3. The Changing Financial System

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3.1 Introduction

The last forty years or so have been ones of great change for banks and other financial institutions and their staff. They have had to cope with the impact of deregulation (and subsequent re-regulation)[1], increased competition (both with traditional competitors and with other financial service providers), and explosive growth in new technology – prompting the recent growth of "fintechs".[2] The outcome has included a widely expanded range of financial products, new methods of delivering financial services, and increased attention to costs, risks, and profit contribution of various activities. In Australia, the major banks have

[1] Typically referred to by policy-makers as "reform".

[2] The potential for the "tech giants" such as Apple, Google, Microsoft, Amazon etc to expand into the provision of banking and other financial services should not be underestimated.

recently been in the process of divesting themselves of insurance and wealth management activities, after expanding into those areas of “bankassurance” in the latter decades of the twenty-first century.

Change will continue, affect the structure of financial institutions, the range of financial products and services produced, and methods of delivery used (particularly the use of electronic communications and documentation). As well as technological change, and partly reflecting that, the regulatory environment will continue to change. Like a dog chasing its own tail it will continue to adapt in response to changes in financial markets which it in part induces, a process labelled the “regulatory dialectic” by Professor Ed Kane. Competition will continue to be pervasive as financial service providers mutate and seek to invade the turf of non-traditional rivals. The types of competition will continue to change as the technology explosion alters the costs of different ways of creating and delivering various financial products via financial innovation.

An implication of this is that knowing how financial institutions are currently structured and operate may be of limited use several years hence, as financial institutions and products evolve in response to innovations. But, it is useful to understand how the current structure of the Australian financial system emerged, since that can also provide insights into future possible changes (as well as explaining why the system and institutions are structured as they currently are). So, the following section provides a brief outline of the recent history of Australian financial sector development incorporating an overview of regulatory change over that period.

3.2 Financial Sector Evolution in Australia

A fundamental change occurred in the Australian financial sector as a result of substantial financial deregulation starting at the end of the 1970s. This reflected a wide-spread ideological shift towards acceptance of the free-market economics paradigm, but also the result of the 1970s stagflation demonstrating inadequacies of the highly regulated financial system.

The Pre-deregulation landscape

Prior to the late 1970s the Australian financial system was heavily influenced by regulation introduced at time of World War II. The focus of financial policy was on monetary policy with banking sector safety based on a policy of limiting the risk-taking ability of banks. There were a small number (12) of trading banks, with a significant role for government owned (savings)

banks[3], and preclusion of foreign banks. The trading banks were subject to extensive direct controls including

- Interest rate controls (including zero interest on chequing (transaction) accounts)
- Lending directives
- Liquidity ratio requirements (the variable reserve requirement known as the Statutory Reserve Deposit (SRD) ratio
- Portfolio controls – involving required minimum holdings of government debt and liquid securities (the LGS ratio) and a minimum 30 day maturity for term deposits for Trading Banks.
- Limits on activities

The savings banks were restricted by:

- Deposit raisings were restricted to the personal sector and subject to interest rate ceilings
- Asset portfolios were restricted essentially to government paper and household mortgage debt
- An LGS type requirement of initially 70 per cent applied which was gradually reduced to 40 per cent by the end of the l970s.
- Mortgage interest rates were subject to government imposed ceilings.
- Only "at call" and "notice of withdrawal" accounts were permitted (although the state savings banks were permitted to offer chequing accounts).

But the banking groups also had finance company subsidiaries (accounting for over 50 per cent of that sector's assets) and were allowed minority interests in money market corporations (merchant banks). Through their finance company activities the banking groups were able to partially avoid government regulation, since Federal government powers to control NBFI activities contained in the l974 Financial Corporations Act had never been proclaimed.

Interest rates were pegged and government bond issuing procedures were structured to be consistent with that, and the exchange rate was fixed. Life Insurance companies (with the

[3] Until 1960 the Government-owned Commonwealth Bank undertook both savings and trading (commercial) bank activities and also acted as the Central Bank. The private banks were permitted to have Savings Bank subsidiaries in 1956.

industry dominated by four large mutual companies) faced significant portfolio restrictions (involving required amounts of investment in government debt). The insurance companies were relatively important savings vehicles through the savings element in whole of life and endowment insurance policies, and managed the bulk of the very small amount of superannuation savings which existed outside of public sector and company based schemes. However, their growth was relatively slow particularly in the 1970s when inflation reduced the real returns on the large proportion of fixed rate assets in their portfolios. Regulation of non-bank financial institutions, and of companies and securities markets, was divided between State and Federal Governments. Foreign banks provided finance for companies and institutions via representative offices and merchant banking and other non-bank structures – often operated in conjunction with local entities.

Notably, while competition between stockbrokers was restricted, the securities (stock) markets were subject to very little effective regulation.[4]

Bank regulation led to the growth of unregulated (or less regulated) financial institutions, creating complications for monetary policy. In particular, retail lending constraints on banks led to the growth of finance companies, building societies, and credit unions, while interest rate controls prompted the growth of cash management trusts (money market mutual funds). Automatic teller machines began to appear, phone banking became a service offered, and the Australian banks rolled out a new credit card (BankCard) available to the bulk of the population as a competitor to the less readily available Visa and MasterCard products. A process of bank branch closures began, reflecting the ability of banks to now compete via prices rather than excessive branching, as well as the opportunity to deliver financial services via technological innovations – although it was not until the mid 1990s that internet banking (in a relatively primitive form) began to emerge.

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[4] Mees and Ramsay (2008) provide an historical overview and analysis of the development of securities regulation in Australia, highlighting the lack of effective government (or self) regulation – especially prior to the establishment of the National Companies and Securities Commission (NCSC) in 1980. They also highlight many of the major corporate finance and securities market scandals which occurred over the years.

During the 1970s, the surge in inflation made constraints on interest rate levels problematic and increased the distortionary effect of portfolio restrictions on banks and insurance companies.

The Deregulation Phase (1979-1990)

Deregulation took hold in the latter part of the 1970s. The Campbell Inquiry (appointed by the Liberal-National Party, Fraser, government in 1979 reflected the government's free market philosophy, and recommended significant deregulation in its Final Report issued in 1981. It took as fundamental that: competitive neutrality should apply; social and sectoral objectives should be tackled through fiscal measures; some risk free, deposit type, asset should be available. Even the election of a Labor government, which had nationalization of banks in its party platform until the late 1970s, did not reduce the impetus to deregulation which had begun during the life of the Campbell Inquiry. The Martin Report, appointed by the Hawke government to review the Campell Inquiry findings endorsed the broad deregulatory thrust in its report in 1984. Among the changes were removal of interest rate ceilings on banks, Government bond market structure changes (including new issue tenders), adoption of a flexible interest rate policy and removal of compulsory portfolio holdings requirements. Banks were allowed to compete in expanded range of deposit and loan markets, portfolio restrictions were abolished. The exchange rate was floated in 1983, and limited foreign bank entry permitted in 1985, and by 1986 most of the deregulatory phase was completed. During this period mergers with competitors led to the four major bank structure common today, the first new domestic bank was approved[5], and a process of mergers between building societies and credit unions began. Several building societies demutualized (as did major Life Insurance offices) and became banks (such as Challenge Bank and Advance Bank), many of which were later acquired by the major and other regional banks.

The consequences were dramatic including a rapid expansion of bank lending – much of which turned out to be imprudent, leading to a financial "crisis" in 1989-91. There were large loan losses for banks, including the "failure" of two State government owned banks, and the "near failure" of several major banks and a large building society failed. There were significant business failures (particularly of the "entrepreneurs" who took advantage of lax lending by banks) and a property market collapse. There were a number of managed fund (unit trust)

[5] The Australian Bank, which was acquired by the SBV in early 1989.

failures (including freezing of withdrawals). Investors, concerned about declining asset values, attempted to withdraw funds from illiquid open ended property and mortgage funds, leading to liquidity crises for those funds.

With hindsight the cause of the problems were obvious. Deregulation was not accompanied by improved bank governance, improved market discipline or adequate prudential regulation. Banks were given freedom to compete, and that led to a race to the bottom in terms of credit quality as banks chased loans. Inadequate accounting and disclosure requirements for corporate clients also contributed as did inadequate risk management systems in banks.

The 1990's

Following the problems of the financial crisis, much greater attention was paid to prudential regulation, including the introduction of the Basel Accord (Basel I) capital requirements. The Accord had been agreed in July 1988 for introduction by 1992 by G10 members (too late to prevent the imprudent lending of the 1980s). A process of coordination of financial and corporate regulation by State governments and transfer of some responsibilities to the Federal government began[6], culminating in a range of changes in the late 1990s following the Wallis Inquiry and a Major Review of Corporations Law. The regulatory restructure (often referred to as the "twin peaks" model) occurred in 1998 with the creation of a separate prudential regulator (APRA) and the securities markets/ companies (conduct) regulator (ASIC). The former was given responsibility for prudential regulation of ADIs (banks), insurance, and superannuation, while the latter also took over responsibility for financial consumer protection from the ACCC. The RBA remained responsible for monetary policy, financial stability and payments policy.

The start of the massive growth of superannuation followed the incorporation of employer superannuation payments into industrial relations agreements by the Hawke Government's Wage Accord in the 1980s and introduction of compulsory employer superannuation (pension) contributions in 1991. The SIS legislation in 1993 introduced the regulatory framework for supervision of superannuation funds. The major review of corporations law, known as CLERP (Corporate Law Economic Reform Program) culminated in legislation in 1998

[6] These involved creation in 1991 of the Australian Securities Commission (to later become ASIC in 1998) and AFIC (Australian Financial Institutions Commission) – which operated until 1998 - to oversee state regulation of building societies and credit unions.

and 1999 including the Financial Sector Reform (Consequential Amendments) Act, the Company Law Review Act, and the Managed Investments Act. Company law reforms related to such matters as: fundraising, directors duties, financial reporting, takeovers, while the Managed Investment Act introduced the notion of Responsible Entities for managed funds.

The early 21st Century

The regulatory changes of the 1990s led to a regulatory approach involving a strong distinction between the prudentially regulated sector (banks/ADIs, insurance, institutional superannuation funds) and the non-prudentially regulated sector. ADIs and insurers faced capital requirements and APRA supervision, but there was no explicit government protection. The non-prudentially regulated financial sector, included non-bank financial institutions such as finance companies, managed investments schemes, direct investments in shares and bonds etc. Providers of financial services and products (but not credit) were required to hold an Australian Financial Services Licence (AFSL) following its introduction in 2001. For the non-prudentially regulated sector, wholesale investors were assumed to be able to identify and manage risks, while retail customers were precluded from wholesale markets. The approach to financial consumer protection was based on the triumvirate of "Education, Advice, Disclosure" and *"Caveat emptor" (buyer beware).* Securitisation boomed, and there was a proliferation of structured financial products.

While there were some financial sector "hiccups" at the start of decade, such as the (international) tech stock boom and bust, and the failure of the major insurance company HIH in Australia[7], the initial years of the decade were relatively calm. Indeed it was labelled as the "Great Moderation", a period of low volatility, an asset price inflation build-up, increasing leverage, low pricing of risk, and significant financial innovation. Despite sectoral and international imbalances, it was a time of low inflation and sustained economic growth. There were minor developments in the regulatory arena with eventual agreement on Basel 2 in 2006. Concerns about financial system and economic stability began to emerge, but not in any way predictive of the Global Financial Crisis (GfC) which was to emerge in 2007-2009.

[7] The Australian Government introduced a large government funded compensation scheme for policy holders, which called into question the oft-touted claim that there was no implicit government protection of financial institutions.

The GFC

The Australian banking sector emerged relatively unscathed from the GFC, although there was strong government fiscal and monetary policy support which made that possible. Several smaller banks, with weakened financial positions, were taken over by the major banks. The Government introduced a deposit guarantee scheme in Oct 2008[8] and provided the option for banks to purchase guarantees over new wholesale borrowings. It also provided support for the securitization sector. There were significant failures of finance/investment companies which were part of the non-prudentially regulated sector, meaning that there were no credible arguments for government compensation for customer losses. But the experience exposed the deficiencies in the education, advice, disclosure (EAD) approach and many financial consumers suffered substantial losses.

Post GFC

The GFC led to a re-regulatory phase, most notably the introduction of Basel 3 regulatory changes involving enhanced prudential regulation of banks, with those changes not being "finalized" until the early 2020's. The policy response to the GFC ushered in a period of low interest rates which was further reinforced by the policy response to the Covid Crisis in the early 2020's.

There was an increased regulatory focus on financial consumer outcomes (and the demise of EAD) following the GFC experiences. This led in April 2010 to Government legislation directed at the reform of the financial advice industry, and introduction of Responsible Lending Obligation (RLO) requirements associated with the introduction of Australian Credit Licences (ACLs). But, despite that, the Australian banks and other financial institutions continued to engage in behavior which had adverse consequences for financial consumers, ultimately leading to the establishment of the Hayne Royal Commission which reported in early 2019. This exposed the extent of such misconduct and misbehavior and led to a large number of recommendations for reforms to governance, accountability and remuneration arrangements in the financial services sector.

That need for improved regulatory arrangements had been noted earlier by the (Murray) Australian Financial System Inquiry (AFSI)which recommended in its 2014 report that ASIC

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[8] Known as the Financial Claims Scheme, the initially unlimited, then $1 million guarantee cap, eventually was adjusted back to the $250,000 cap which currently applies.

should be given extended powers through introduction of Product Intervention Powers (PIPs) enabling temporary banning of unsuitable financial products and services, and Design and Distribution Obligations (DDOs) upon financial product producers and distributors. These became operational in the early 2020's.

The Murray AFSI also noted the impact of the rapid growth of "fintech" on the financial sector, and made a number of recommendations in that area. It should not be underestimated how many of the financial products and services currently available are only available because of advances in technology, and could not have been possible twenty years or so ago. Regulation is always struggling to keep up with the effects of those technological changes. Since then the pace of development of fintech appears to have increased, including the growth of financial services and products and information provided by way of internet platforms, innovations in payments arrangements, and emergence of crypto-currency. One consequence has been the need to focus on the consequences for financial sector competition (which was investigated in a major Productivity Commission Report (2019), and legislate to promote social benefits such as those expected from providing consumers with data ownership rights via Open Banking legislation.

As explained at the start of this brief history, the financial sector is not static. Change will continue. In 2021, for example, the Liberal-NP Government has been digesting the 2020 Retirement Incomes Review and is in the process of making changes to the regulation of superannuation. It has also attempted to roll back some of the financial consumer protection regulation (such as RLOs) reflecting its underlying free market ideology (if not practice) and pressure from vested interests in the industry who claim that there are significant adverse consequences for lending.

Because financial regulation is shaped by historical forces and new developments (such as technological change), and is a major influence on future financial sector development, understanding how such changes have occurred and led to the current *status quo* is important for understanding likely consequences of ongoing change. Before that, however, it is important to outline a major change that has occurred in the nature of Australian bank lending activity.

3.3 Banks as "Bloody Big Building Societies"

Former NAB CEO Don Argus is reported to have opined back in 2013 that Australia's major banks had become "bloody big building societies", reflected in a large increase in the share of housing lending to commercial lending. This trend has continued since that time and the growth in mortgage financing has also been buoyed by the growth of securitisation in facilitating non-bank housing lenders. The explosion in mortgage financing has been positively correlated with housing price growth and long term decline in home affordability. How much is cause (increased availability of finance prompting higher house prices) and how much is effect (housing price increases leading to need for larger mortgages)? That is a difficult question to answer, and the objective of this section is the simpler one of providing some data on bank mortgage lending growth and outlining some background on factors which may have contributed to its growth.

Kohler and van der Merwe (RBA, 2015) provide an analysis of long run trends in housing prices and possible causes up until 2015. Housing price inflation in excess of the general level of wages and prices growth emerged in the relatively low inflation rate period of the 1990s (with high housing price growth in the 1980s largely matching the inflation rate). Population growth relative to housing supply is one relevant factor, as also was an increase in housing demand due to low inflation increasing mortgage affordability.[9]

As well as the resulting demand for mortgage finance, Kohler and van der Merwe also point to the financial deregulation of the 1980s. This included removal of interest rate controls on housing loans, which could be expected to have increased the attractiveness of such loans to profit-seeking banks. But also relevant are the Basel risk-weighted capital requirements which

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[9] Low nominal interest rates, reflecting low inflation, mean a reduction in the "front-end loading" of real mortgage repayments under the traditional credit foncier mortgage loan. From a high of around 17 per cent at the start of 1990, the variable rate mortgage rate fell by around 50 per cent by mid 1994. Since initial repayments on the traditional loan are mostly interest, this means that the loan size consistent with an unchanged repayment/income ratio was almost doubled.

also came into effect in the late 1980s. These gave favourable regulatory treatment to housing loans in the form of a lower risk weight than for commercial loans in determining risk-weighted capital requirements. Subsequently, the Basel II and Basel III changes increased that preferential treatment for large banks regulated under the internal models approach.

The extent to which the growth in residential mortgage financing reflects banks responding to higher demand for such finance brought about by higher housing prices, versus their lending practices being a cause of those higher housing prices, is a complex question. Undoubtedly there are elements of both mechanisms involved. But, nevertheless, the effect on bank loan portfolios has been dramatic.

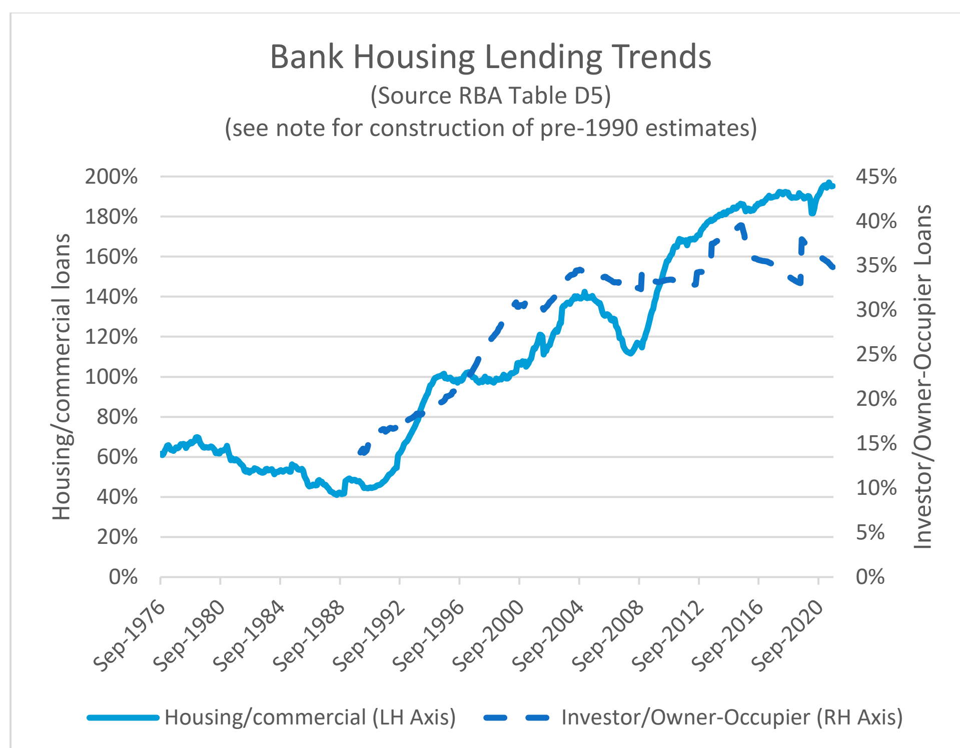

FIGURE 1: BANK HOUSING LENDING TRENDS

Figure 1 provides aggregate data on some features of the composition of bank lending since the mid 1970s.[10] There are two obvious trends. First the ratio of housing/commercial loans has grown from around 50 per cent at the start of the 1990s to around 200 per cent in 2021

[10] Note: before 1990, separate figures for investor housing loans are not available, and appear to be included in commercial loans. The series for total housing lending before 1990 is constructed by assuming the ratio of investor/owner-occupier loans was constant at its 1990 value and shifting investor loans from commercial classification to housing classification.

(after falling somewhat in the 1980s). The dip in the ratio between 2005 and 2009 appears to be partly due to rapid expansion in commercial lending by foreign bank branches prior to the GFC (and subsequent contraction).

The second trend is the increasing share of investor relative to owner-occupier housing loans from around 15 per cent in 1990 when figures are first available to around 35 per cent since the mid-teens. The plateau, or slight decline, since then reflects APRA initially having limited investor housing loan growth and then making it less attractive for banks compared to owner-occupier loans. One factor behind the longer run growth of investor loans has been the tax advantages of investment properties for individuals – particularly negative gearing. Interest payments on such a loan, if exceeding rental income on the property, can be deducted against other income in calculating taxable income, while long run capital gains on eventual sale of the property are concessionally taxed. There are thus tax benefits from highly levered property investment, although the strategy involves significant risk of large losses if property prices fall (which was a reason behind APRA's actions referred to above).

What explains the shift of bank lending into housing mortgages? Some part of that trend is due to the conversion of most of the pre-existing building societies to banks (most ultimately to be taken over by the major banks) with their (predominantly) mortgage loan portfolios having previously been outside the aggregate figures for bank lending. That direct effect is relevant in explaining the growth in mortgage lending in the decade between 1985 and 1995 when around 13 conversions occurred. For example, the conversion of St George from building society to bank in July 1992 accounts for around 70 basis points of the 160 basis point increase in banking sector mortgage loans to total assets in that month.

For the major banks, the acquisition of many of those new banks (see Chapter 6, Appendix 1) has shifted the emphasis of their activities towards residential mortgage lending.

Figure 2[11] shows how housing/total loans have grown since the late 1980s for each of Australia's major banks, consistent with the data in Figure 1 (which shows the ratio to commercial loans rather than to total loans). The significant growth in the ratios started at around the start of the 1990s. Some part of that reflects acquisitions of more mortgage oriented banks (SBV in the case of CBA and Challenge Bank and Bank of Melbourne in the case

[11] Data are extracted from Annual Reports, for Australian business only. 1987 data for CBA is not available. Non-housing lending may be understated (increasing the ratio above that shown) for the earlier years when acceptance of bills was a more important method of commercial lending. (The figures should be treated as approximations due to deficiencies in the data).

of Westpac). Those banks experienced a much greater increase in the mortgage/commercial loans ratio than ANZ and NAB.

But the shift in the early 1990s also partly reflects the decline in commercial lending in that period of "mini-crisis". (Commercial loans outstanding for the banking sector declined by 13.4 per cent from its peak in September 1991 to a trough in February 1994, not regaining the September 1991 value in nominal terms until June 2000, equating to a fall in real terms of almost 20 per cent)[12]. But the trend in the mix of housing and commercial loans has continued since then.

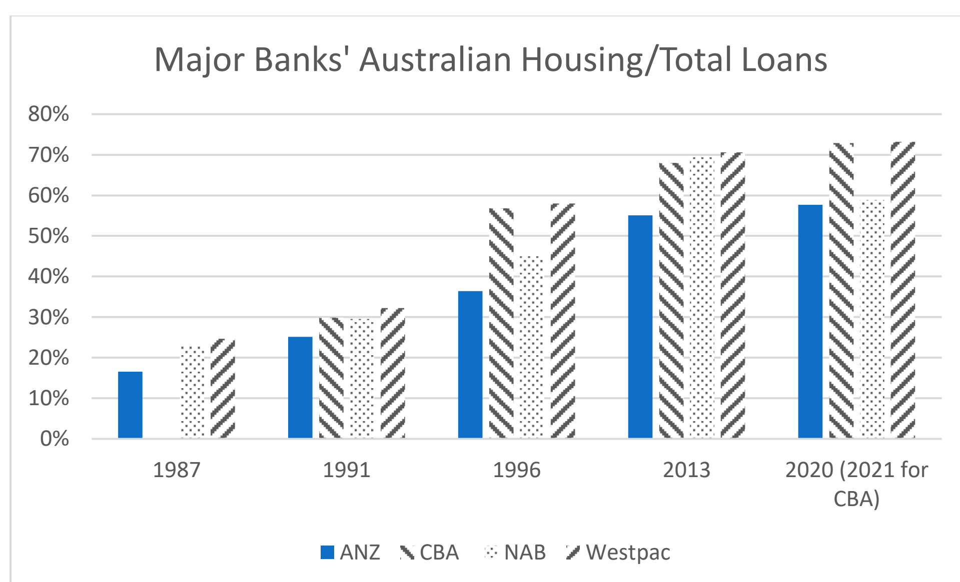

FIGURE 2: MAJOR BANKS' HOUSING/TOTAL LOANS

As noted earlier, it is not clear what role bank lending decisions have played in the large growth in house prices and mortgage debt outstanding, compared to demand for housing (and for mortgage financing) relative to housing supply. But what the figures above demonstrate is that loan portfolios have become markedly biased towards mortgage lending relative to commercial lending. Our banks have indeed become "bloody big building societies".

[12] Data on commercial lending drawn from RBA Table B2.

3.4 Drivers of Change

The preceding section briefly examined how the Australian financial sector has changed since WW2. Implicit in that story were a number of possible causes of change, and it is useful to consider each of those possible causes in a more general context to assist in thinking about possible future changes in the financial sector. We start with a discussion around theories of innovation.

Theories of Financial Innovation

There are two general requirements for a viable financial innovation. It must either make markets more *operationally efficient* or it must involve *market completion*. The two requirements are interrelated. The latter relates to providing risk-reward opportunities which were not previously available either to any party or to some sub-group (such as enabling individuals the opportunity to invest in a market portfolio of shares through an ETF). Improved operational efficiency refers to developments which remove market distortions, reduce costs, and also make it feasible to provide new products and services which complete markets.

Consistent with Kane's perspective outlined earlier, one stimulus for innovation is the existence of binding constraints limiting firm profitability (such as regulation). These provide an incentive to find ways to loosen the constraints and as the impact of a constraints increases, incentive to expend resources to loosen that constraint increases. Changes in technology and increased financial competition can also contribute by, respectively, reducing the cost of making innovations and increasing the cost of not innovating (and losing market share to competitors who do innovate).

It is also relevant to look at the demand side. Economic conditions, such as high inflation or volatility of financial prices can create a demand for innovations which ameliorate adverse effects.

Differential taxation of different sources or uses of income is also important. Where taxes distort returns, innovation to take advantage of those distortions can be expected. Such arbitrage need not wipe out the originating profit opportunities, thus providing a continuing stimulus to the innovation.

The role of financial institutions in financial markets and the agency problems thereby created are also relevant. Innovations can emerge to solve moral hazard problems, even though they appear to offer little new in the way of completion of markets.

Electronic Technology and "Fintech"

Over recent decades, technological change has altered fundamentally a number of features of the financial system. Bank payments services are a good example. Payments services have evolved from predominant reliance on cash and cheques, through paper based credit card facilities, direct credit of payrolls, and debit cards to popular acceptance of EFTPOS and ATM facilities. More recently the development of trade and payments via the internet, provision of web-based banking services, and mobile phone "apps" are accelerating the pace of change. Central Banks are investigating the implications of possible introduction of central bank digital currencies (CBDCs).

Such changes have had significant effects on bank cost structures, and the ability for customers to access payments and other banking services without interacting with bank staff has had an effect of "de-personalising" banking. Staffing numbers have fallen as technology has provide alternative ways of performing front-office and back-office functions. Customers are increasingly able to obtain information about, and purchase alternative services and products via the internet.[13] Given the growing competitive significance of customer loyalty (discussed below), this de-personalisation creates some major challenges for strategists in financial institutions.

Doing business over the Internet involves problems and opportunities which are familiar to financiers. Payment can be effected immediately at a keystroke, but delivery of merchandise takes time. Standard trade finance issues assume importance, providing financiers with business opportunities from facilitating trade on the Internet (where PayPal and AliPay have prospered). Delivery of financial services can be divorced from physical location of the supplier relative to the consumer. Competition becomes increasingly global – unless national regulators create barriers which prevent such developments

Regulators and Governments face significant problems from such developments. Consumer protection becomes more complicated – as customers can access (via the internet) suppliers of services who operate outside of their physical jurisdiction. Traditional measures of market competition and power start to look less robust, as markets become more contestable by

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[13] The growth of *comparison sites* where financial consumers can compare (and purchase) alternative offerings of loans, investments, insurance etc., create new regulatory problems for financial consumer protection.

physically far distant competitors. Prudential regulators face problems of dealing with financial institutions whose activities increasingly cross national boundaries as physical presence becomes less of an impediment to service provision.

These developments also raise numerous issues for national governments in the area of competition policy associated with the operation of payments technology.

Customer Focus and Customer Loyalty

Once, customers of financial institutions typically remained loyal for life to the financial institution they first embraced. The long-standing provision and subsidization of school banking accounts (analysed in this 2020 ASIC report), such as the "Dollarmite" scheme operated by CBA reflected this. This raised concerns about competitive equality for institutions not able to negotiate operation of such programs with school authorities, as well as about the benefits to children participating in the scheme. The CBA scheme became mired in controversy in 2018 when remuneration incentives for staff, linked to new accounts created, led some to set up thousands of "phoenix" accounts. The Victorian government was one which subsequently prohibited such schemes in public schools from 2021

Independently of the school banking schemes, now, like that other great social institution of marriage, lifetime commitment is no more, and financial institutions must continually woo their existing customers.

Here financial institutions walk a tightrope. They appear to profit most from long term customers. A prime objective is thus to entice customers away from competitors into a long term relationship creating fierce competition in the area of "special deals" for new customers. The risk is that unless one's own long term customers are looked after they will be poached by others pursuing similar strategies. If long term customers are not to be lost, financial institutions need to ensure that they share with customers some of the cost savings that a long term relationship brings, and avoid excessive exploitation of customer immobility resulting from account transfer costs.

There is plenty of evidence that Australian banks have exploited the "stickiness" of their customers. One tactic was via the use of "break" or "exit fees" whereby, for example, a borrower wishing to pay out a home loan early to switch to another provider would be charged an explicit fee. This practice was prohibited by legislation in 2010 (although fees for

fixed rate loans and for reasonable costs resulting for the lender were still allowed, as described in more detail in ASIC Regulatory Guide 220).

More recently the differential between the rates on variable rate mortgages offered to new borrowers versus those charged to existing borrowers has become an issue of contention. The higher rates charged to existing borrowers have been described by some as a "loyalty tax". The RBA found in 2020 (using data from its securitization data base) that the gap was in the order of 40 basis points p.a. (on a $500,000 loan that amounts to around $2,000 extra interest per year).

The ongoing challenge for financial institutions is thus to develop pricing structures for services which achieve three goals. First, they must provide incentives for new customers to switch business. Second, they must provide incentives for long term customers to remain with them, and/or increase the costs of leaving. Third, the overall pricing structure must deliver adequate profits. It will be necessary to pass on to long term customers some part, but not all, of the benefits of lower costs of long term accounts, and cross subsidise new customers in the hope of recouping those subsidies as a long term relationship develops.

As with any situation where cross subsidisation is involved, this is fraught with dangers. Longer term customers may leave if their share of cost savings is felt inadequate, although by doing so they destroy the asset (a long term relationship) which creates their potential benefit. New customers may be enticed away by competitors, so that initial subsidies are never recouped. For pricing strategies to work, they must be carefully designed and continually adapting to changes by competitors.

For long term relationships to evolve, financial institutions need to examine how to best respond to the technological de-personalisation of the financial services industry. At the business/institutional level, strategies which are relevant include:

- greater emphasis on the roles of account relationship managers to create personal links;
- provision of specialised advice and services upon which the customer becomes reliant;
- inducing customers to "lock in" to software etc. which interfaces with the financial institution's systems (and is costly to change from).

At the retail level, the importance of the financial advice and planning industry indicates an area in which financial institutions can expand services in a way which encourages customer loyalty. But this involves a different skill base and career path for employees to that traditionally seen, and has proved fraught with operational risk dangers. Following the revelations of the Hayne Royal Commission (although already in progress prior to that) the banks have moved away from providing financial advice and sold those businesses to others.

Pricing and Fees for Service

In a competitive market where there are few regulatory constraints on prices which can be charged, it is important to have good information about the costs of providing various services and products. If competitors link prices to the cost of production, a bank which doesn't will quickly suffer losses. It will attract business for products where it is undercharging and lose business where it is overcharging.

Large financial institutions have in-depth knowledge on the cost of particular services (although allocating many costs, such as those of head-office, is somewhat problematic). In some cases they will use activity based costing to build up the total cost of a product or service from the component activities (staff time, physical inputs, etc) involved in production. Estimates of profitability by lines of business are important for internal resource allocation.

Increasingly, adequate profitability of individual lines of business is being required. The stock market emphasises the need for a return on equity capital adequate for the risks involved, and penalises the share price of financial institutions not delivering. The regulatory approach to supervision of financial institutions, based on risk weighted capital requirements, has further focused management's attention on the cost of equity capital. Those external pressures find internal reflection in the need for business units to return an appropriate risk related return on capital employed, and to do so by appropriate pricing of individual products to recover both explicit costs and required return on equity capital.

The need to return an adequate return on individual products arises because given the mobility of customers, or more particularly their money and business, it is not generally feasible to cross subsidise the provision of some products at prices below cost by excessive charges on other products. Customers, naturally, use intensively the products which are subsidised and shun the expensive products, so that no excess profits are made to support the cross subsidisation.

That does not mean that some cross subsidisation is not feasible across products where customers consume them as a "package". A retail transactions account, for example, involves a payments services facility (itself incorporating many individual services) as well as a deposit facility. Some forms of cross subsidisation across these services are feasible if they limit the extent to which customers can exploit the cross subsidisation, and this is reflected in the variety of systems of account fees and charges used by financial institutions.

Industry Structure and Competition

The composition of the financial industry is continually changing, under the influence of number of factors. First, there is international competition. National barriers to entry into domestic financial markets have generally fallen over recent decades. Standardisation of prudential regulation via common capital requirements based on international proposals also levels the international playing field. Combined with modern electronic technology, which reduces the significance of geographical location, commonality of prudential supervision may enable far distant institutions to compete with locals for some parts of the financial services market, even in retail markets. Absent restrictive entry legislation, competition for business in the era of modern technology is increasingly global rather than national.

A second factor affecting the structure of the financial services industry is the impact of modern technology on the cost structures of institutions of different sizes. Numerous statistical studies have provided mixed evidence on whether "bigger is better" from a cost perspective. Average costs do not appear to decline as size increases above some mid-size level, but very large entities do appear to capture some economies. Of course, with the changes in technology currently being experienced, that historical evidence based on old data may be outdated. Certainly, managements of financial institutions appear to believe that bigger is better. That phenomenon may also reflect their personal prestige arising from running a larger organisation, or the fact that greater market power may arise from larger size, or that certain attractive activities can only be conducted by large scale institutions.

Blurring of the boundaries between banking and other financial service providers is a continuing phenomenon. Banks have expanded into "non-banking" areas, as evidenced by the growth of "bankassurance", the combining together of traditional banking and life insurance / funds management activities as well as "wealth management" involving financial advice. But the absence of financial benefits from economies of scope, and control problems in large complex institutions, have seen most Australian banks reverse that trend.

All types of institutions are continually facing new competitors. Mortgage Brokers (such as Aussie Home Loans) have made their presence felt in Australia, facilitating the securitisation industry and initially provided a new source of competition to the housing loan business of banks. Financial planners and advisors have usurped the traditional role of the bank manager and life insurance agents as a source of advice, and increasingly influence the direction of savings funds of their advisees. Large companies have sophisticated in-house treasury functions which enable them to undertake activities previously provided to them by banks. The funds management industry has boomed, with an explosion of mutual funds (unit trusts) available to investor / savers. Combined with growth of superannuation savings this has led to an increasing proportion of savings bypassing the traditional banking industry or the role of whole of life and endowment policies as forms of long term savings.

A fourth factor influencing change relates back to customer relationship issues. Recent years have seen the development of branded credit cards and credit point schemes enabling receipt of benefits from particular businesses associated with credit card schemes. The objectives of such schemes are to encourage customer demand and "lock in" continued business, ie to promote customer relationships. This can be expected to continue, and liaisons between banks, life offices, and large businesses further developed.

Organisational Structure

Over recent years, financial institutions have changed dramatically their internal structures and organisational arrangements in the face of an evolving financial services industry. Organisational charts have been, virtually continuously, rearranged, the security of employment reduced, and relevance of traditional career paths reduced.

These changes seem likely to continue. As financial institutions adapt and the range of activities undertaken expands, it is unlikely that organisational structures will remain unchanged. Institutions have to grapple with the task of assimilating quite differing cultures (and salary arrangements) as that occurs. The bottom line, though, is that traditional services and the careers based on those services are unlikely to be growth areas. Experience will remain important, but a greater emphasis on computer literacy and financial education and knowledge will be required to cope with the modern financial system and provide service to customers.

APPENDIX: Major Government Reports/ Inquiries

Independent Inquiries commissioned by the Government (or Industry Associations) are relevant not just because of the recommendations made, but also because of the wealth of information provided in the reports and submissions made to the Inquiries. The Table below lists most of the major ones relevant to banks and the financial sector. There are also many reports produced by Parliamentary Committees (and information about those up till 2013 can be found here). Treasury also undertakes many consultations which can be found on its web page, while ASIC and APRA also undertake consultations and produce relevant reports.

TABLE 1: MAJOR FINANCIAL SYSTEM RELATED INQUIRIES

Year of Report	Title	Chair	Focus
1981	Australian Financial System Inquiry:	Sir Keith Campbell	Deregulation
1984	Martin Report: Appointed by Hawke government to review Campell findings; endorsed broad deregulatory thrust in report in 1984	Mr Vic Martin	
1991	A Pocketful of Change: Banking and Deregulation	Senator Stephen Martin	
	Industry Commission (Availability of Capital) Report 1991		
1997	Australian Financial System Inquiry Report	Mr Stan Wallis	Stocktake of effects of deregulation and recommendations for regulatory change
1998	Managed Investments Act Review	Treasury	

2004	Study of Financial System Guarantees	Prof Kevin Davis	
2010	Australia as a Financial Centre	Mr Mark Johnson	
2010	Super System Review	Mr Jeremy Cooper	
2014	Australian Financial System Inquiry	Mr David Murray	
2016	Inquiry into Small Business Loans	Ms Cate Carnell	
2017	Retail Banking Remuneration Review	Mr Stephen Sedgwick	
2017	Independent Review of the Code of Banking Practice	Mr Phil Khoury	
2017	Review into External Dispute Resolution and Complaints Framework	Prof Ian Ramsay	
2018	Review into Open Banking in Australia	Mr Scott Farrell	
2018	Competition in the Australian Financial System	Productivity Commission	
2019	Superannuation	Productivity Commission	
2019	Royal Commission into Misconduct in the Banking, Superannuation and Financial Services	The Hon Kenneth Hayne	
2020	Retirement Incomes Review	Mr Mike Callaghan	
2020	Review of the Australian Payments System	Mr Scott Farrell	

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