stock exchange business rules under frequent review and supervise their application, to ensure that they do not operate unreasonably to exclude applicants for membership.**
- (b) **Any denial of membership should be subject to an appeal process.**

33.120 The Committee now turns to the issue of whether stockbrokers should be permitted to incorporate, and the closely associated issue of whether companies should be admitted to membership of the Stock Exchanges.

33.121 The present entry rules may be said to impede the operational efficiency of the industry by dictating the business structure which brokers must adopt.

33.122 The capital of member firms may be inadequate in some cases and thus hinder the development of their operations, having regard to the fact that the exchanges require firms to maintain adequate capital in relation to the volume of business they transact. The taxation system may discourage the accumulation of capital by partnerships relative to companies: stockholders, through a company, can retain some portion of the surplus earned, in which case, if their personal tax rates exceed 46%, they will be taxed less heavily than partners.⁵⁴

33.123 While there is no clear evidence that a lack of capital has posed major problems to date, the growth in size and sophistication of the market may require, in the long term, injections of capital beyond the ability of individual partners. Allowing brokers to incorporate and permitting outside shareholdings in brokerage firms, for example, as is done in the United Kingdom⁵⁵, would ensure that capital requirements do not impede innovation and growth in the future.⁵⁶

33.124 At the same time, the existence of an appropriate capital base may enable brokers to compete more directly with merchant banks in the provision of a wider range of financial services to clients and as underwriters, and would ensure a more prudent backing where they act as principal. The Committee recognises that brokers may underwrite issues on a syndicated basis and that firms may merge or take on additional partners to increase their capital base. However, the ability to take on outside shareholders, by allowing capital to be introduced from outside the industry, would provide brokers with greater flexibility in their operations.

33.125 One argument that has been advanced in opposition to incorporation is that the personal liability concept that is characteristic of existing entry

54 In Chapter 14, the Committee argues that this inequity in the tax burden is best redressed by the adoption of a full integration system of company taxation.

55 Details of the conditions applying in respect of corporate membership of the London Stock Exchange are provided in Appendix 33.2.

56 It is also relevant that the limitation of partnership to twenty members under the Companies Act imposes certain constraints on the expansion of stockbroking firms.

requirements would be eliminated, and thus an important protection for investors would disappear. The Committee is not convinced that this concept is as relevant as in the past. Stockbrokers are not at present prohibited from divesting themselves of assets in order to limit (e.g. by establishing family companies) their exposure to liability required under stock exchange rules. It should also be pointed out that the Sydney Futures Exchange allows corporate membership.

33.126 The Committee would not claim that incorporation, in itself, necessarily enhances efficiency to any marked degree. It simply supports the view that brokers should **not be debarred** from adopting this form of business structure if they feel it would be beneficial. However, the Committee is not, of course, suggesting that brokers should be **required** to incorporate.

33.127 The Committee *recommends* that **stock exchange rules should be amended to allow members to incorporate.**

33.128 The question then arises as to who might be admitted as 'outside' shareholders to an incorporated stockbroking business. If some of the advantages of incorporation are to be achieved it is clear that policies in respect of such matters as outside shareholders, directors, voting, control etc. need to be addressed.

33.129 Pending further consideration of a larger issue (i.e. that of corporate membership generally) the Committee is inclined to favour an approach somewhat, but not totally, along the lines of the London Stock Exchange. In particular it would suggest that:

- the majority of the board of directors should be members (as appropriately defined for the purpose) of an exchange although there should not be a directors' qualification to hold shares;
- no single non-member should hold more than 10% of the issued and paid-up capital and voting shares; and
- appropriate prudential requirements should remain in place, especially those related to the fidelity fund.

33.130 As regards the larger issue of the admission of corporations to stock exchange membership, fears have been expressed that, in the absence of restrictions on corporate ownership, the admission of financial institutions, particularly banks, will eventually lead to a market dominated by a few principal traders and brokers, with prices being determined by them rather than by market forces reflecting a wider spread of participants.

33.131 While the possibility cannot be completely ignored, it is difficult to see why — given the apparent absence of significant economies of scale — a pronounced trend toward market concentration should develop if unrestricted entry of financial institutions were permitted. As well, if brokerage rates were deregulated, the incentive for institutional investors to seek membership would be reduced.

33.132 One specific area of concern is the possibility of conflicts of interest when institutions which manage superannuation funds become members of an exchange. The potential exists, particularly with flat management fees, for such brokers to generate turnover solely to maximise brokerage. The latter problem can be at least reduced by requiring intermediaries engaged in funds management to make appropriate disclosure to trustees etc.

33.133 The possible admission of overseas-controlled merchant banks or

foreign-owned stockbroking houses as members of stock exchanges raises the question of **foreign ownership and control**. In particular, given the high degree of foreign participation in Australian stock markets, there is a possibility that admission of non-resident broking houses to the industry could lead to them achieving a dominant position, with implications for the liquidity of the local market. Conversely, adoption of the recommendation (Chapter 8) that the restriction on the listing of foreign corporations on Australian stock exchanges be lifted could lead to increased business for Australian stockbrokers and may lower the transaction costs of resident transactors in respect of overseas portfolio investments.

33.134 The Committee is conscious that the outright exclusion of overseas-owned merchant banks or foreign-owned stockbroking houses would remove a significant potential source of new entry and competition. However any relaxation of existing barriers to corporate membership could be expected to attract some Australian-owned entrants; levels of competition are thus likely to be adequate even if foreign-owned corporations were excluded. Foreign ownership considerations are, largely, outside the scope of this Inquiry.

33.135 It has been suggested that, if entry requirements were substantially relaxed, with many corporate members being admitted, the process of self-regulation would become more difficult and the ability of stockbrokers to deal with each other in complete confidence would be impaired; it is said that the confidence of investors would also be affected. The Committee has difficulty in accepting such an outcome, so long as:

- appropriate prudential requirements remain in place, including contributions to a fidelity fund; and
- effective control of stockbroking houses remains with stock exchange members.

33.136 Nonetheless, the Committee accepts that if entry requirements were greatly relaxed at a time when brokerage rates were being deregulated, it could cause some instability in the stockbroking industry.

33.137 In summary, the Committee has expressed a view on brokerage rates and the question of the incorporation of members. In addition, it has recorded certain considerations on the wider issue of corporate membership. There are, no doubt, other considerations which the TPC will take into account in making its ultimate findings on the various issues.

F. STOCK EXCHANGE LISTING REQUIREMENTS

(a) New Listings of Company Securities

33.138 Listing requirements aim to ensure that the market is kept fully informed of all matters that are relevant to the making of investment decisions and to ensure that listed companies are of a sufficient size and have a sufficient spread of shareholders to enable a market to be maintained in their shares.⁵⁷

33.139 The listing of companies on stock exchanges is important for the development and growth of Australia's capital market because it:

⁵⁷ The listing requirements are set out at paragraphs 17.147-57 of the Interim Report.

- enables the risks associated with development of new products, markets and technologies to be shared among a larger number of investors, thereby encouraging risk taking and innovation;
- provides a more reliable and continuing source of finance for established companies;
- generally entails fuller disclosure of company information and permits closer and more frequent assessment of the prospects of companies; and
- may facilitate the redirection of existing capital into more efficient uses through takeovers.⁵⁸

33.140 The Committee has looked closely at the declining trend in the number of companies on the official list since 1972 and in companies coming forward to have their securities listed. This is shown in Table 33.10.

TABLE 33.10: MELBOURNE STOCK EXCHANGE — COMPANIES ON THE OFFICIAL LIST

<i>Year ended 30 June</i>	<i>Industrial</i>	<i>Mining</i>	<i>Prefs only</i>	<i>Debentures and notes only</i>	<i>Semi-govt</i>	<i>Total</i>
1972	1 169	382	n.a.	33	n.a.	1 584
1973	1 100	349	n.a.	24	n.a.	1 473
1974	1 054	318	n.a.	37	n.a.	1 409
1975	1 012	296	n.a.	38	20	1 366
1976	968	260	29	37	20	1 314
1977	920	239	32	37	21	1 249
1978	868	225	34	33	20	1 180
1979	797	226	31	32	20	1 106
1980	726	236	27	27	24	1 076

Source: The Stock Exchange of Melbourne *Annual Report*, 1980.

33.141 One point should be stressed at the outset: Australia has a very large number of listed companies, both in absolute terms and having regard to the size of the population.⁵⁹

33.142 Nevertheless, the decline of more than 30% in the number of listed industrial companies between 1973 and 1980 raises some concerns. There are a number of reasons — not all of equal importance — for companies not seeking listing or being delisted:

- The poor performance of shares in the 1970s relative to yields on alternative investments, reduced investor interest in equities, thereby necessitating an earnings performance which many companies were unable to sustain, to make a new listing successful.
- The same factors have also generated a number of takeovers. Apart from directly leading to a reduction in the number of listed companies, this may have drawn the attention of owners/managers of unlisted companies to the possibility of losing control and discouraged them from seeking listing.
- The inability of small companies to achieve the spread of ownership and the minimum capital requirements necessary for listing.

⁵⁸ However, see paragraph 33.5 and footnote 2.

⁵⁹ Thus, in absolute terms, Australia has more companies listed than either Canada or Germany. It also has more companies listed per head of population than the New York, London, Tokyo or Toronto Exchanges. (Federation Internationale des Bourses de Valeurs, FIBV Statistical Network for 1978 and 1979, New York Stock Exchange Inc.)

- The costs and complications of listing, which include the direct costs associated with drawing up the required documentation (prospectuses etc.), listing fees and annual fees, and the burdens of the additional disclosure and reporting requirements of the stock exchange listing rules (which may also be seen as providing competitors with advantageous information).

33.143 The desire to avoid any of the costs associated with listing, including the need to issue a prospectus, has also, in the past, been reflected in the practice of 'back door' listing.

33.144 In other countries, the problems associated with listing have led to various initiatives to assist unlisted companies to obtain equity finance. In the United States there is an over-the-counter (OTC) market in unlisted securities, while in the United Kingdom the London Stock Exchange has recently established a formal market in unlisted shares, i.e. shares in companies which do not meet (or wish to meet) the formal requirements for full listing.

33.145 In Chapter 38, the Committee looks more closely at these less-regulated markets and advises against a formal government incentive to accelerate their development in Australia as a means of facilitating the provision of equity finance for small business.

33.146 This is **not** to say that the development of an unlisted securities market on a commercial basis would be unwelcome. There could well be merit in the stock exchanges undertaking a survey of the demand for equity finance which might be met through the development of alternative approaches to listing, e.g. along the lines of the unlisted securities market in the United Kingdom.

33.147 The development of such a market might also provide an opportunity to improve certain of the listing requirements applying to companies at present (e.g. through the introduction of quarterly reporting requirements — see discussion in Chapter 21), encouraging greater investor confidence. Smaller and more speculative companies might then be listed on a 'Second Board' in respect of which less onerous requirements might apply. While the issue of shares should still be subject to some form of prospectus requirements, and semi-annual disclosure would be required, such companies might not require as many as 300 shareholders. **The matter of a 'Second Board' seems worthy of consideration by the NCSC.** If adopted, the principle of *caveat emptor* might assume greater importance.

(b) Enforcement of Listing Requirements

33.148 Listing requirements have important prudential aspects, being designed to ensure that the market operates fairly and openly. Effective enforcement of these requirements is essential for the maintenance of investor confidence in the stock market.

33.149 The principal methods available to an exchange to ensure compliance with its listing rules have been the threat of suspension and, in extreme cases, the delisting of a company's securities.

33.150 Experience in recent years, including several court decisions, highlighted certain deficiencies in this method of enforcement. It became apparent that listing requirements:

- were of little use in protecting investors in a listed company which is subject to a takeover bid by an unlisted company; and

- placed no obligation on a company to comply with stock exchange disclosure and other requirements once it had been delisted.

33.151 As well, delisting is a questionable method of enforcement in that it deprives shareholders of a market for their securities. **The Committee therefore endorses the inclusion in the Securities Industry Act of a provision enabling the enforcement of listing rules through the courts on the application of the NCSC, the stock exchange or an ‘aggrieved person’ (s. 42).**

33.152 However, as a corollary of this, **The authorities should have the power to ensure that listing requirements are appropriate for the achievement of a liquid, informed market.**⁶⁰

G. CREDIT RATING SYSTEMS

(a) Background

33.153 The term ‘credit rating’ refers to the assessment of the quality of debt securities of governments, semi-government authorities and companies. As issues may offer different levels of security (e.g. through trust deeds) and be for different periods, the issue, rather than the borrower, is usually rated.

33.154 Formalised credit rating systems of this type have to date operated in only a few countries; the United States has had three rating services for some time, while Canada has recently established two such services.

(b) Impediments to the Development of a Credit Rating Service

33.155 So far as the Committee can establish, there are no **major** obstacles to the development of a credit rating service in Australia, arising from government legislation and regulation. However, certain other impediments need to be noted.

(i) Defamation Laws, Negligence etc.

33.156 It has been suggested that credit rating agencies may have insufficient protection under Australian defamation laws, which vary somewhat among the states. Agencies may be placed ‘at risk’ where publication of ratings adversely affects the trading reputation of the companies concerned. There are also doubts about the position of rating agencies in the case of errors of judgment or negligence.

33.157 The rating process may involve a company seeking a rating from an agency in respect of a particular issue of securities. The company may elect to use or not to use such a rating when given. If it elects to use the rating, the issue may thereafter be periodically reviewed, and the rating perhaps changed, without the endorsement of the company. It is the latter situation where uncertainty arises. There is also the matter of where the circumstances of the company and the rating of the particular issue could have changed in the intervening period — giving rise to questions of original judgment etc.

33.158 Overseas experience is of interest:

- In the United States, certain agencies reduce the possibility of a defamation suit by including an appropriate caveat regarding the rating or its modification

⁶⁰ The issue of whether the NCSC should have the power to require stock exchanges to set certain listing requirements is discussed in Chapter 21.

in their contract with issuers. They also carry insurance against negligence suits.

- In Canada, the Dominion Bond Rating Service seeks to minimise the problem by maintaining close communication with both the companies it rates and the institutional lenders who subscribe to the service.

33.159 Advice obtained by the Committee indicates that protection would be afforded in some Australian States under common law where the contract between the issuer and the rating agency indemnified the latter with regard to any revision of a rating subsequent to a review it has undertaken. However, in Queensland and Tasmania, a code containing the civil law of defamation makes no provision for a defence against defamation where the plaintiff has assented to the publication of defamatory material. In the matter of negligence, judgment etc. there is, however, the possibility of insurance.

33.160 A related matter, but not one which is believed likely to pose a fundamental problem, is whether the Courts or other authorities would be able to compel a rating agency to divulge confidential information it has received from borrowers.

(ii) The Limited Depth of Private Securities Markets

33.161 The Committee has discussed elsewhere in this Report a number of factors — e.g. prospectus requirements and stamp duty — inhibiting the development of a primary and secondary market in private debt securities.

33.162 It has suggested ways of moderating these inhibiting factors which could be expected to stimulate interest in new public issues. This might have the incidental effect of facilitating the commercial development of a credit rating agency.

(iii) Local and Semi-government Securities

33.163 The principal demand for rating services in the United States is by municipalities, whose borrowings are not government-guaranteed. The existence of State and Commonwealth government guarantees for borrowings by local and semi-government authorities in Australia, therefore, clearly limits potential demand for rating services.

33.164 It is possible that, in the future, public enterprises of a commercial character will tend to rely less on government guarantees for their borrowings (see Chapter 12). If this were to happen, the market for rating services might be correspondingly enlarged. On the other hand, the Committee's recommendations for the establishment of State Borrowing Authorities may lessen the scope for credit rating services.

(iv) Taxation

33.165 Under present laws, the fees paid to a rating agency would be treated as ordinary borrowing expenses and would be deductible against assessable income over the lesser of the life of the loan or five years. (Any **subsequent** annual fee would be deductible in the year in which the expense is incurred.) There might be a greater incentive for some borrowers to have their securities rated if the expenses were fully deductible in the year in which they were incurred.

(v) Disclosure

33.166 A credit rating agency is very much dependent on the availability of

adequate financial and operating data; this presupposes disclosure requirements of a reasonably high standard. The Committee's recommendations in Chapter 21 and the proposed emphasis of the NCSC on disclosure should do much to remedy any existing deficiencies in company disclosure practices.

(c) Feasibility of a Credit Rating Service in Australia

33.167 A decision to establish a rating agency must be a matter for commercial assessment by its sponsors. The key factors in such an assessment will be the potential number of fixed-interest securities which can be rated and the charges that the market will bear. This will depend on the perception by users of the credibility of a rating agency and the quality and timeliness of its ratings.

33.168 The commercial paper market is a segment of the fixed-interest markets which has shown rapid growth over recent years. The promissory note area, in particular, is a prime candidate for a rating service since the quality of the notes may not be as uniform as in other areas such as the market in bank paper. It has been suggested, for example, that interest rate differentials on promissory note issues have tended to reflect the skills of individual underwriters rather than the underlying security.

33.169 It is true that participants in a commercial paper market are usually sophisticated investors and should be able to make their own credit assessments; there could nevertheless be a demand for a rating service as this would reduce duplication of credit assessment once a rating agency had established its reputation.

33.170 It remains to be seen whether the Australian market could generate sufficient borrowers and/or investors willing to pay the fees charged for having their securities rated.⁶¹ The Committee understands that in Canada, prior to the establishment of the Dominion Bond Rating Service (DBRS) in 1975, there had been no indication of willingness on the part of issuing companies to pay for a credit rating. The DBRS was funded initially through subscriptions by large, short-term investors, but more recently it has also been able to charge companies a modest fee for rating. While a similar course of development might be expected in Australia, it has been suggested that the Australian financial community is too small and closely knit for such a system of charging investors to be feasible.

33.171 The Committee notes that a number of Australian companies have been rated by agencies in the United States in connection with the issue of securities overseas. Such companies may seek a similar rating in Australia so as to obtain greater value for the costs incurred in respect of their overseas loans. Conversely, some companies obtaining a rating in Australia may be encouraged to issue their securities overseas.

33.172 It appears that a market for a rating service may take some years to develop fully. Once its credibility is widely accepted, demand would become to some extent self-generating as those which did not have their issues rated may find it more difficult to market their securities.

(d) Potential Benefits of Credit Rating Agencies

33.173 Once a rating agency has established a reputation for reliability and credibility, a number of benefits might flow from it:

⁶¹ The Committee understands that one credit rating organisation has recently commenced operations in Australia.

adequate financial and operating data; this presupposes disclosure requirements of a reasonably high standard. The Committee's recommendations in Chapter 21 and the proposed emphasis of the NCSC on disclosure should do much to remedy any existing deficiencies in company disclosure practices.

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Investors/Creditors

- To the extent that a rating agency has superior skills as financial analysts (relative to many investors), and by their inquiries have access to more information, it would assist investment appraisal and credit evaluation and more generally help to educate investors about risk/return relationships.
- It might expand the investment horizons of many small investors, who currently invest primarily with deposit-taking institutions.
- There may be economies from the centralisation of investment analysis and information gathering.
- The benefits may extend beyond the companies being rated or the direct subscribers to the issue; for example, some of the criteria used by rating agencies may become public knowledge and serve an educational role for other securities analysts; the secondary market for debt securities might become better informed and more active.
- On the other hand, it should be noted that rating agencies have been criticised overseas because of the lack of explicit information on the procedures and benchmarks they adopt for establishing a rating; this stems in part from the lack of a well-defined theory on ratings and what they represent. Overseas studies designed to evaluate the informational value of ratings have produced conflicting results. It has also been pointed out that changes in ratings are not always timely and may sometimes lag the market.

Corporate Borrowers

- A credit rating system might contribute to the marketability of debt securities, thus enhancing their standing in the market.
- Many smaller and less well-known companies with only a limited track record may, by obtaining a credit rating, gain better access to the financial system. (While it might also make it more difficult for less highly rated borrowers to obtain access to funds at acceptable rates, to the extent that the cost of borrowing more accurately reflects the underlying security, the efficiency of the financial system would be improved.)
- Interest rates paid by borrowers might be lower if credit risk assessment costs imposed on lenders were reduced.
- It is possible that overseas interest in Australian public securities would be enhanced.
- More generally, it is possible that the availability of credit ratings might encourage greater public raisings by companies, thus broadening the market for investors; but it might be noted that other factors, such as prospectus and half-yearly audit requirements, are at present far more important in deterring public issues.

Implications for Stability

- An established, widely accepted credit rating system might act as an incentive to the maintenance of sound business practices and high prudential standards, particularly by finance companies. It should be recognised however that this might also have the effect of discouraging risk taking because of concern that the rating agency may be unduly pessimistic about the implications of a particular risk for the security of lenders to the company; in that respect, the availability of credit ratings could have adverse efficiency consequences; this would not be so if the circumstances were to induce a desirable change in the

debt/equity ratio. The attitude of stockholders and the reaction on stock markets might determine the balance.

- A rating from a well-established, well-accepted agency might help to maintain investor support for a financial corporation during periods when confidence in other similar corporations is at a low ebb.
- In some instances the rating process might contribute to a clarification (for the benefit of the investing public) of the precise commitment of a parent company in respect of an issue of securities by a subsidiary.

(e) Role of Government

33.174 It is not difficult to see potential long-term advantages for some borrowers and investors from the establishment of an appropriate rating agency or group of agencies. When considering the role of government, however, the key questions are whether:

- there are government-induced impediments; and whether
- the benefits from the establishment of a rating service are broadly recoverable through the market (in the prices and charges set by the rating agency) or whether some are of a kind that cannot be so recovered.

33.175 On the first of these questions, the Committee concluded that there may be an impediment arising from the lack of protection against defamation in Queensland and Tasmania (see paragraph 33.159).

33.176 The Committee recommends that the Government should raise with the Queensland and Tasmanian Governments the possibility of amending their codes of defamation to provide a defence at law where a company whose issue is being rated consents to the rating being revised at a later time by the rating agency.

33.177 On the second question, if most of the benefits are such that they can be charged to the users of the rating service, the decision whether or not to establish such a service could appropriately be left entirely to the market.

33.178 On the other hand, it has been argued that many of the benefits of a rating service are 'external' in character, i.e. extend beyond the parties directly involved. Some of these have been noted above, e.g. the possibility that it might encourage sound business practices, promote a better informed, broader securities market and provide investors with a wider diversity of choice.

33.179 However, it is very difficult to determine the extent of such externalities and whether they are significantly larger than those associated with most financial services and facilities.

33.180 A related argument for government support is that because of the likelihood of slow market acceptance, the Government has a role in assisting the early development of the industry until such time as it is large enough to stand on its own feet.

33.181 This is a variant of the 'infant industry' argument. Its validity again hinges on whether the benefits are internal or external to the industry. To the extent that the benefits are internal to the business they are normally allowed for in any commercial feasibility study and there is no case for government intervention. It is possible however that, given the long gestation period involved, a private agency may discount future profits at a higher rate than is appropriate for the

community as a whole. It is also possible that, because rating information may easily be transmitted to potential users at little additional cost, the credit agency may not be able to charge fully for all the benefits obtained in the market. In both these instances there would be a divergence between social and private benefits.

33.182 On balance, the Committee's judgment is that the externalities are unlikely to be so significant as to warrant any government subsidy to accelerate the development of one or more rating agencies in the early years. Government action would more appropriately be directed to removing the impediments arising out of government legislation or regulation.

H. OTHER ISSUES

33.183 In this chapter, the Committee has discussed only some of the more important factors affecting the efficiency of securities markets. Issues such as the ability of companies to repurchase their shares, the ability to short sell securities and the general question of investor education, which may affect the liquidity of the market, are discussed in Chapter 21.

33.184 Other areas of interest not discussed, most of which are mentioned briefly in paragraph 29.23 of the Interim Report, include:

- branch share registers;
- aspects of unclaimed moneys legislation affecting share registry operations;
- the need for appropriate legislation governing the use of computers and their output in the maintenance of share registers;
- the desirability of a reduction in the ten-day scrip-issuing cycle;
- a computerised national securities market; and
- a central clearing house for scrip and cash.

33.185 While these issues may not be very significant in isolation, they may, in aggregate, have a significant impact on the efficiency of the stock market. It can be assumed that the NCSC will examine them as part of its program of review of the securities industry.

MEMBERSHIP REQUIREMENTS OF AUSTRALIAN STOCK EXCHANGES

The Stock Exchange of Perth Limited

1 The Exchange's Committee has absolute discretion to refuse to submit to ballot a candidate's application.

2 Other prerequisites for membership include that the candidate be of good character, reputed business integrity, be not less than 25 years of age and have appropriate educational and work experience. A prescribed entrance fee, annual subscription fee etc. must accompany the application.¹

Hobart Stock Exchange

3 Admission to membership is by ballot of members. However, the Exchange's Committee has absolute discretion to refuse to hold a ballot.

4 Other prerequisites for membership include that the candidate must be not less than 21 years of age and have appropriate educational and work experience. A prescribed entrance fee, annual subscription fee etc. must accompany the application.²

The Stock Exchange of Melbourne Limited

5 The Exchange's Committee may admit as a member any person who is of good character, of high business integrity, and is suitably qualified and experienced to deal in securities, has the required financial resources and, where required by law, its the holder of a dealer's licence.

6 The Committee has absolute discretion to decide in the public interest whether an applicant has suitable qualifications and experience. On election, a joining fee of \$3000 and a \$2000 deposit, and other amounts as prescribed by the Committee, are payable to the Exchange.³

The Brisbane Stock Exchange Limited

7 Admission to membership is by ballot. The Exchange's Committee has absolute discretion in deciding whether an application for membership shall proceed. A candidate must satisfy the Committee that he is of good character and of high business integrity and be not less than 21 years of age.

8 Other prerequisites include that the candidate have appropriate educational and work experience. A prescribed entrance fee, annual subscription fee etc. must accompany the application.⁴

The Stock Exchange of Adelaide Limited

9 Members are elected by the Exchange's Committee by ballot — candidates must be sponsored by two members, be not less than 21 years of age, and satisfy the Committee as

1 Stock Exchange of Perth Limited; Rules 7-9.

2 Stock Exchange of Hobart Limited; Rule 29.

3 The Stock Exchange of Melbourne Limited; Rules 49-56.

4 The Brisbane Stock Exchange Limited; Rules 45.1-54.

to their personal and financial suitability in such manner as it shall in its sole discretion from time to time determine.

10 Other prerequisites for membership include appropriate educational and work experience. A prescribed entrance fee, annual subscription etc. are payable after election.⁵

APPENDIX 33.2

CORPORATE MEMBERSHIP OF THE LONDON STOCK EXCHANGE

1 In the United Kingdom, in addition to ordinary individual membership, membership may take the form of an unlimited or limited liability corporate member, or a member may be employed by a stock exchange trading subsidiary. The main purpose for permitting Limited Corporate Members was to provide a means by which 'investors' outside the Stock Exchange could supply permanent capital to Stock Exchange businesses.

2 Each director (who must be a member of an exchange) of a Limited Corporate Member, and any member employed by a Stock Exchange Trading Subsidiary formed with limited liability, must execute a liability deed accepting personal and joint liability for all its debts and obligations. Equity ownership by each non-member is restricted to 10% of the issued share capital and to no more than 10% of voting powers. Other features are:

- a company cannot commence business until elected by the London Stock Exchange Council;
- in the case of unlisted Limited Corporate Members, permission must be sought before its securities can be sold except where the sale is between directors or employees of that Limited Corporate Member or their respective families;
- every director of a Limited Corporate Member must own shares to the value of £10 000 at the time of appointment or have outstanding a subordinated loan to the Company of not less than £10 000, or have some combination of both to the value of at least £10 000; and
- jobbing firms may not deal in their own shares.

3 Brokers or jobbers may also carry on business as unlimited corporate members, i.e. corporations not having any limit on the liability of shareholders. Only natural persons may be shareholders of an unlimited corporate member and all of its directors must also be shareholders.

⁵ The Stock Exchange of Adelaide Limited; Rules 6-10.

CHAPTER 34 FINANCE FOR BUSINESS

COMPANY FINANCING

- Ch. 34 Finance for Business
- Ch. 35 Role of Foreign Capital

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CHAPTER 34: FINANCE FOR BUSINESS

34.1 This chapter looks at:

- major trends in corporate financial structures, profitability and patterns of demand for funds, with particular emphasis on their implications for business stability; and
- how the structural supply of business finance has been affected by the institutional characteristics of the financial system and by government interventions in the system.

34.2 Issues specific to particular sections of the business community, e.g. small business finance, are taken up in later chapters dealing with sectoral finance.

A. CORPORATE FINANCIAL STRUCTURE, PROFITABILITY AND STABILITY

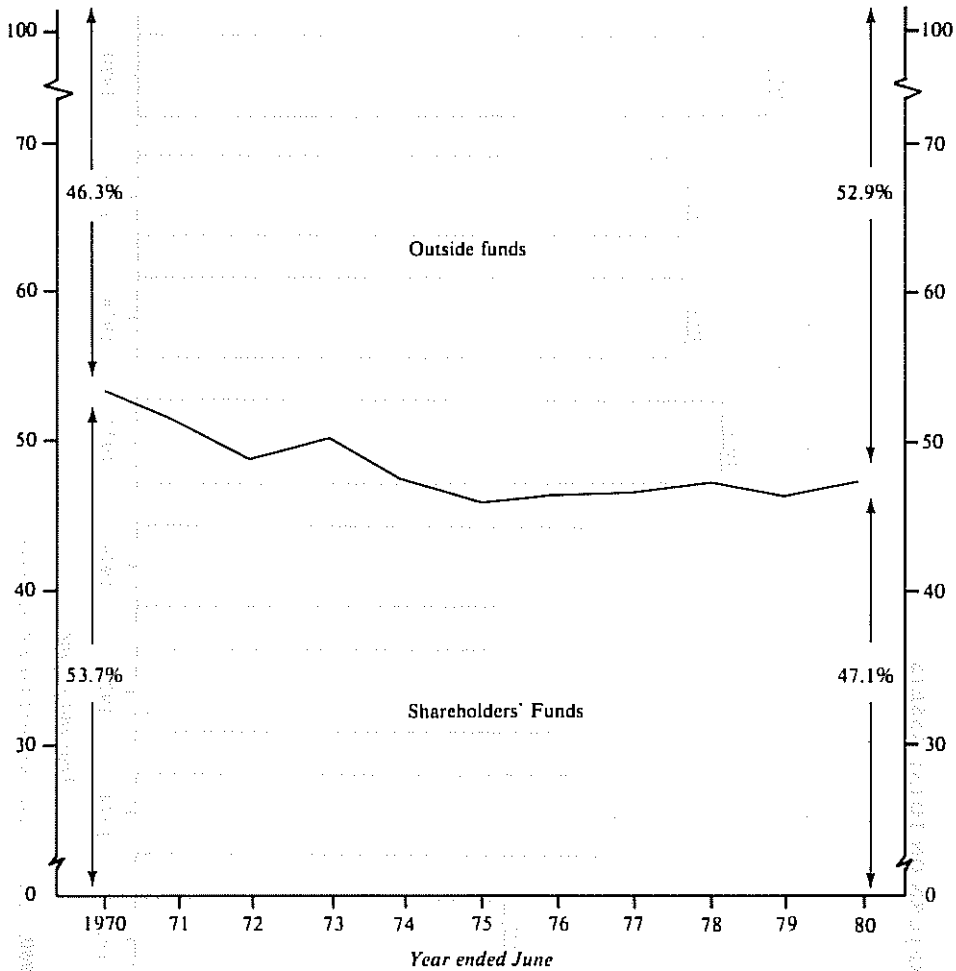
(a) The Broad Picture

34.3 The Committee records the findings from a survey of 752 companies prepared by PA Australia.¹ It is noted that:

- (i) As regards the structure of corporate funding:
 - the equity component (measured by shareholders' funds as a percentage of total assets) decreased for the average company from 53.7% in 1969–70 to 46.3% in 1974–75 (see Figure 34.1);
 - since that date and up to 1979–80, the equity component has remained fairly constant — at about 47% (finance industry excluded) (see Figure 34.1 and Table 34.1);
 - as between industry groups, marked changes took place (see Table 34.1).
- (ii) As regards profitability:
 - the median percentage return on total assets, **before interest and tax**, in 1979–80 was the highest for a decade, at 10.7% — having moved, with some stumbles, from a low point of 8% in 1971–72 (see Figure 34.2);
 - not all industry groups shared that experience (see Table 34.2);
 - most groups improved their return on shareholders' funds over the period 1975–76 to 1979–80; there was some variability as between industry groups and sub-groups (see Tables 34.3 and 34.4);
 - the median return on shareholders' funds, **after interest and tax**, declined marginally from 11.4% in 1978–79 to 11.3% in 1979–80 (see Figure 34.3);

¹ PA Australia Profitability Year Book 1980.

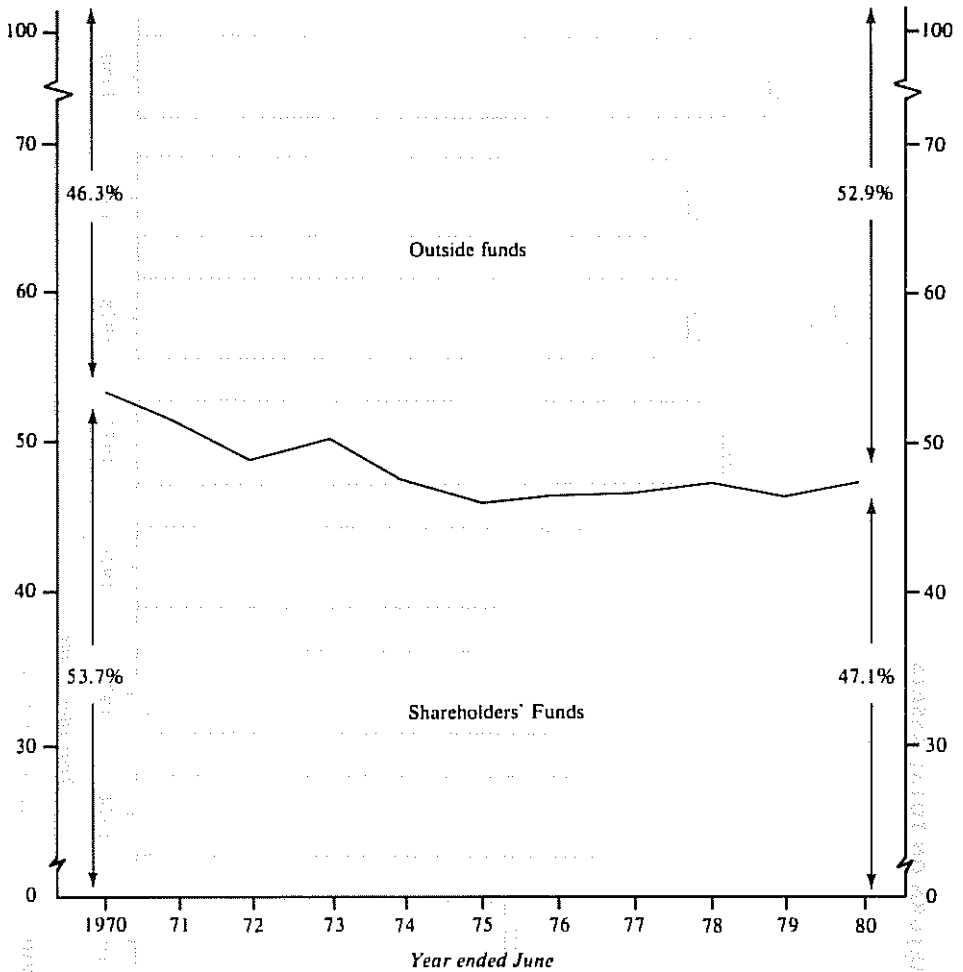
FIGURE 34.1: SHAREHOLDERS' FUNDS AS A PERCENTAGE OF TOTAL ASSETS



Source — PA Australia Profitability Yearbook 1980

- over the last four years the median return on shareholders' funds has been fairly constant in the 11.0% to 11.4% range; these years represent, however, a significant increase on the early and mid 1970s, when returns ranged from 8.3% to 9.8% (see Figure 34.3);
- notwithstanding this near peak, 32 out of the 57 sub-groups measured had a lower return in 1979-80 than the two-year government bond rate of 11.5% (at year end) (see Table 34.4);
- the median return on shareholders' funds produced by the top 100 Australian companies (by market capitalisation) in 1979-80 (11.3%) was well behind the 13.5% achieved by the UK's top companies (by market capitalisation) and the 15.9% achieved by the Fortune 500 (by sales) in the USA (see Figure 34.4);

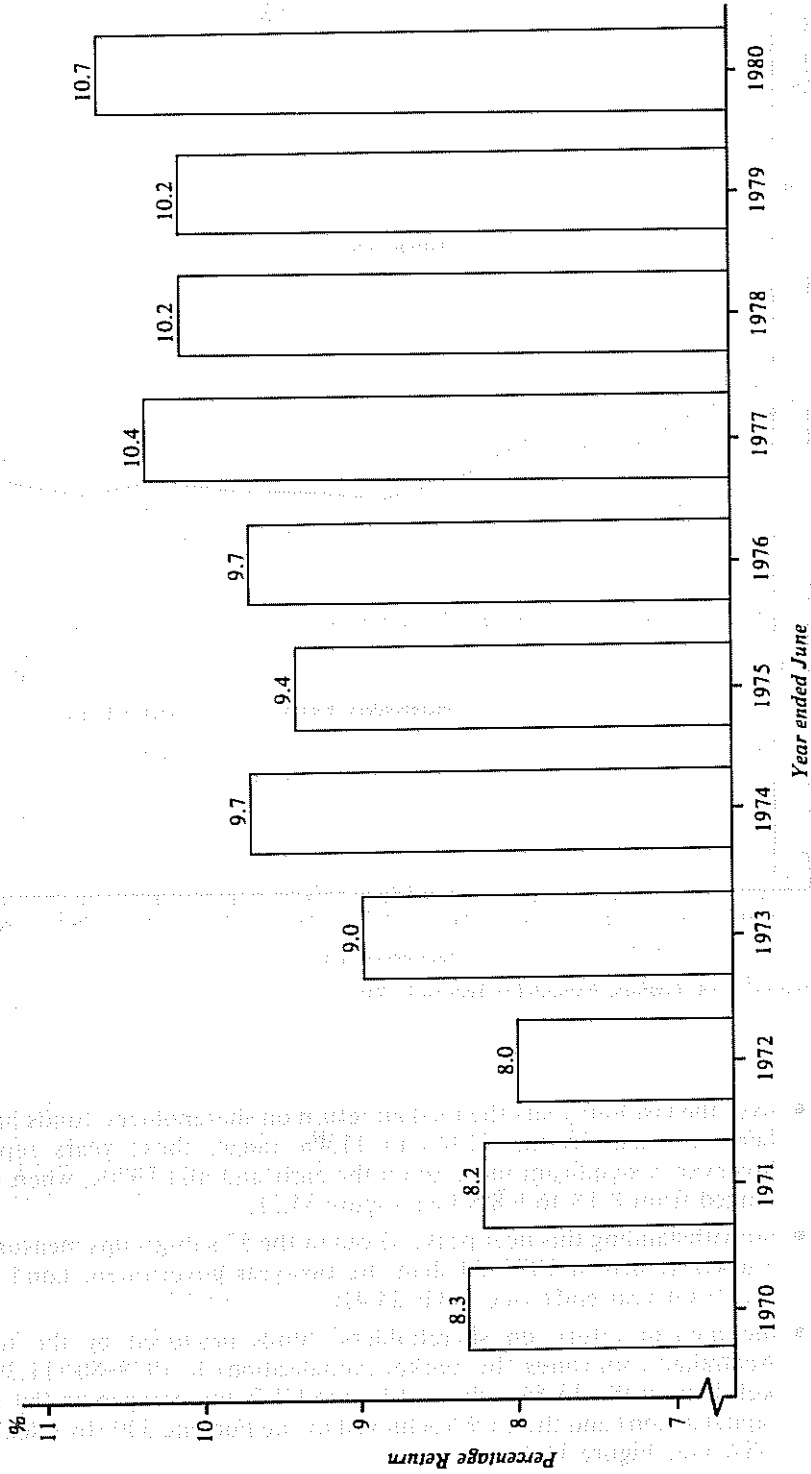
FIGURE 34.1: SHAREHOLDERS' FUNDS AS A PERCENTAGE OF TOTAL ASSETS



Source — PA Australia Profitability Yearbook 1980

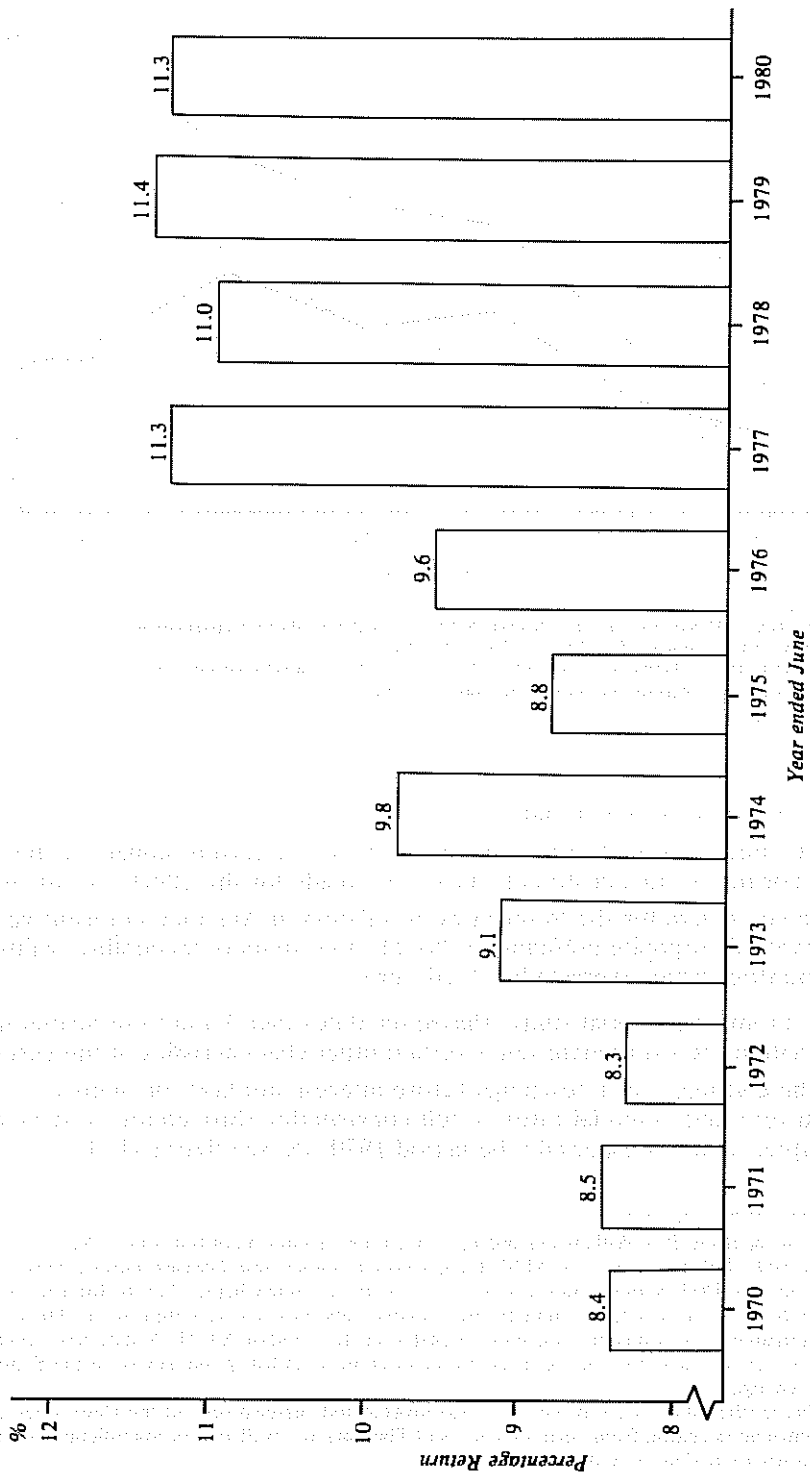
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**FIGURE 34.2: MEDIAN PERCENTAGE RETURN ON TOTAL ASSETS
(BEFORE INTEREST AND TAX)**



Source: PA Australia Profitability Yearbook 1980

**FIGURE 34.3: MEDIAN PERCENTAGE RETURN ON SHAREHOLDERS' FUNDS
(AFTER INTEREST AND TAX)**



Source: PA Australia Profitability Yearbook 1980

TABLE 34.2: RETURN ON TOTAL ASSETS BY INDUSTRY GROUP — PERFORMANCE OF TOP COMPANIES AND MEDIAN COMPANIES (%)

Industry group	Class	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80
Mining	Top 5%	30.6	32.7	24.6	38.2	41.4	32.0	39.6
	Median	6.9	11.8	7.7	7.4	7.4	7.4	7.9
Manufacturing Durables	Top 5%	20.6	22.2	21.6	22.0	19.6	21.1	22.3
	Median	10.6	10.4	10.7	11.1	10.2	10.5	11.7
Non-durables	Top 5%	30.2	29.1	23.1	23.7	23.5	22.7	21.9
	Median	10.7	9.3	10.3	11.0	11.0	11.5	12.0
Total	Top 5%	22.4	24.2	22.0	23.1	22.1	22.3	22.0
	Median	10.7	9.9	10.5	11.1	10.7	10.9	11.7
Primary prod. & distribution	Top 5%	16.0	13.5	12.8	14.6	13.4	22.9	n.a.
	Median	7.8	5.5	6.1	7.6	6.4	9.2	10.9
Building & construction	Top 5%	14.9	17.4	13.4	17.7	14.7	16.0	21.3
	Median	7.0	6.9	8.5	9.2	9.8	10.0	9.5
Finance	Top 5%	11.7	12.6	14.0	12.7	12.9	14.3	13.5
	Median	6.3	7.1	7.9	7.9	8.1	8.3	9.0
Transport	Top 5%	21.8	20.9	16.1	23.8	22.2	17.7	n.a.
	Median	8.5	9.1	8.2	11.2	11.0	11.6	11.6
Utilities	Top 5%	9.4	10.1	15.5	20.2	15.7	n.a.	n.a.
	Median	5.9	6.1	6.9	7.1	6.0	7.9	7.1
Retail trade	Top 5%	21.9	25.3	19.5	18.2	22.4	17.6	16.5
	Median	11.4	12.7	11.2	12.1	10.2	10.4	9.8
General merchants	Top 5%	n.a.	n.a.	n.a.	n.a.	n.a.	14.0	14.3
	Median						6.5	8.9
Vehicle distribution	Top 5%	22.4	26.6	19.7	19.9	22.7	21.6	n.a.
	Median	11.8	12.7	12.1	12.6	11.8	11.1	8.3
Hotels & motels	Top 5%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Median						9.6	10.0
Computers & office equipment	Top 5%	24.3	24.3	33.7	34.1	32.2	n.a.	n.a.
	Median	10.3	10.2	10.2	11.5	11.3	17.4	18.2
Broadcasting & TV	Top 5%	n.a.	n.a.	n.a.	n.a.	n.a.	32.9	n.a.
	Median						25.7	18.4
Misc. goods & services	Top 5%	n.a.	n.a.	n.a.	n.a.	n.a.	31.6	28.9
	Median						10.7	12.0
Total all companies	Top 5%	21.4	23.2	21.5	23.4	22.8	22.9	24.1
	Median	9.7	9.4	9.7	10.4	10.2	10.2	10.7

Source: *PA Australia Profitability Year Book 1980*.

(b) Changes in Financial Structure

34.6 From the survey and the study, it was clear to the Committee that a considerable change had occurred in the overall financial structure of corporations — although the extent of this change varied between industry groups and as to time.

34.7 Many of the trends and characteristics identified (especially higher debt component, lower interest cover and shorter debt maturities) have been seen as a possible threat to the financial stability of companies — particularly when combined with further increases in interest rates. There has been understandable concern as to the implications of these elements for debt service.

TABLE 34.3: RETURN ON SHAREHOLDERS' FUNDS BY INDUSTRY GROUP — PERFORMANCE OF TOP COMPANIES AND MEDIAN COMPANIES FROM 1973 (%)

Industry group	Class	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80
Mining	Top 5%	37.5	62.1	27.1	56.1	51.3	61.3	82.8
	Median	7.7	12.8	8.5	6.9	6.3	8.0	7.2
Manufacturing Durables	Top 5%	23.1	22.4	21.1	23.9	23.0	22.8	24.0
	Median	10.2	10.0	10.4	11.8	10.6	11.3	11.8
Non-durables	Top 5%	24.5	34.6	25.5	24.2	23.2	24.8	27.2
	Median	9.8	8.1	9.1	10.9	11.2	12.1	12.2
Total	Top 5%	23.5	26.5	22.4	24.1	23.2	23.9	25.4
	Median	10.1	9.0	9.8	11.4	11.2	11.5	11.9
Primary prod. & distribution	Top 5%	13.7	n.a.	25.4	33.8	17.6	28.5	n.a.
	Median	7.8	4.1	5.3	7.3	4.8	10.2	11.4
Building & construction	Top 5%	21.0	23.5	21.1	34.2	24.0	32.7	42.4
	Median	7.8	6.5	7.1	9.3	11.2	10.8	8.1
Finance	Top 5%	21.8	18.9	24.5	25.7	21.5	20.3	21.0
	Median	9.9	6.6	9.9	9.5	10.1	10.2	9.9
Transport	Top 5%	17.7	18.8	21.9	25.2	27.3	22.3	n.a.
	Median	9.5	7.7	10.3	17.2	12.8	12.6	14.3
Utilities	Top 5%	8.1	9.9	15.6	21.2	14.2	n.a.	n.a.
	Median	6.0	7.5	8.7	8.3	6.7	6.9	6.7
Retail trade	Top 5%	30.9	44.5	25.0	25.7	21.2	20.8	21.7
	Median	9.4	10.8	10.6	11.9	11.1	9.1	7.7
General merchants	Top 5%	n.a.	n.a.	n.a.	n.a.	n.a.	22.4	23.8
	Median	n.a.	n.a.	n.a.	n.a.	n.a.	9.9	7.9
Vehicle distribution	Top 5%	43.3	32.6	21.6	19.0	20.1	22.7	n.a.
	Median	11.2	11.0	11.5	13.3	11.1	8.7	4.8
Hotels & motels	Top 5%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Median	n.a.	n.a.	n.a.	n.a.	n.a.	8.2	7.6
Computers & office equipment	Top 5%	34.1	30.5	30.9	39.1	41.6	n.a.	n.a.
	Median	10.3	9.7	9.9	13.7	14.1	26.9	26.7
Broadcasting & TV	Top 5%	n.a.	n.a.	n.a.	n.a.	n.a.	31.7	n.a.
	Median	n.a.	n.a.	n.a.	n.a.	n.a.	24.9	18.2
Misc. goods & services	Top 5%	n.a.	n.a.	n.a.	n.a.	n.a.	39.0	22.1
	Median	n.a.	n.a.	n.a.	n.a.	n.a.	11.7	12.8
Total all companies	Top 5%	28.1	26.9	25.9	28.1	26.9	25.9	28.0
	Median	9.8	8.8	9.6	11.3	11.0	11.4	11.3

Source: *PA Australia Profitability Year Book 1980*.

34.8 The observed changes in debt/equity ratio in the 1970s partly reflect 'cyclical' factors such as levels of profitability and levels of capacity utilisation.

34.9 They also reflect:

- the effects of accelerating inflation during the 1970s;
- the 'bearishness' of new equity issues, albeit temporary, throughout some of that period;
- a reluctance in some instances to bring about a dilution of the equity of original or principal shareholders;

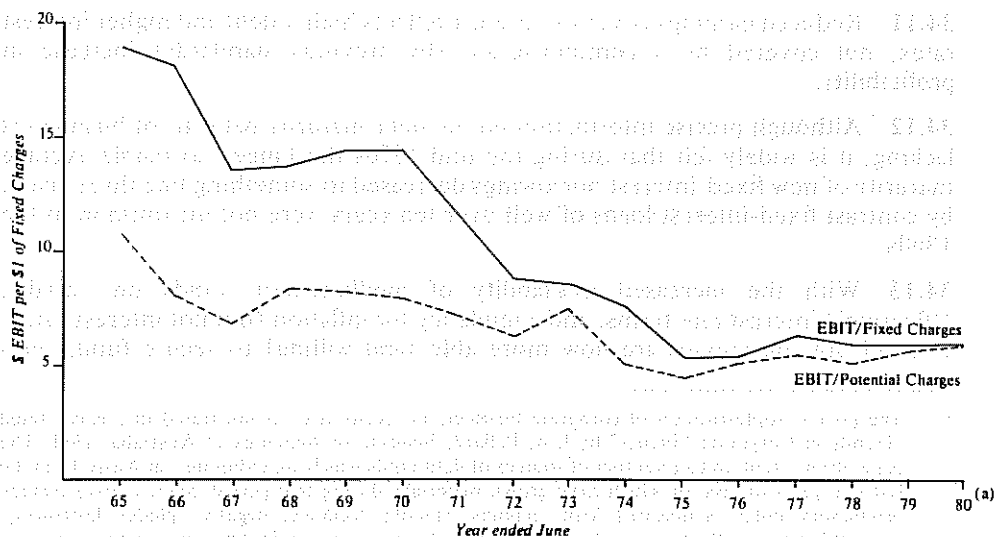
TABLE 34.4: AVERAGE PERCENTAGE RETURN ON SHAREHOLDERS' FUNDS AFTER INTEREST AND TAX, BY INDUSTRY

<i>Industry</i>	<i>1975-76</i>	<i>1976-77</i>	<i>1977-78</i>	<i>1978-79</i>	<i>1979-80</i>
<i>Mining</i>					
Non-ferrous	9.9	12.1	9.6	12.7	17.2
Coal	14.8	17.5	21.6	15.0	10.5
Oil and gas	n.a.	2.1	4.0	4.3	9.5
Misc. including mining investment	4.3	11.6	16.6	11.4	7.5
<i>Manufacturing</i>					
<i>Durable</i>					
Primary metals	4.2	4.6	6.0	8.7	8.7
Heavy engineering including distribution	11.7	11.3	10.0	11.3	11.1
Machinery manufacture & distribution	10.4	11.0	8.6	7.1	10.7
Motor vehicles	16.0	6.3	n.a.	n.a.	4.7
Motor vehicle parts, accessories & distribution	12.3	13.8	11.1	12.9	11.3
Light engineering including distribution	9.8	11.0	11.6	11.7	11.7
Electrical	9.5	10.2	7.3	10.9	7.2
Timber products	11.3	13.4	8.5	9.3	10.4
Cement & concrete	9.7	11.5	12.4	14.4	14.3
Bricks, pipes & other building materials	8.7	11.7	10.6	10.9	12.6
<i>Non-durable</i>					
Petroleum refining & marketing	7.1	7.0	8.4	6.4	8.9
Chemical fertilisers	7.0	7.4	8.7	9.1	10.7
Industrial chemicals	6.3	10.1	10.7	11.9	12.0
Pharmaceuticals	13.4	13.5	14.4	13.9	15.4
Paints & enamels	11.6	13.8	13.7	14.1	15.7
Rubbers & plastics	4.6	5.7	4.9	10.1	11.7
Tobacco & cigarettes	11.7	12.7	13.2	12.5	11.4
Dairy products	10.7	13.0	12.4	14.8	13.8
Bakeries, oils & stock feeds	9.3	11.9	9.1	12.6	10.9
Meat	13.0	14.6	15.2	16.9	5.0
Sugar	12.3	12.3	8.6	10.7	9.8
Confectionary & aerated waters	9.0	11.6	11.9	10.3	9.2
Beer, wine & spirits	8.4	9.8	11.0	11.1	8.7
Other food	9.8	12.6	12.9	11.0	11.5
Textiles	3.7	5.2	7.7	12.4	13.1
Clothing	14.1	18.2	16.2	17.6	16.5
Leather & leathersgoods products	7.1	7.4	7.5	10.5	13.0
Pulp & paper	7.4	9.2	9.0	11.1	12.8
Newspapers & magazines	11.2	14.8	13.6	14.9	12.5
Printers & stationers	7.1	10.8	11.2	14.9	13.3
Packaging	7.9	11.0	11.6	11.2	10.2
<i>Pastoral & agricultural</i>	4.5	5.9	5.4	10.5	16.1
<i>Building & construction</i>					
Building & civil engineering	11.8	15.7	14.5	9.5	8.4
Property development	6.3	6.9	9.8	6.7	6.9
<i>Finance</i>					
Trading & savings banks	16.6	12.0	13.2	16.5	16.2
Investment & merchant banks	12.7	10.4	9.7	11.5	13.1
Hire purchase	6.9	9.0	7.7	11.6	11.3

Investment & others	6.5	7.3	7.9	7.1	8.4
Trustees	12.2	11.0	12.7	12.4	12.9
Insurance	15.0	17.2	14.9	9.0	13.0
<i>Transport</i>					
Airlines	4.9	15.6	13.4	12.8	4.9
Shipping	8.2	12.0	12.9	10.5	10.7
Land	17.3	18.6	16.5	17.9	18.9
<i>Utilities</i>	8.9	9.6	8.8	7.7	7.9
<i>Retail</i>					
Department & general stores	10.4	11.0	8.7	6.9	5.1
Specialty stores	12.8	16.3	16.0	14.9	12.6
<i>General merchants</i>					
Merchants	7.5	10.3	7.6	9.1	8.3
Import & export	3.4	13.8	4.7	5.5	8.4
<i>Motor vehicle distribution</i>	13.8	11.7	9.3	11.5	6.8
<i>Hotels & motels</i>	3.9	6.5	8.2	5.8	7.7
<i>Computers & office equipment</i>	15.1	15.5	24.0	25.6	27.6
<i>Broadcasting & television</i>	13.0	19.9	18.7	20.7	16.6
<i>Miscellaneous goods & services</i>	14.3	12.0	13.9	12.6	10.8

Source: PA Australia Profitability Yearbook 1980.

FIGURE 34.5: FIXED CHARGE COVER

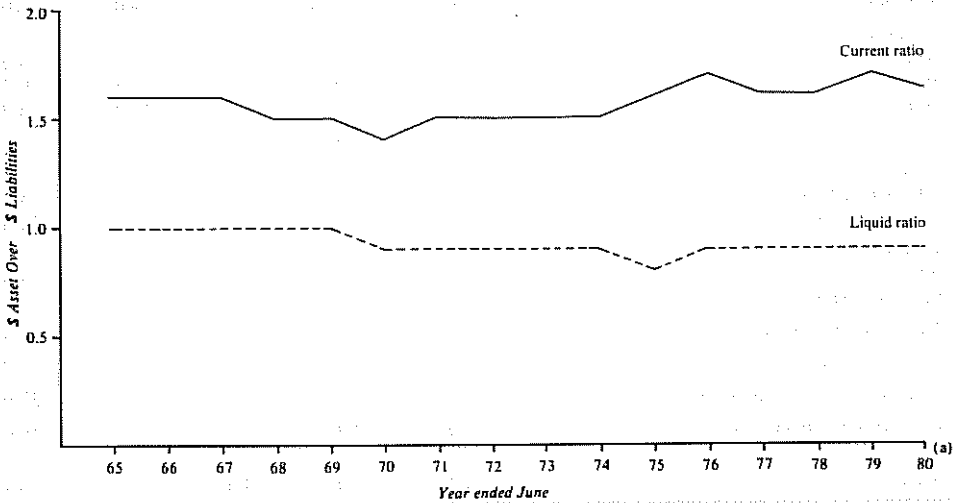


a) 1980 observation is based on a revised sample of companies; continuity is not affected

b) EBIT: Earnings before interest and tax

Source: AFSI — STATEX STUDY (All Industries Average — Excluding Finance)

FIGURE 34.6: CURRENT AND LIQUID RATIOS



a) 1980 observation is based on a revised sample of companies; continuity is not affected
Source: AFSI — STATEX STUDY (All Industries Average — Excluding Finance)

- the growing sophistication of financial markets⁶ and the greater willingness by corporate management to 'leverage' projects and the overall business; and
- changes in the underlying industrial structure.

34.10 Seen in this light, the changing debt/equity ratio may be viewed as a desirable commercial adaptation to a changing economic and financial environment. Moreover, as pointed out earlier, the rise in the ratio has levelled out in recent years. It should also be noted that present ratios are fairly conservative by comparison with those applying in many other countries, e.g. USA.

34.11 Reduced earnings cover for interest reflects higher debt and higher interest rates, not covered by a commensurate (by previous standards) increase in profitability.

34.12 Although precise information on the debt-maturity patterns of business is lacking, it is widely felt that during the mid 1970s the longest available average maturity of new fixed-interest borrowings decreased to something like three years; by contrast fixed-interest loans of well over ten years were not uncommon in the 1960s.

34.13 With the increased availability of medium-term funds on variable ('floating') interest rate terms, and a tendency for inflation (but not interest rates) to level out, businesses are now more able (and willing) to secure funds on a

6 The greater sophistication of corporate financing in recent years is illustrated in a paper titled 'Trends in Corporate Finance' by I. A. Pollard, Institute of Actuaries of Australia, 1981. The paper drew attention to a number of sources of debt funds which are either new in Australia in the last five years or less, or which have grown materially during that period. Such sources include promissory notes, syndicated loan facilities, standby facilities, negative pledge borrowing, convertible notes, floating rate leasing, leveraged leasing, equity leasing, project financing and non-recourse lending, innovative applications of unit trusts (reconstructions involving property trusts), money market funds and new instruments and markets for overseas debt. In addition, there have been such facilities as foreign currency hedging and interest rate futures.

medium-term basis. New methods of financing, such as leasing, have also been developed. However, long-term, fixed-interest loan finance has remained relatively unattractive to both borrowers and lenders.

34.14 From the viewpoint of stability it would seem that some of the elements which produced the marked changes in corporate financial structures in the years up to 1974-5 have since levelled out — and the threat which many saw to the survival of corporations in that period is now much less evident. Nonetheless, the range of maturities available to borrowers has remained much narrower than in the 1960s, with potentially destabilising implications for them in periods of rising interest rates.

(c) Trends in Profitability

34.15 The Committee also looked at other aspects of **business profitability**, such as how profit rates compared with the rate of inflation and the returns available from other (financial) forms of investment. The level of profits has, of course, a crucial bearing on the ability of business to obtain 'capital'

34.16 Table 34.5 contains some further estimates of rates of return on stockholders' funds and assets. Certain of the elements, viz. profitability and taxation, have been adjusted for the effects of inflation on the replacement costs of stock and depreciable assets. The Committee is conscious of the limited value of such calculations; at best they can be regarded only as broad approximations. Nevertheless, the figures suggest that the 'real' rates of return were on the average considerably lower in the 1970s than in the 1960s.⁷

34.17 For a full assessment, it is necessary to look not only at operating profits per unit of capital but also at the unit cost of the finance needed to acquire that capital.⁸

34.18 The Committee notes the many practical problems in measuring the average cost of capital⁹, encompassing the combined cost of equity and borrowing. This is more so during periods of inflation. A few available Australian studies¹⁰

7 Readers interested in exploring further the issue of corporate 'real' rates of return are referred to: R. G. Hawkins, 'Business Fixed Investment in the 1970s', Conference in Applied Economic Research, Reserve Bank of Australia *Conference Papers*, December 1979; P. L. Swan, 'An Optimum Business Tax Structure for Australia', *AFSI Commissioned Studies and Selected Papers*, Part 3.

8 Strictly speaking, what is relevant to the firm's investment decision is not the comparison of the average rate of return with the average cost of capital but the expected **marginal** rate of return on the proposed investment compared with the cost of the **last tranche** of funds supplied.

9 The average overall cost of capital is the rate at which the company's future earnings (whether in the form of interest, dividends or retention) are discounted by the capital market in valuing its securities. In practice, expectations of future earnings are unobservable. One measure often used to approximate average overall cost of capital is the ratio of current 'real' earnings to the market (financial) valuation of the company's capital stock — a form of comprehensive 'earnings yield'. Methods of adjusting nominal incomes for the effects of inflation are far from resolved.

10 See for example: N. C. Mackrell, J. Frisch and P. Roope, 'Equations for Business Fixed Investment', in *Three studies of Private Fixed Investment*, Reserve Bank of Australia, Occasional paper No. 3E, June 1971; A. B. Smith, 'The Share Market and the Cost of Capital', Australian Bureau of Statistics, *Mimeo*, August 1973; H. N. Johnston, 'Corporate Profitability and the User Cost of Capital for the Corporate Trading Enterprise Sector', Australian Bureau of Statistics, *Mimeo*, December 1975; C. I. Higgins, H. N. Johnston and P. L. Coghlan, 'Business Investment: The Recent Experience', in *Conference in Applied Research, September 1976*, eds W. E. Norton and D. W. Stammer, Reserve Bank of Australia, Sydney; E. Kiernan and P. O'Shea, 'An Analysis of Fixed Investment, Aggregate Production and the Cost of Capital in Australia', 48th Anzaas Congress, September 1977; R. G. Hawkins, and B. Fitzgibbon, 'Estimating the Tobin Ratio', Reserve Bank of Australia, Sydney, mimeographed, 1978; P. L. Swan, *op. cit.*

TABLE 34.5 PROFITABILITY, INFLATION AND TAXES

Year ended 30 June	RBA's constant group ^(a)		AFSI-STATEX Study ^(b)		Profit after tax/total assets	Profit after tax/shareholders' funds	Effective ^(d) tax rate	Inflation adjusted profitability ^(c) as a % of historic cost profits		Taxation as a % of inflation adjusted profitability	
	Profit after tax/shareholders' funds	EBIT ^(e) total assets	Profit after tax/total assets	Profit after tax/shareholders' funds				CEDA	Dept of Industry & Commerce	CEDA	Dept of Industry & Commerce
1963	7.6	10.1	6.0	9.2	37.5	—	93.4	—	39.1	1.2	
1964	8.0	11.0	6.4	10.2	41.2	96.0	94.4	41	40.2	4.6	
1965	8.3	11.2	6.5	10.6	37.5	88.7	87.6	42	41.3	2.8	
1966	7.8	10.4	6.0	9.8	38.1	89.8	87.1	44	43.7	3.2	
1967	8.1	10.5	6.0	10.0	38.0	87.8	83.3	44	42.6	3.1	
1968	8.3	10.8	5.9	10.0	39.6	86.0	81.7	46	44.8	3.0	
1969	8.7	11.0	6.1	10.3	40.2	84.9	80.5	46	45.0	3.2	
1970	8.8	11.0	6.0	10.0	44.0	79.5	79.0	50	48.1	4.7	
1971	8.7	10.7	5.6	9.9	44.7	66.8	74.8	53	49.4	5.1	
1972	8.8	10.9	5.3	9.7	45.5	54.5	64.8	57	51.9	6.8	
1973	9.6	11.3	5.5	10.0	45.1	57.5	62.0	58	55.6	9.7	
1974	9.1	11.6	5.5	10.2	47.2	41.7	42.5	64	64.1	13.9	
1975	8.6	11.3	5.4	10.0	44.0	12.3	12.5	86	85.6	18.2	
1976	8.9	11.9	6.1	11.0	41.8	5.1	2.0	93	97.4	14.7	
1977	9.4	12.1	6.5	11.9	40.7	19.9	12.2	77	86.0	11.3	
1978	9.4	11.2	5.9	10.8	39.7	17.2	18.8	81	77.0	7.8	
1979	n.a.	11.7	6.4	11.6	40.9	17.5	18.7	83	76.1	7.8	

(a) RBA Company Supplement 'All Industries Constant Group'.

(b) AFSI commissioned study conducted by the Sydney Stock Exchange based on a sample of approximately 300 listed companies.

(c) Two inflation adjustments have been made:

1. Trading stock valuation adjustment

2. Depreciation valuation adjustment

(d) These figures were supplied in the submissions of these organisations (see also Tables 34.6 and 34.7). The Committee does not necessarily endorse the calculations.)

(e) % change in the implicit price deflator for GDP.

(f) Earnings before interest and tax.

(g) Tax expense/pre-tax group profits (excluding extraordinary items).

Sources: Reserve Bank of Australia, Company Supplement;

CEDA Economy 80's Monograph Paper: 'The Crucial Role of Profitability';

Department of Industry and Commerce submission to the Inquiry.

Australian Bureau of Statistics, National Accounts, Catalogue No. 5204.0.

TABLE 34.6: REPORTED PROFITS OF CORPORATE TRADING ENTERPRISES (EXCLUDING PUBLIC TRADING ENTERPRISES) (\$m)

Year ended 30 June	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Income as reported																	
Gross operating surplus (including stock valuation adjustment)	2 235	2 546	2 884	2 898	3 210	3 639	4 185	4 872	5 169	5 701	6 727	7 950	8 951	10 028	11 074	11 693	13 103
Less																	
• Depreciation (historical cost)	549	610	694	785	877	980	1 077	1 188	1 313	1 483	1 575	1 752	1 968	2 257	2 537	2 769	2 970
• Net interest paid	184	194	237	292	313	349	433	550	683	793	947	1 114	1 586	1 761	1 891	2 133	2 341
Income before tax	1 502	1 742	1 953	1 821	2 020	2 310	2 675	3 134	3 173	3 425	4 205	5 084	5 397	6 010	6 646	6 791	7 792
Less income tax payable ^(a)	563	677	744	734	771	922	1 062	1 323	1 339	1 409	1 838	2 195	2 301	2 586	2 840	2 625	2 910
Net income after tax	939	1 065	1 209	1 087	1 249	1 388	1 613	1 811	1 834	2 016	2 367	2 889	3 096	3 424	3 806	4 166	4 882
Less net dividends Paid	444	470	478	471	588	624	677	787	781	841	948	1 014	1 140	1 281	1 477	1 604	1 716
Undistributed income	495	595	731	616	661	764	936	1 024	1 053	1 175	1 419	1 875	1 956	2 143	2 329	2 562	3 166
Effective tax rate (%)	37.5	38.9	38.1	40.3	38.2	39.9	39.7	42.2	42.2	41.1	43.7	43.2	42.6	43.0	42.7	38.7	37.3

(a) To be paid in the following year.

Sources: ABS *National Income and Expenditure 1978-79* and various prior issues; *1980-81 Budget Paper No. 9*; and Department of Industry and Commerce estimates.

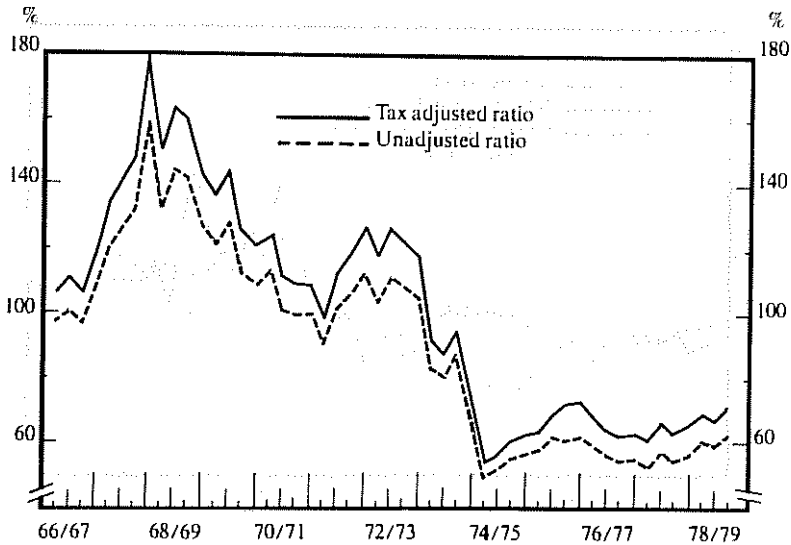
TABLE 34.7: REAL INCOME OF CORPORATE TRADING ENTERPRISES (EXCLUDING PUBLIC TRADING ENTERPRISES) (\$m)^(a)

Year ended 30 June	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Adjusted income																	
Gross operating surplus (including stock valuation adjustment)	2 235	2 546	2 884	2 898	3 210	3 639	4 185	4 872	5 169	5 701	6 727	7 950	8 951	10 028	11 074	11 693	13 103
Less																	
• Stock valuation adjustment	16	20	97	83	107	138	158	183	219	356	541	1 188	1 683	1 770	1 350	1 137	2 111
• Depreciation (replacement cost) ^(b)	595	650	748	842	979	1 096	1 233	1 386	1 557	1 836	1 934	2 225	2 995	3 841	4 529	5 015	4 829
• Net interest paid	184	194	237	292	313	349	433	550	683	793	947	1 114	1 586	1 761	1 891	2 133	2 341
Real income before tax ^(c)	1 440	1 682	1 802	1 681	1 811	2 056	2 361	2 753	2 710	2 716	3 305	3 423	2 687	2 656	3 304	3 408	3 822
Less income tax payable ^(d)	563	677	744	734	771	922	1 062	1 323	1 339	1 409	1 838	2 195	2 301	2 586	2 840	2 625	2 910
Real net income after tax	877	1 005	1 058	947	1 040	1 134	1 299	1 430	1 371	1 307	1 467	1 228	386	70	464	783	912
Less net dividends paid	444	470	478	471	588	624	677	787	781	84	948	1 014	1 140	1 281	1 477	1 604	1 716
Real undistributed income	433	535	580	476	452	510	622	643	590	466	519	214	-754	-1 211	-1 013	-821	-804
Real effective tax Rate (%)	39.1	40.2	41.3	43.7	42.6	44.8	45.0	48.1	49.4	51.9	55.6	64.1	85.6	97.4	86.0	77.0	76.1

(a) Equivalent to Table 34.6 but with the varied assumption related to the average age of equipment covered by depreciation allowances in a given year; see footnote (b) below.
 (b) Depreciation at replacement cost is calculated by multiplying the historical cost depreciation by $(1 + P)$, where P represents the increase in the gross fixed capital expenditure (equipment) deflator over a 6 year period for the years 1962-63 to 1972-73, 5 year period for the years 1973-74 to 1976-77 and a 4 year period in the years from 1977-78 up to year i . For the years 1965-66 to 1978-79 the 'equipment' deflator was used, for the years 1962-63 to 1964-65 the 'other' deflator (equipment plus non-dwelling construction) was used.
 (c) Depreciation at replacement cost and stock valuation adjustment deducted from income.
 (d) To be paid in the following year.

Sources: ABS *National Income and Expenditure 1978-79* and various prior issues; 1980-81 *Budget Paper No. 9*; and Department of Industry and Commerce estimates.

FIGURE 34.7: RATIO OF MARKET VALUE TO REPLACEMENT COST OF CAPITAL — AUSTRALIA



Source: R. G. Hawkins, 'Business Fixed Investments in the 1970's,' in Reserve Bank of Australia, *Conference Papers*, December 1979

have looked at the cost of capital, and have attempted to measure the relative profitability of investment. One test used is the ratio of the value of capital assets in the share market to their replacement cost.¹¹ There is a variety of other techniques employed to compare real rates of return with the 'true' cost of capital. From the various studies seen by the Committee, the picture which emerges is broadly that **relative profitability** fell sharply in the early to mid 1970s, but recovered somewhat in later years. Figures 34.7 and 34.8 reproduce results from one of the Australian studies.¹² Overseas studies¹³ also point to a similar overall picture (see Table 34.8), although the results should be read with the usual caution. (It is notable that in the UK there was a deterioration in relative returns in 1980.)

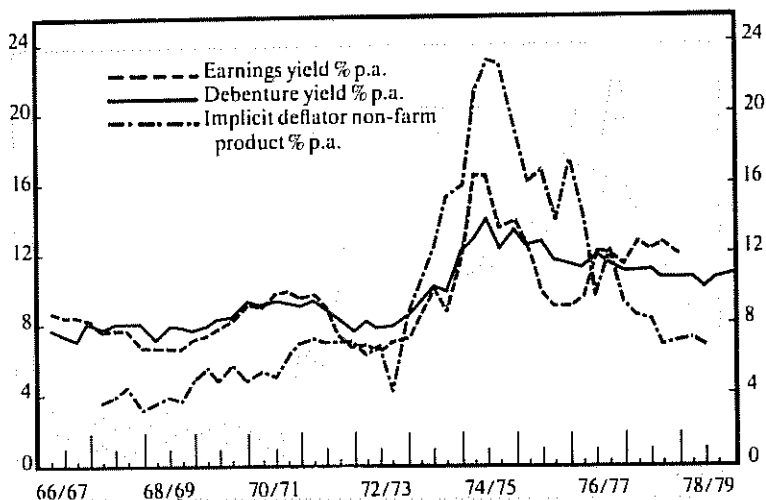
34.19 The strains on business profitability during the 1970s were tempered by two factors. First, the changes in corporate gearing ratios in that period and the low and even negative real interest rates during most of the decade. Secondly, the tax relief provided to companies late in the period — both through stock valuation adjustments and investment allowances. However, the overall tax charge rose in 1979–80, reflecting reductions in these benefits.

11 Commonly called the **Tobin ratio**. Keynes (1937) appears to have been the first to emphasise the importance of this relationship as a possible determinant of investment. In his 1969 paper, Tobin argued that businessmen's demand for investment goods should be positively related to this ratio. The market valuation of capital investment (the numerator in the ratio) is of course heavily influenced by expectations regarding future profits and interest rates on financial assets. J. Tobin, 'A General Equilibrium Approach to Monetary Theory', *Journal of Money, Credit and Banking*, 1: 15–29.)

12 R. G. Hawkins, *op. cit.*

13 See, for example, F. Modigliani and R. A. Cohn, 'Inflation, Rational Valuation and the Market', *The Financial Analysts Journal*, March–April 1979; various issues of the *Bank of England Quarterly Bulletin*, particularly March 1976, June 1979 and June 1980.

FIGURE 34.8: COST OF FUNDS — AUSTRALIA



Source: Hawkins, R.G., op. cit.

TABLE 34.8: UNITED KINGDOM: RATES OF RETURN ON TRADING ASSETS OF INDUSTRIAL AND COMMERCIAL COMPANIES^(a)

Rates of return				
Year ended 30 June	Pre-tax historic cost	Pre-tax real ^(b)	Post-tax real	Post-tax real cost of capital ^(c) (d)
1963	15.9	11.4	7.4	5.8
1964	16.6	11.9	7.8	6.0
1965	15.8	11.2	7.3	5.3
1966	14.1	9.9	5.9	6.3
1967	13.6	10.0	5.8	5.0
1968	14.8	10.1	5.7	3.9
1969	14.9	9.9	6.0	4.0
1970	14.4	8.6	5.2	5.0
1971	15.1	8.8	6.1	4.6
1972	16.8	9.3	6.5	4.8
1973	19.8	9.1	8.1	3.9
1974	18.7	5.2	6.0	3.0
1975	18.5	5.3	3.9	5.0
1976	20.1	5.4	5.4	6.8
1977	19.4	6.2	6.8	6.5
1978	19.0	6.2	6.3	6.1
1979	18.5	4.3	6.1	5.0
1980	14.2	2.9	3.2	4.4

(a) Excluding their North Sea activities.

(b) Net of stock appreciation and capital consumption at replacement cost. (For derivation of the real rate of return see appendix to this table.)

(c) Percent per annum end year. The cost of capital is defined as the rate at which future earnings are discounted by the capital market. It is estimated as the ratio of real post-tax profits to the market (financial) valuation of the capital stock. The financial value of the capital stock is the sum of the company's financial liabilities, i.e. equity, loans, preference shares and bank advances all valued at market price.

(d) Figures not updated in June 1981 issue. Figures quoted include Secretariat's re-estimates from published graphs.

Source: Bank of England Quarterly Bulletin, March 1976, June 1976, June 1977, June 1980, June 1981.

Derivation of the real rate of return

The algebraic formulations to the calculation of the real rate of return are as follows:

Pre-tax real rate of return

Historic cost rate of return:

$$\frac{GTP+R-CCH}{FH+W} \quad (1)$$

a after revaluation of the capital stock:

$$\frac{GTP+R-CCH}{FR+W} \quad (2)$$

b after revaluation of capital consumption:

$$\frac{GTP+R-CCR}{FR+W} \quad (3)$$

Real pre-tax rate of return:

$$\frac{GTP+R-CCR-SA}{FR+W} \quad (4)$$

where

- CCH is capital consumption at historic cost,
- CCR is capital consumption at replacement cost,
- FH is net capital stock at historic cost,
- FR is net capital stock at replacement cost,
- GTP is gross trading profits,
- R is rent received by companies,
- SA is stock appreciation, and
- W is book value of stocks and work in progress.

Post-tax real rate of return

Taxation affects rates of return not only because post-tax profits are smaller than pre-tax profits but also because taxation reduces the relevant capital base. The relevant capital base (CB) is the company's stock of assets at replacement value (FR) net of this tax liability:

$$CB = FR - C(FR - WDT) + W$$

where

- CB is tax-adjusted capital stock;
- WDT is tax-written-down value of fixed assets; and
- C is the Corporation tax rate.

Source: *Bank of England Quarterly Bulletin*, March 1976.

34.20 The situation at the start of the 1980s is different in most, but not all, respects from what it was in the mid to late 1970s.

- there is evidence of a recovery in corporate profitability in more recent years — certainly in nominal terms but possibly also in real terms (an exception, currently, would be those sections of the mining industry affected by low world commodity prices and other factors);
- the rate of inflation is generally seen as having 'levelled out';

TABLE 34.9: AVERAGE DIVIDEND AND EARNINGS YIELD

<i>Year ended 30 June</i>	<i>Listed equities average dividend yield^(a)</i>	<i>Listed equities average earnings yield^(b)</i>
1950	4.94	n.a.
1951	4.83	n.a.
1952	6.91	n.a.
1953	6.60	n.a.
1954	6.30	n.a.
1955	6.69	n.a.
1956	7.97	n.a.
1957	7.37	n.a.
1958	7.11	n.a.
1959	6.12	n.a.
1960	4.91	n.a.
1961	6.27	11.74
1962	5.54	8.67
1963	5.61	7.77
1964	5.11	6.89
1965	6.09	10.04
1966	6.33	12.48
1967	6.59	11.38
1968	5.71	10.30
1969	5.24	8.94
1970	6.23	10.96
1971	6.60	13.69
1972	5.34	8.49
1973	4.96	7.71
1974	7.33	11.65
1975	9.34	17.65
1976	7.75	12.62
1977	8.33	16.62
1978	7.46	15.98
1979	7.08	13.70
1980	6.66	14.84
1981	5.63	11.43

(a) Unweighted average dividend yield (percent per annum). From 1972 yields calculated on national listings; prior to that date only on Sydney Stock Exchange listings.

(b) Random sample of companies on Melbourne Exchange; 50 companies to June, 1973, thence 100 companies. Source: Melbourne and Sydney Stock Exchange.

- against the background of greater volatility in short-term interest rates, overall dividend and earnings yields¹⁴ on listed shares have fallen in recent years (see Table 34.9)¹⁵;
- it is evident that there has recently been a notable improvement in longer term business profit expectations¹⁶, judging by the high levels of capital expenditure incurred and anticipated in 1980–81 and thereafter.

14 'From the point of view of the business, the earnings yield is the cost of raising equity finance. To the shareholder the nominal return in a particular period is the sum of dividends received and the nominal capital gains on shares. When share prices are expected to fall the shareholder will be expecting the return on shares to fall in the short term, while the firm will be expecting the earnings yield to rise. Hence, a firm may find it difficult to raise share capital when share prices are falling, even though it could be prepared to pay the cost implied by current earning yield', R. G. Hawkins, *op. cit.*, p. 209.

15 There has been some reversal during the course of 1981.

16 Most economists agree that current investment decisions are being made on the basis of expected rates of return — not past rates.

34.21 To the extent that any action is needed to improve overall business profitability — and the Committee does not claim that such action is needed — the solution lies not in the financial system but in appropriate domestic stabilisation policies. In that regard, it offers the following comments:

- In the short run, profitability depends on the level of demand. The Committee stresses, in this context, the importance of a stable policy environment. Sudden contractionary policies (which are unexpected) can often lead to lower business profitability partly because of lower capacity utilisation and partly because nominal wage increases do not moderate quickly enough.
- Over a longer period profitability depends on the relationship between productivity and real wage movements. Many argue that a central problem in the period after 1973 was that real wages got out of line. There is some evidence that this trend has been checked but there are obvious lessons for the future.

(d) Conclusions

34.22 The broad impression which emerges from this brief survey of trends in corporate finance structures and profits is that the disturbing trends evident during the 1970s are much less pronounced today. Many of these trends reflect the inflationary environment business had to operate in during this period. By and large they raise issues for macroeconomic management rather than the efficiency of the financial system. Against a background of a more stable economic and monetary environment, most businesses appear to have adjusted to the problems and challenges.

34.23 The Committee therefore sees no immediate need for government initiatives. However, an acceleration in the rate of inflation, coupled with any drop in profitability and consequent cash flow, could revive many of the stresses of the 1970s and reactivate some of the earlier concern. In an unsettled world economic and financial environment, it is vitally important to ensure that Australian businesses, and the financial system, are able to respond flexibly to changing economic circumstances. The Committee now focuses on some of the factors that might constrain such flexibility.

B. BARRIERS TO EFFICIENCY

(a) Market Structure

34.24 The competitive structure of financial markets — the range and diversity of institutions within the system and the general level of competition — can have an important bearing on the cost and distribution of capital available to the business sector. Efficiency can also be affected where government regulations and technical imperfections in the financial markets impede the flexible developments of financial market structures. The end result is to raise the cost of funds to businesses.

34.25 Various aspects of competitive structure are discussed in Chapter 32. The general conclusion reached there is that **'wholesale' business finance** markets are generally highly competitive, with large corporations having access to overseas, direct and internal sources of finance, as well as local institutional funds. On the other hand, sources of **'retail' (small) business finance** appear to be less varied and less numerous. While to a significant degree this is a by-product of

government intervention — which is discussed later — it may also, in small part, reflect the structural characteristics of the financial system.

34.26 Two key features of the Australian financial system which are thought to bear on the distribution of business finance are:

- the ‘institutionalised’ character of available savings, evidenced by the high proportion of household savings that are channelled through financial intermediaries; and
- the high levels of concentration, characterised by the dominant role played by a few large banks and life insurance companies.

34.27 It is not at all clear that the structural allocation of funds to the business sector is significantly altered simply because savings are channelled through institutions. It is partly a question of whether those institutions are more risk-averse than individual investors as a group. Because of their very size and strength, institutions are generally better able to spread their risks and returns and to place their funds in ‘lumpy’, sometimes longer term investments than most individuals.

34.28 Because most institutions are usually better informed, and more national in their investment perspective than individuals, the institutionalised character of the system should contribute to a more efficient allocation of finance to businesses generally.

34.29 The issue of concentration is less clear-cut. It can be argued that, given the overall size of the Australian financial system and its growing links with overseas financial markets, some degree of concentration is desirable from an efficiency viewpoint. Beyond a point, however, the concentration of finance in a few large institutions may yield little in operational economies while possibly having undesirable economic effects. For example:

- competition could suffer if key financial markets were dominated by a few large institutions;
- some of the very large institutions could be expected to set relatively high limits on the minimum size of their commercial loans or investments, thus restricting the availability of funds to smaller businesses;
- in selecting securities for investment, large institutions might be expected to be more concerned than small institutions about the effects of their transactions on the prices of these securities, and this could introduce a bias against corporations whose shares are thinly traded.

34.30 At some point, therefore, concentration may prevent an efficient allocation of business finance. For reasons discussed in Chapter 32, however, the Committee **does not believe that present levels of concentration have reached this critical point**, although the trends need to be closely reviewed.¹⁷ It is appropriate here to reiterate the view frequently expressed in this Report that entry into financial intermediation should be relatively unhindered, so as to enhance the competitiveness of financial markets.

(b) Government Intervention

34.31 There can be little question, in the Committee’s judgment, that various actions of government have had a significant distorting effect on the cost and

¹⁷ The issue is also briefly discussed in Chapters 24 and 25.

availability of capital to business. This is a theme which recurs repeatedly throughout the Report and some of the main threads relating to business finance are drawn together here.

34.32 Various aspects of **taxation** bear heavily on business balance sheet structures and funding patterns. In Chapters 14–17, attention is drawn, *inter alia*, to:

- present company tax arrangements and their effect on investors' portfolio preferences and on business decisions concerning retained profits, debt/equity ratios and corporate structures generally;
- the non-neutrality of stamp duties, with consequences for the choice of financial instrument.

34.33 The implications of **lending and interest rate controls** on banks are considered in Chapter 4. For borrowers such controls can mean:

- higher bank interest charges for larger customers;
- rationing of bank funds particularly to small customers;
- increased resort to more costly (and often less efficient) non-bank or 'direct' sources of financing, as part of the rationing process.

34.34 The extent to which particular institutions are subject to various **portfolio restrictions**¹⁸ is set out in Chapters 15–17 of the Interim Report. In brief:

- banks cannot hold deposits with a maturity beyond four years; this in turn affects their ability to lend on a longer term basis;
- funds marshalled from the household sector by credit unions, building societies and savings banks are generally not available for on-lending directly to the business sector as either debt or equity; in part this is the result of restrictions on the types of investment made by these institutions;
- the 30/20 requirement on life offices and pension funds may affect the cost and availability of funds to the business sector.

34.35 **Exchange controls** and the restrictions on forward cover facilities have, from time to time, played a significant part in limiting the range of financial choice available to business (see Chapter 8).

34.36 The Committee believes that if the recommendations made elsewhere in the Report were adopted, they would go a long way to removing many of the regulatory obstructions to the efficient allocation of funds to the business sector.

34.37 The following recommendations are of particular relevance:

- the removal of direct bank interest rate, maturity, and quantitative lending controls (see Chapter 4);
- the abandonment of the LGS ratio (see Chapter 4);
- the abolition of the 30/20 requirements (life offices etc.), and the reliance on market-directed initiatives to appropriately fund government borrowing requirements (see Chapter 10);
- the abolition of the 40% and 7.5% requirements (savings banks) and the replacement of these by an appropriate reserve requirement (see Chapter 10);

18 The issues discussed here are closely related to the effects of interest rate controls.

- that the Government work towards the introduction of a system of full integration of company and personal income tax (see Chapter 14);
- that private companies be given the option to be treated as a partnership for tax purposes and the shareholders be taxed accordingly (see Chapter 14);
- that a loss suffered by one company should be permitted to be offset against the taxable income of another company in the same group (see Chapter 14);
- that the agreement of the States be sought to abolish the existing system of stamp duties on financial transactions and replace it with a uniform and Australia-wide flat tax on all financial transactions and instruments (see Chapter 16).

CHAPTER 35: ROLE OF FOREIGN CAPITAL

A. INTRODUCTION

35.1 Overseas capital has financed a significant proportion of Australia's industrial and resource development.

35.2 It may assume even greater importance in the future, in view of the concerns expressed in some quarters that Australia faces a resource-led investment upsurge and an overall 'capital shortage' in the 1980s.

35.3 It is suggested that the community's willingness to save may fall short of its economic growth aspirations and that this might lead to a shortage of 'real' resources (labour and capital). Viewed in this way, the problem is not essentially one arising from any failure of the financial system.¹ Nevertheless, the Committee has an interest in this issue because imported financial capital can be 'transformed' into additional real resources (in the form of additional imports of goods and services). Barriers to the flow of foreign capital may therefore be seen as an important dimension of any long-term 'capital shortage' problem that might be thought to exist.

35.4 Estimates of future supply and demand for capital are of course subject to considerable uncertainty. Saving ratios have proved extremely difficult to predict in the past and will be even more difficult to predict in the rapidly changing economic and financial environment of the future. On the demand side, many of the estimates of anticipated capital expenditure, especially in the resources development area, involve assumptions about costs, overseas markets, prices, exchange rates and interest rates which are at best highly speculative.

35.5 Nevertheless, the Committee accepts that, on any realistic assessment of prospective resource developments, large capital expenditure sums are likely to be involved and this might (other things remaining equal) put upward pressure on interest rates. If interest rates are allowed to rise sufficiently, any excess demand for capital will, of course, disappear.

1 It is of course possible for capital 'shortages' to emerge as a result of imperfections in financial markets. In relatively underdeveloped capital markets, for example, the facilities for mobilising household savings and transferring them to ultimate spenders may be inadequate and the available savings may not all be 'transformed' into real investment, despite the existence of attractive unused investment opportunities. This does not appear to be a significant problem in Australia; although there are some rigidities and imperfections in financial markets which obstruct the flow of funds, the 'gaps' they create are principally structural in character, i.e. they relate to particular types of capital. In any case, while the resulting 'gap' may be viewed as stemming from deficiencies in the financial system, in the final outcome the responsibility rests with economic management.

35.6 Such a 'free market' solution may not however be the most desirable outcome. There are at least three alternative approaches:

- governments could aim to slow down the level of capital expenditure and hence the future potential rate of economic growth;
- they could seek to increase the domestic saving ratio; and
- foreign capital could be allowed to enter more freely.²

35.7 Thus increased foreign capital could be seen as an alternative to either lower rates of economic growth or lower levels of immediate consumption — or a combination of both, probably accompanied by higher interest rates.

35.8 Against this background, the Committee now turns to briefly consider present foreign investment policy and in particular the desirability of:

- Australia reducing its dependence on overseas capital; or
- at the other extreme, adopting a more *laissez-faire* policy towards foreign investment.

B. FOREIGN INVESTMENT POLICY

35.9 Chapter 20 of the Interim Report outlined the existing foreign investment policy arrangements and the role of the Foreign Investment Review Board in the implementation of those arrangements.

35.10. The aim of foreign investment policy is '... to strike a balance between the benefits of long-term investment ... and the possible costs to the national interest of foreign ownership and control'.³ The basic approach is to examine new investment proposals individually to assess whether:

- they offer net economic benefits; and
- provide adequate opportunities to Australians to participate as fully as practicable in the ownership and control of local natural resources and industries.

35.11 The Committee has not attempted to carry out a full discussion of the long-term economic benefits from foreign investment. Detailed analyses of the diverse issues are contained in a number of Australian studies.⁴

35.12 The main strands of the arguments are briefly:

- Over the longer term, foreign investment serves to finance, directly or indirectly, a real increase in Australia's productive capacity. It thus augments the potential rate of economic growth sustainable on any given level of domestic savings.
- As a general rule, foreign capital yields net gains to Australia so long as the expected returns (contribution to increased national income) exceed the costs of servicing the foreign capital and any other costs associated with foreign ownership and control. Provided foreign investment is not subsidised directly

2 This would have to be associated with a larger external deficit on current account to ensure that there was an addition to Australia's real resources.

3 Commonwealth Treasurer, *Press Release No. 87*, 22 May 1981.

4 *Treasury Economic Paper No. 1*, 'Overseas Investment in Australia', May 1972; W. M. Corden, *Trade Policy and Economic Welfare*, Clarendon Press, Oxford, 1974; E. A. Russell, 'Foreign Investment Policy — What Role for the Economist', *Australian Economic Papers*, December 1978; G. D. A. MacDougall, 'Benefits and Costs of Private Investment from Abroad — A Theoretical Approach', *Economic Record*, March 1960.

or indirectly (e.g. through excessive tariff protection), it is likely to yield a net gain to national income, both through the tax collected⁵ and because of the tendency for real wages to rise when the capital stock is increased relative to labour. There are also likely to be favourable employment effects.

- Foreign equity investment provides a medium through which Australians can share with overseas investors some of the risks associated with investment in Australia.
- There might be potential gains from **economies of scale** under a freer foreign investment policy, but it is probable that such economies are already largely being exploited within the constraints of the current foreign investment guidelines.
- There are some returns from foreign investment which accrue to the community at large and not just to those directly participating in the investment; these '**external**' benefits are usually attributed to the know-how that foreigners bring to Australian industry. It has been argued that foreign companies are generally more willing to exploit their latest technology where they can maintain ownership and control over the project, and that the spread or flow-on of new techniques to Australian companies might be slower when foreign investors are required to act jointly with Australian companies.

35.13 The present foreign investment policy commands a broad cross-section of community support; however, there are some who favour a **more restrictive** policy and others who favour a **more liberal** one. The choice hinges partly on socio-political considerations but there are implications for the level and structure of financing that need to be understood.⁶

(a) More Restrictive Policy

35.14 A more restrictive policy would require greater local participation in new development projects. If all other things were to remain equal, such a policy would reduce the resources available for capital expenditure in Australia and slow down the pace of economic development. To avoid such an outcome it would be necessary for either (i) the domestic saving ratio to increase, or (ii) the reduction in equity capital inflow to be offset by an increase in debt capital inflow, leaving Australia's total net access to foreign resources unchanged.

35.15 A difficulty with (i) is that Australia already has a fairly high saving ratio by world standards (see Appendix 35.1) and the community may not be prepared to accept lower levels of immediate consumption. Many of the factors influencing the trend in savings (such as changes in the age structure of the population, in the distribution of incomes or in the general level of expectations) fall outside an area susceptible to simple fiscal incentives.⁷ Some of the varied factors that may influence the long-term trend in household savings are discussed in Appendix 35.1.

⁵ On this point see *Treasury Taxation Paper No. 9, 'Company Income Tax Systems'*, November 1974.

⁶ Issues relating to foreign ownership of financial institutions are discussed in Chapter 25.

⁷ This is not to suggest that fiscal incentives are totally ineffective in encouraging savings although it was pointed out in Chapter 15 that only an expenditure tax would achieve the desired incentive without significant by-product distortions. Selective concessions to particular forms of savings can lead to inequities between taxpayers and to resources being drawn away from possibly more profitable areas into avenues offering tax advantages.

35.16 Alternative (ii) might present fewer problems as there appears to be scope to raise additional loan finance from overseas. There is no apparent shortage of foreign debt capital for Australia — nor is there likely to be in the immediate future.

35.17 However, if the requirements of investment projects are to be satisfied, a further condition must be met, viz. there must be a change in the debt/equity mix of domestic savings to offset the change in debt/equity mix of foreign capital inflow. In other words, Australians must be prepared to take on more risk.

35.18 It is recognised that the debt/equity structures of various projects are not fixed and rigid. Significant changes in corporate structures have occurred over the years, particularly in the resources development area, and new financing arrangements (project financing, leveraged leasing etc.) have in recent years facilitated higher debt/equity ratios. There may be scope for further change in the same direction.⁸ Nonetheless, there is no doubt that some of the adjustment burden would have to fall on domestic capital markets. The increased relative importance of household savings in total savings in the 1970s (see Figure 35A.1) has helped to promote the necessary adjustment because household savings are more flexible and mobile than corporate savings and generally easier to redirect, if the inducement is there. However, household saving ratios have been tending to recede in recent years.

35.19 A key issue therefore is whether, in the face of a more restrictive foreign investment policy, the domestic capital market could respond effectively to the changed debt/equity requirements. The essential ingredient here is a competitive and responsive financial system.

35.20 Significant changes are already occurring in the deployment of domestic equity capital, within the existing foreign investment policy framework. There is evidence that in recent years the financial system has been responding strongly to the growing demand for local equity capital for direct investment in resource development. For example, there have been:

- diversification moves by large industrial corporations into the resource area⁹;
- various partnership arrangements between Australian companies and institutions, enabling the latter to participate directly in large resource developments, notably involving iron ore, coal, oil and aluminium; and
- the establishment by some life offices and superannuation funds of equity-linked investments, predominantly oriented towards resource development.

35.21 While these initiatives are encouraging evidence of the resilience of the Australian capital market, there is a real possibility that a **more restrictive foreign investment policy**, without any reduction in planned capital expenditure, might impose excessive strains on the domestic financial system, even if the total volume of foreign 'capital' inflow for these purposes were to remain constant. Normal

8 In a recent address (April 1981), the Managing Director of AIDC, Mr J. R. Thomas, has forecast that 'whereas in the 1960s major mining developments were financed using 80% internal funds and 20% borrowings, it would not be surprising to see some developments in the 1980s where the position is reversed — with projects going ahead using 80% in the form of borrowed funds'.

9 The Treasurer, in a recent address to the Economic Society of Australia and New Zealand (22 May 1981), said that 'as of early May 1981, fourteen of the top sixteen listed companies (in terms of market capitalisation) on the Sydney Stock Exchange were wholly or partially engaged in natural resource development'.

market processes might not be able to cope readily with the size and speed of the adjustments required in debt/equity patterns of financing. The authorities might feel impelled in these circumstances to dampen down the general level of investment.

35.22 It has been suggested that a National Resource Development or Investment Fund with government support (more recently referred to as 'Australia Trust') could be used as a vehicle to accelerate the desired structural changes in the capital market. The Fund would have a specific charter to attract small and large savings and deploy them (principally in equity form) into resource developments.

35.23 The Committee has a number of reservations about such suggestions:

- If the proposed Fund were run on a self-financing commercial basis it would merely duplicate the role of private institutions such as life offices, superannuation funds and unit trusts. These institutions are increasing the proportion of resource-based equities in their overall investment portfolios. In some instances this is taking the form of partnerships with Australian companies in the development of resource projects. Where the size of the project so requires, it has not been uncommon for several funds to combine together for a specific project to enable adequate pooling and spreading of risk. Therefore, it is difficult to see why a government-backed fund would have any intrinsic comparative advantage over private institutional funds.
- Some of the advocates of a government-sponsored Fund envisage a subsidy to make it more attractive to investors. Any subsidy, however, whether in the form of tax concessions to subscribers, capital grants, loan guarantees or the like, would cut across the principles of competitive neutrality consistently advocated in this Report. The net result might be a less efficient system of financial intermediation.
- Quite apart from efficiency considerations, if the result of a subsidy were principally to divert equity funds from other sources, the effectiveness of such an approach in achieving its basic objectives would be very much open to question.
- Any net incentive effect that a subsidised government Fund might have on the supply of equity capital could equally be achieved through other means such as specific concessions to investors in established private intermediaries or to direct investors. While the Committee does not recommend such concessions (since it is not advocating a more restrictive foreign investment policy and the concessions would be unlikely to be cost-effective in achieving the desired change in the debt/equity mix), it would be a better course than channelling the concessions solely through a government-sponsored Fund, in terms of both neutrality and efficiency.
- The argument that such a Fund might at times be used to influence patterns of development in 'nationally desirable' directions needs to be carefully assessed. Internal contradictions would arise in the management of the Fund if it were asked to pursue both commercial and non-commercial objectives. The pursuit of non-economic investments could at the very least tend to negate the effects of the government subsidy and at worst it could frustrate the capacity of the Fund to attract subscribers.
- Finally, there is a risk that the Government's perceived association with one particular Fund might foster the impression in the community that investment

in that Fund was relatively secure; in the event of losses being incurred, governments might feel an obligation to step in with further 'assistance'.

35.24 Having due regard for these reservations, the Committee does not support the concept of a National Resource Development Fund.

35.25 The Committee would see even more formidable problems in any approach which involved government 'direction' of the investment patterns of domestic institutions. This would be intrinsically inequitable and likely to lead to inefficiencies and distortions (disintermediation, the development of new 'fringe' intermediaries etc.). It could even threaten the stability of certain institutions.

35.26 It has been argued that, as part of a more restrictive foreign investment policy, the Government should undertake increased official overseas borrowing and use the funds to finance a higher proportion of infrastructure and other similar capital outlays associated with resource development. The debt servicing costs could be fully (or even more than fully) recouped, so there need not be any public subsidisation of resource projects. Nor (if the increased government borrowing is viewed as simply an offset to reduced private capital inflow) is there any reason to expect adverse effects on monetary policy.

35.27 Such a policy would have certain superficial attractions: it would help to release Australian equity capital at present locked up in private infrastructure financing; the actual funds would come from overseas in a non-equity form; the borrowing would be undertaken in the cheapest form, i.e. on the credit of the Government; and by maintaining the total level of capital inflow, it would make it possible to maintain the same access to overseas real resources.

35.28 However, official borrowing could never substitute fully for overseas equity; in particular, it could not compensate for the other benefits derived from foreign direct investment — e.g. the effects on technological progress, on the supply of risk capital, and on the development and perception of new investment opportunities in Australia. More generally, such government involvement runs a risk of introducing a 'hidden' element of government subsidy and distorting the relative assessment of various resource projects.

35.29 It should also be recognised that Australian partners in many resource development projects consider foreign equity participation necessary, for reasons relating to competition from similar projects overseas, marketing arrangements, technical expertise and overall financial requirements.

35.30 If stretched too far a greatly increased volume of official borrowing might also affect the Australian Government's borrowing status abroad.

35.31 The above discussion suggests that there are no easy alternatives to foreign equity capital. Indeed it might be economically dangerous for Australia to require local equity participation much beyond the present level.

35.32 If equity participation requirements were made more severe it would almost certainly delay the start of many projects — a delay which might well prove economically inopportune. In the longer term (and if the viability were still there), it would entail a diversion of Australian capital and enterprise from those industries in which Australian investors and entrepreneurs have special knowledge and expertise (and in which overseas investors are unfamiliar) — into industries that have traditionally attracted overseas capital and know-how. The net result could well be an unchanged level of investment in the latter group of industries but a reduced level of investment in the other areas.

35.33 It is also likely that increased reliance on overseas debt (official or private) relative to equity would inject a more inflexible servicing cost into our balance of payments. It would effectively mean that Australians would be required to bear more of the proprietorship risk, instead of sharing it with the rest of the world.¹⁰

35.34 In summary, the Committee, while recognising that there are wider social issues involved, would on **economic grounds**, and in terms of the efficiency of funds flows, caution against the adoption of a **more restrictive** foreign investment policy.

(b) More Liberal Policy

35.35 Is there a case for moving in the other direction and **liberalising** present foreign investment policy? Viewed purely in terms of the efficiency of funds flows, a strong argument can be made for an 'open door' policy (see paragraph 35.12).

35.36 As well, the case for liberalisation is often linked to the argument that Australia's natural resources should be exploited while they are currently in demand; in this way, it is argued, the returns to the Australian community would be maximised. The opposing view is that restraining the pace of development of Australia's natural resources would enable higher returns to be earned later. Of course, there are also broader conservation and environmental issues involved.

35.37 The debate partly hinges on judgments concerning the future economic scarcity of Australia's natural resources. Questions include: whether viable alternative sources of supply would be available if Australia held back its development; whether technological advances would be likely to produce competitive substitutes for Australian resources; and whether such advances would be brought forward if market conditions were favourable.¹¹ **The Committee sees such questions as well outside its terms of reference and does not make judgments on them.** It notes that, to the extent that future market conditions can be forecast, the future returns from resources development are likely to have been discounted to a present value base by the market and incorporated in current equity values. It is true, of course, that the rate at which future earnings are discounted by private investment decision makers may well differ from the rate appropriate to Australia's long-term interests. This is not, however, a problem peculiar to foreign investment.

10 Given the limited number of potential Australian equity participants and the disciplines which institutional investors impose on their level of risk exposure in particular projects or sectors, there is doubt whether the supply of risk capital would be adequate in those circumstances.

11 Essentially these questions parallel facets of risk faced by lenders involved in financing resource development. I. A. Pollard in his article 'Trends in Corporate Finance' (see fn. 6, Chapter 34) classified these facets of risk as:

Resource Risk — the risk that the resources finally recovered may not turn out to be of the magnitude anticipated from the project surveys.

Completion Risk — this is the risk that the construction of the project's facilities and necessary infrastructure will not be completed within a certain time frame.

Market Risk — this is the risk that demand for and/or price of the resource may fall to such an extent during the loan repayment period that loan commitments cannot be met.

Political Risk — this covers such items as the risk of expropriation of the project's assets by the government without adequate compensation, repudiation of overseas loans by the government, changes of government attitudes to the industry or to the provision of infrastructure; changes in government attitudes to the export of resources to a particular country and changes in overseas governments' attitudes to trade with the project's country.

Operating Risk — risks which may threaten the operations of the project after completion of the facilities and infrastructure include changing operating costs (e.g. inflation, labour costs, energy costs) and industrial costs.

35.38 While there are likely to be long-term economic benefits from a more 'open door' policy, these benefits must be weighed against short-term economic considerations.¹²

35.39 The Committee doubts whether it would be economically realistic to expect the productive base of the economy to absorb, in the short run, a much higher level of overseas funding for resource development.¹³ Rapid resource development might cause many sections of the economy to run up against production bottlenecks (especially if the increase in private capital inflow is not reflected in a commensurate increase in the balance of payments deficit on current account). Shortages of skilled labour have been cited as one possible constraint, particularly with reference to the resource development sector. There is also a risk that wage increases in the resource development sector might flow on to other sectors of the economy and in turn feed through to inflation.

35.40 Furthermore, the Committee notes that, within an overall policy framework of monetary restraint, higher rates of capital inflow (channelled into resource development) might entail a lower availability of finance for certain groups in the community, such as small businesses and home buyers. This in turn might create some social tensions.

35.41 In summary, although there are strong economic arguments in favour of a more 'open door' approach to foreign capital, the Committee believes that (non-economic considerations apart) a freeing up of Australia's present foreign investment policy should proceed cautiously because of the short-term economic implications.

35.42 Given a flexible, competitive financial system and an appropriate macroeconomic policy framework (to minimise the risk of a 'scramble' for productive resources or undue monetary disruption), there is no reason why the total volume and 'mix' of capital should not prove adequate, within the constraints imposed by present foreign investment policy.

(c) Present System

35.43 To the extent that present foreign investment policy is maintained, the Committee agrees with the broad approach of current policy which does not seek to prohibit foreign investment as such but aims to give Australian investors an opportunity to participate wherever practicable, subject to net economic benefits.

35.44 From time to time there have been criticisms of some aspects of the administration of the policy. The Committee has not examined these criticisms. It would merely observe that, in an area where flexibility is important, it is impractical to set down hard and fast rules without creating obstructions and inefficiencies. It is also recognised that the operation of the policy requires decisions to be made by the Foreign Investment Review Board on the basis of information which remains confidential to the various commercial parties; therefore it may not always be feasible to provide sufficient explanations to the general public to permit an adequate appreciation and evaluation of every individual government decision.

12 It should also be noted again that social and other non-economic reasons are important factors behind Australia's foreign investment policy; the Committee makes no judgments on these issues.

13 Of course, a rapid appreciation of the exchange rate might occur instead, and this could create structural problems of a different kind.

35.45 Nevertheless, the broad rules and intentions need to be clear to all parties. The Committee believes that the Government is well aware of this need and the general policy appears to be well understood. If doubts arise the Board is available for consultation.

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TRENDS IN HOUSEHOLD SAVING IN AUSTRALIA AND OVERSEAS

1 Household saving¹, broadly defined as the difference between household disposable income and consumption expenditure, is a source of investment funds for the public and private, both corporate and non-corporate, sectors. Essentially savings by government and corporations are retained or rechannelled for investment within those same sectors, so that (apart from foreign capital) the savings of the household sector provide the major potential external (mobile) source of investment funds for the corporate sector.

2 Although a major source of funds for investment, household saving has been subject to considerable variations over the past decade. Figure 35A.1 shows that the household saving ratio rose to a peak in 1975 but has since fallen back; by 1981 the saving ratio was similar to that of a decade before.

3 Table 35A.1 draws out some international comparisons of household saving ratios. Japan's saving ratio rose to around 20% in the mid 1970s, receding in recent years; the saving ratio in the United States has been consistently around 8% up to 1975 but has been falling steadily since that time; it was 5.4% in 1979. In larger European economies, France, the United Kingdom and West Germany, the saving ratios have fallen somewhere between those of Japan and the United States; Australia's saving ratio has tended to be at the 'high' end of the international scale.

4 To some extent these differences in the ratios reflect measurement and definitional problems, and accordingly must be treated with caution.

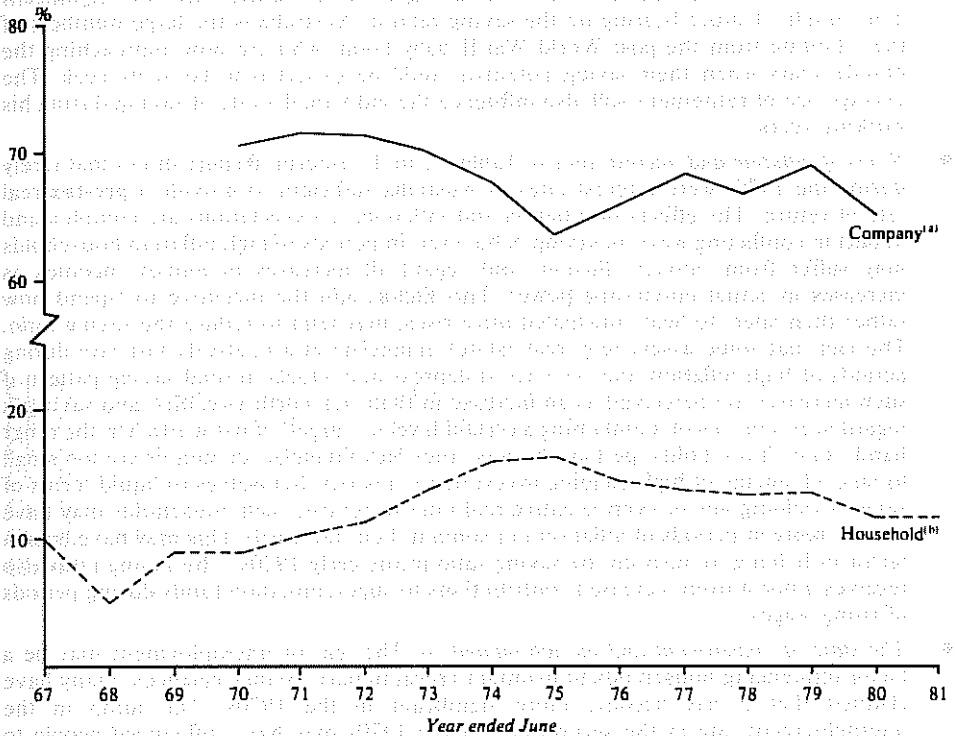
5 While allowance needs to be made for such problems, there are some basic social and economic factors underlying the differences in household saving behaviour and trends as between countries, including:

- *Corporate retention policies* — e.g. US corporations retain more of their earnings and consequently pay out a smaller proportion in dividends than in many other countries. The net result is that US stockholders are saving indirectly and, therefore, may tend to reduce their direct saving. The tax structure in Australia also favours corporate retentions but the retention ratio is lower than in the United States.
- *Tax structure* — Japan has generous tax exemptions for interest income. Certain tax-free savings options are available in France, West Germany and the United Kingdom whereas the United States provides only limited exclusion for dividend income, and no broad-based relief is available on investment income in Australia.² The extent to which consumption taxes are levied in place of equivalent-yielding income taxes also affects the decision to save. France places more emphasis on broad-based value added

1. Household saving is defined in The Australian National Accounts as the excess of household income over the sum of private final consumption expenditure, interest paid, income tax payable, other direct taxes, fees, fines etc., and transfers overseas. Household saving is estimated as the balancing item in the household income and outlay account. It includes saving through life insurance and superannuation funds (including net earnings on these funds) and the increase in assets with marketing boards. Household saving may also take the form of increases in holdings of cash and net purchases of securities, the net increase in bank deposits less advances, the reduction in the outstanding advances of instalment credit companies to households etc.

2. Australia, however, does not have a general capital gains tax.

FIGURE 35A.1: ESTIMATED COMPANY AND HOUSEHOLD SAVING RATIOS



a) Ratio of undistributed income plus depreciation allowance to after-tax company income (including dep. allow.) of corporate trading enterprises.

b) Ratio of household sector saving to household disposable income.

Source: Based on data provided by the Australian Bureau of Statistics.

taxes than on income tax. More interestingly, the UK Government deliberately shifted the emphasis of taxation towards consumption in its 1979-80 Budget. It is too early to determine the effects of this move on saving, especially as the change occurred at a time when other important economic variables, notably high unemployment and inflation, could be expected to have some effect on saving.

- *The structure and sophistication of financial markets* — e.g. the cost and availability of consumer credit facilities may significantly affect consumption patterns.
- *Social security arrangements* — Generally social security benefits are provided more widely in European countries than in the United States and Australia, which in turn have more extensive social security systems than that provided in Japan. The provision of social security by governments may lead to reduced need to save for sickness and old age by individuals; the effect will partly depend on the demographic structure.
- *The extent of contractual or compulsory saving* — The availability of occupational superannuation schemes, and their method of funding, is one factor of crucial importance. It was noted in Chapter 15 that only about 20% of the private sector workforce in Australia are presently covered by superannuation. In some countries coverage is more comprehensive and often there are compulsory national insurance schemes.
- *The age structure of the population* — Different age groups have characteristically different patterns of saving. Younger people under the age of about 35 tend to be substantial net debtors in the process of setting up a home and in the early years of rearing a family. In the middle years up to retirement incomes tend to increase, debts

decrease, families grow up and often wives return to work. In retirement savings are often used to augment pensions and the saving rate falls. Perhaps the most significant demographic feature bearing on the saving ratio in Australia is the large numbers of the offspring from the post-World War II baby boom who are now approaching the middle years when their saving potential could be expected to be at its peak. The average age of retirement will also influence the individual's rate of saving during his working years.

- *Rates of inflation and interest rates* — Table 9.2 in the Interim Report shows that rarely during the 1970s were interest rates in Australia sufficient to provide a **pre-tax** real rate of return. The effects of inflation and inflationary expectations are complex and impact in conflicting ways on saving behaviour. In periods of high inflation households may suffer from 'money illusion' and regard all increases in money incomes as increases in actual purchasing power. This factor, and the incentive to 'spend now rather than later' to beat anticipated price rises, may tend to reduce the saving ratio. The fact that some assets (e.g. real estate) appreciate at a relatively fast rate during periods of high inflation may also act to depress individuals normal saving pattern if such increases are perceived as an increase in their net worth (wealth), and saving is regarded as a means of maintaining a certain level or 'target' of net worth. On the other hand, many households, perhaps because they lack financial acumen or are too small to take advantage of high-yielding investments, restrict themselves to liquid forms of savings yielding low or even negative real rates of return; such households may have to save more in periods of inflation to maintain their net worth. This may have been a factor in helping to push up the saving ratio in the early 1970s. The saving ratio also receives a boost from increased contributions to superannuation funds during periods of rising wages.
- *The state of employment and the job outlook* — The fear of unemployment may be a factor influencing households to maintain precautionary savings balances, many have claimed that it has become more significant in the 1970s. The jump in the unemployment rate in the second half of the 1970s may have influenced people to maintain higher savings balances.
- *The distribution of incomes* has a significant bearing on the average saving ratio, e.g. high income groups and particular occupational groups such as farmers may have a relatively high propensity to save.

TABLE 35A.1: HOUSEHOLD SAVING RATIO^(a): SELECTED COUNTRIES (%)

	<i>Aust.</i> ^(b)	<i>Canada</i>	<i>France</i>	<i>Germany</i>	<i>Italy</i>	<i>Japan</i>	<i>Sweden</i>	<i>UK</i>	<i>USA</i>
1960s (av.)	9.9	5.7	11.4 ^(c)	15.1	21.2 ^(c)	17.3	n.a.	5.3	6.7
1970s (av.) ^(d)	14.2	9.4	12.9	12.6	21.8	18.8	3.5	7.5	7.2
1970	10.6	6.1	12.5	12.1	20.4	17.0	3.5	6.1	8.2
1971	11.6	6.5	12.6	12.0	22.0	16.6	3.8	4.3	8.6
1972	14.2	7.7	12.7	13.3	23.0	16.9	1.8	6.3	7.1
1973	16.2	9.5	13.2	12.9	22.4	19.4	3.5	7.6	8.6
1974	17.2	10.8	13.1	13.6	21.2	22.1	4.6	9.1	8.0
1975	15.2	11.1	14.2	14.1	22.0	20.5	4.2	8.6	8.4
1976	14.6	10.3	12.0	12.5	21.6	20.7	2.5	7.7	6.5
1977	14.2	10.1	12.4	11.5	21.3	19.4	3.2	6.6	5.7
1978	14.6	10.7	13.4	11.4	23.0	19.0	3.9	8.7	5.5
1979	13.3	10.9	12.4	n.a.	n.a.	16.8	3.8	9.9	5.4

(a) Defined as the ratio of household saving to household disposable incomes, where the latter is defined as current receipts less the sum of direct taxes, compulsory fees, fines etc. and social security contributions.

(b) Financial year ending at 30 June of year indicated.

(c) 1960-69.

(d) Average to last year shown.

Source: *National Accounts of OECD Countries*, Paris, Organisation for Economic Co-operation and Development, annual (latest issue: 1962-79).

