Fashioning Financial Systems:
Some Lessons from Australia

ABSTRACT:

This paper provides an overview of how Australia's financial system has developed over recent decades, and indicates how government policies have contributed to influencing that development. It suggests that there is relatively limited evidence available to assess whether government policies have contributed to improved performance of the financial sector. It attempts to draw some lessons from that experience which may be of relevance to policy makers in other economies in the Asia-Pacific region and elsewhere.

KEYWORDS: financial development; financial regulation; financial structure

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1. Introduction

There is little disagreement that financial sector development is an important causal factor for economic growth.[i] But how governments can most effectively contribute to that development is a more contentious question. As Wachtel (2003) notes “the research does not yet tell us enough about development strategies and processes. It provides little in the way of rigorous guidance about how best to develop the financial sector.”

This paper addresses that question, drawing on experiences from Australia, but recognising that financial sector development will also be shaped by the nature of the economy and society within which it is located.[ii] Consequently, financial sector development policies which seem to have worked in any particular country such as Australia, may need modification before they are applied to another country. But particularly where there are similar legal systems and historical influences (such as past British colonization) upon the pattern of financial sector development, there is scope for a transfer of valuable knowledge about what works (and what does not).

Section 2 of the paper briefly reviews the economic functions performed by the financial system, since it is only by improved performance of these functions that financial system development can be said to have occurred. It observes that rarely is the performance of such functions easily measurable directly, leading researchers to use less reliable indicators of financial sector development. Section 3 provides an overview of Australian financial sector development drawing on such indicators. Section 4 briefly presents an organizing framework for thinking about the role of government policy in financial sector development. Section 5 considers how government policy has contributed to the evolution of the Australian financial system using this framework, and Section 6 draws lessons which can be learned from this experience which may be applicable elsewhere. Section 7 concludes with some comments on the implications of the 2007-9 financial crisis for financial development.

2. Functions and Performance of a Financial System

Table 1 provides a listing of the key economic functions of the financial system and an illustration of the types of financial institutions, markets and products involved in their performance.[iii]

Financial development means that these functions are better performed, although there is no presumption that one particular type of financial sector structure (eg relative reliance on intermediaries or markets) will be preferable. Unfortunately, measuring financial sector performance of those ultimate economic functions is problematic, and much analysis is limited to assessing financial sector development in terms of growth of the sector and evolution of alternative types of institutions, products and markets. Thus much of the analysis of the relationship between financial sector development and economic growth is based on cross-country studies. These typically examine statistical relationships between economic development and such things as indicators of financial sector size, the relative importance of financial institutions and markets, and measures of legal, political and social arrangements relevant to financial sector performance. As noted earlier, however, such studies have provided little guidance to date on specific types of policy initiatives best suited for effective financial sector development in specific cases.

An alternative approach is suggested by Rodrick's (2006) taxonomic hierarchical approach setting out potential causes of poor economic performance as a way of identifying appropriate policy reform measures for an economy. This suggests an approach to formulating policy for financial sector development via identification of key areas of poor performance of economic functions by the financial sector and analysis of the causes. Thus, for example, if national saving is low, is this because of demographic reasons, lack of profitable investment opportunities, excessive taxation of savings, unattractive savings institutions etc? If, for example, the last of these is deemed relevant, does this reflect barriers to entry and inadequate competition, legal impediments to the development of specific types of savings institutions or products, over-regulation, individuals' perceptions of lack of safety of funds placed with savings institutions, or other factors? If a lack of safety is thought important, is this because of inadequate supervision, poor governance, uncertainty over property rights etc? Careful analysis of this type for an individual country may be able to identify causes of problems and indicate possible policy responses.

Yet another alternative (drawing on past literature on monetary policy) is to identify "intermediate targets" for financial sector development policy, by asking what potentially measurable indicators are likely to be consistent with achieving good performance of its economic functions by the financial sector. Davis (2007) suggests a number of potential intermediate targets for policy makers to consider, where improvements over time might be (albeit imperfectly) measured. They include: well informed end users of financial products; well informed financial services providers; good governance structures; credibility of contracts; effective failure risk mitigation and management schemes; economic and financial stability; minimal market distortions; cost efficiency of financial institutions.

Another possible approach, and that adopted here, is to utilize information from case studies of similar economies. The ultimate objective is to identify key influences upon financial sector structure and development, and how these impact upon the sector's performance of its core economic functions. In doing so, it is worth noting that there is a three fold classification of relevance. The various economic functions are provided (in various combinations and different degrees) by particular financial products and services, while financial institutions each develop and market a range of those financial products and services. A purely "institutional" focus risks ignoring the possibility that different institutional arrangements can be compatible with efficient performance of economic functions, while a "financial product" focus also ignores the possibility that apparently different products can fulfil the same economic functions.

3. The Australian Financial Sector Evolution

Although the Australian financial system has a relatively large equity market and a growing bond market (at least until the subprime crisis struck)[iv], most household purchases of financial assets are via financial intermediaries or institutions such as collective investment vehicles, rather than direct between end users and suppliers of funds. As Figure 1 illustrates, the main exception to non-intermediated purchases of assets is that households still hold over half (by market value) of their assets in the form of dwellings, and the relative share has changed little over the past two decades.[v] The increase in dwelling assets has accounted for over half of the increase in total household asset holdings from around 3.5 to 5.5 times GDP over the last two decades, with the growth in superannuation assets accounting for much of the remainder. Household equity holdings (including via public unit trusts) have grown somewhat, to now match their bank deposit holdings in size, but only half of those equity holdings are equities of non-financial corporations, with bank and insurance company equities and managed funds accounting for the remainder. Households have financed their increased asset holdings partly by incurring debt, and household leverage has increased substantially. The household debt/income ratio has increased from 45 to 161 per cent between 1987 and 2007, while the ratio of interest payments to income increased from 7.8 to a record 11.9 per cent over the same period (higher than the early 1990s when mortgage interest rates were in the high teens).

The developments in the liability side of the balance sheet of the non-financial corporate sector are shown in the top panel of Figure 2. Reliance on equity financing has increased over the past twenty years, with a corresponding reduction in use of debt financing, and the predominance of loans from intermediaries over money market and debt capital market financing has changed little. These liabilities support both real and financial asset holdings and the latter have fallen steadily from 44 per cent of liabilities in 1988 to 33 per cent in 2007, suggesting improved cash management practices. The composition of financial asset holdings shown in the lower panel of Figure 2 suggests that this effect has been even greater in terms of reduced provision of trade credit.

The growth in household asset holdings is reflected in the growth in assets of financial institutions, from around 100 per cent of GDP prior to the 1980s to almost 400 per cent currently, shown in Figure 3. That ratio (of assets to GDP) has grown substantially since 1979, at annual rates of 5.4, 3.7 and 5.2 per cent over the periods 1979-89, 1989-99, and 1999-07 respectively, with the slower growth rate in the 1990s attributable to the financial problems of the first half of that decade.

Approved Deposit Institutions (banks, building societies and credit unions) had virtually the same share of total financial institution assets in 2007 as they did in 1969 (53 versus 52 per cent), although the share had decreased to 46 per cent in 1999. Large scale overseas borrowings by banks over the past decade, rather than substantial growth in household (or business) deposits explains the resurgence. The main growth sectors over the past decade have been superannuation funds, public unit trusts and securitizers. Australia now has the second largest securitization market and the fourth largest funds management sector in the world – although very little of that involves the management of offshore assets for foreign investors.

Growth in total assets of financial institutions (relative to GDP) does not necessarily give a reliable guide to the contribution of the finance sector to the economy, since it may partly reflect changes in the form of financial intermediation and involve some double counting.[vi] Alternative measures of the growth of the finance sector can be obtained by examining changes in its contribution to GDP (gross value added) or its share of employment. Figure 4 illustrates that these measures (value added and employment) suggest a less dramatic (but still substantial) increase in the sector's role in the economy. The finance sector's share of GDP has increased from around 4.5 per cent in the mid 1980s to well in excess of 7 per cent in recent years. However its share of employment has decreased from a peak of 4.8 per cent in 1990 to its 2007 value of 3.88 per cent. Most of that decline occurred in the first half of the 1990s when the Australian banks undertook substantial branch closures and shed labour, both in response to opportunities for electronic delivery of services created by technological change and as cost-cutting measures aimed at restoring weakened profitability.

Also shown in Figure 4 is the changing size of markets for traded securities – equities and bonds. Market capitalization of the Australian Stock Exchange (ASX), has increased over the past two decades from around 50 to 150 per cent of GDP. While those figures reflect both valuation (share price) and quantity (securities on issue) effects, there is little doubt that the relative importance of the equity market has increased substantially – reflecting in turn the increased demand for securities from the growth of superannuation and other managed funds. Non-financial corporate sector liabilities (debt plus equity) have increased relative to GDP, with most of the increase reflecting the increase in equity financing.

As can be seen in Figure 5, Australian equity market capitalization substantially exceeds the value of resident bank deposits, and was the eighth largest in the world in mid 2007. Figure 5 also illustrates that superannuation now exceeds ADI (bank) deposits as an asset class for residents, with the larger size of ADIs shown in Figure 3 reflecting the importance of their overseas borrowings to finance domestic assets.

Similar factors have also contributed to the (albeit much smaller) growth in Australian bond markets. Market capitalization has increased from around 30 per cent of GDP in the early 1990s to 46 per cent of GDP in 2007, (see Figure 4) with most of the increase occurring since 2003. As Figure 6 shows, Government Bonds on issue have declined substantially (relative to GDP) since the mid 1990s as a result of continuing government budget surpluses (including proceeds of asset sales from privatizations). Aggregate bond market growth has been due to the rapid expansion since around 2000 of securitization in Australia (until the sub-prime crisis struck in mid 2007) and issuance of “Kangaroo” bonds.vii Bond issues by Australian financial institutions (particularly banks) have also contributed to the increase, but there have been fewer issues by Australian non-financial corporations.

Figure 7 illustrates the growth of the domestic bond market relative to offshore issuance. While by 2007, the relative importance of domestic and foreign markets to Australian issuers of ABS and to foreign issuers of AUD securities was equal, the ABS market had begun as primarily domestic issuance, while foreigners had initially issued primarily in Euro-AUD markets. There is some evidence of both non-financial corporations and financial institutions making more use of domestic issues, but foreign issues still dominate for both.

The market for short term paper is (and has been) dominated by bank issuance. Bank accepted bills and negotiable certificates of deposits accounted for $352 billion of the $383 billion of private sector short-term securities on issue at June 2007. Asset-backed commercial paper accounted for $25 billion while non-financial corporations had only $6 billion on issue (equivalent in size to short term government securities on issue).

Australia's derivative markets, both exchange-traded and over-the-counter, have developed strongly. The Sydney Futures Exchange (which merged with, and became part of, the ASX in 2006) was among the international leaders in the introduction of exchange traded interest rate and share index futures (in 1979 and 1983 respectively). The ASX has promoted the development of its exchange traded options markets, structured products such as third party issued warrants (of various types), and most recently listed Contracts for Difference. It has promoted the growth of listed managed funds (including infrastructure and property trusts often using a stapled securities structure), and also hybrid markets with company (and bank) issued securities based on variations of convertible or converting bonds or preference shares. The listed hybrid market, with a large retail investor base, is as large as the straight corporate bond market.

Also important are the various financial services firms such as financial advisers, fund managers, insurance brokers and stockbrokers who provide advice and financial management/ broking services to individuals and companies. Such organizations (whose employees are required to be trained to an appropriate level as authorised representatives) or individuals are required to hold an Australian Financial

Services Licence, of which there were about 4,500 on issue in 2007. The financial advising industry has grown markedly over the past two decades, with a number of large "dealer groups" (often associated with large financial institutions) in existence. In 2008, the fifty largest dealer groups employed over 11,300 individual financial advisers/planners. Mortgage brokers are reported to have originated 37 per cent of all housing mortgages in 2007.

The development of the funds management sector is particularly worthy of note. At August 2007 (based on Morningstar data) there were over 10,000 managed funds offered in Australia by some 250 fund managers. There were at March 2007, 87 Hedge Fund managers offering 180 different hedge funds to both retail and wholesale investors, around 1/3 of which were "fund of funds" investing almost exclusively in overseas hedge funds. The growth of this sector is reflected in the growth of Public Unit Trusts shown in Figure 3, but is understated by their important role in managing funds for the superannuation sector (and other investors) under mandates.

The Private Equity sector has also grown substantially and has been estimated to be of a size equal to approximately 1.75 per cent of the ASX market capitalization. Around 50 per cent of its funding comes from superannuation funds who have allocated approximately 4 to 5 per cent of assets to the sector.

4. Potential Government Policies for Financial Sector Development

International agencies, such as the IMF, World Bank, BIS, IOSCO, OECD, have been at the forefront in building international acceptance of a set of necessary conditions required for effective financial sector contribution to economic development and growth. The importance of this "core financial infrastructure" has become "conventional wisdom" and is primarily based on informal and formal reasoning – in some cases supported by empirical studies.

This conventional wisdom emphasizes the need for economic agents to have reliable information for decision making, and the need for confidence in ownership rights in (physical and financial) investments made as a result of such decisions. Because principal-agent relationships will generally be involved, appropriate legal, institutional and social structures are needed to facilitate monitoring and disciplining actions and minimize agency costs. Arrangements to ensure stakeholders have reliable information about corporate performance and opportunities for stakeholder discipline via "exit" (market transactions) and/or "voice" (effective voting rights) are thus required. But impediments to effective private sector monitoring create a role for some level of public sector regulatory and supervisory activities, which is also reinforced by the possibility of financial institution failures having spillover effects which create economic and social disruption.

The resulting set of "core infrastructure requirements" for a sound and efficient financial system are thus seen as:

- Strong Corporate Governance Standards and Practices
- Effective Legal Protection and Enforcement of Property Rights
- Enforcement of Reliable Accounting and Auditing Standards
- Appropriate Information Disclosure Requirements and Practices
- Strong and Effective Supervisory Agencies

These have been enshrined in a number of standards, guidelines and principles issued by the international agencies referred to earlier (see Davis (2007) for a listing), and used as benchmarks by agencies such as the IMF and World Bank when undertaking country evaluations such as under the Finance Sector Assessment Program (FSAP).[viii]

The core infrastructure requirements do not dictate the specific shape of the financial system (eg reliance on markets versus intermediaries), and much government policy is directed towards measures designed to develop or improve specific features of the financial system. Examples (from a range of countries) include measures to: develop bond markets; develop ratings agencies; develop credit bureaus;

develop institutional investor bases; improve bank capitalization; promote financial literacy; improve provision of venture capital; develop financial safety net arrangements; implement risk based capital requirements for banks and insurance institutions. Competition and merger policy determinations directed at the financial sector are also relevant for shaping the financial sector evolution and performance.

In addition to such specific initiatives, the shape and performance of the financial sector is directly or indirectly affected by a range of other government policies – including legal and taxation changes. In principle, the likely effect of such changes on the financial sector should be considered as part of the analysis involved in a Regulatory Impact Statement (RIS) which has been required in Australia since 1997. In practice, however, such analysis has been relatively low-level, with little attempt at quantification of costs and benefits. Government acceptance of the recommendations of a recent review of the regulatory burden faced by business indicate that subsequent regulatory changes will be accompanied by more detailed cost-benefit analysis.[ix]

5. Australia: Government Policy and Financial Sector Development

Table 2 presents information on major policy changes and other events which have significantly influenced the development of the Australian financial system. Major reform commenced at the end of the 1970s with a process of deregulation through till the mid 1980s focused primarily upon the banking sector. As is well known, the removal of economic regulation (controls over prices, activities etc) and stimulation of competition, was not accompanied by adequate attention to ensuring good corporate governance, supervision, transparency and disclosure, contributing to significant banking sector problems at the start of the 1990s. Subsequent regulatory change was directed towards rectifying those deficiencies, by developing the financial infrastructure, and focused on prudential and information provision issues, in order to ensure the efficient functioning of a competitive financial system.

Several other changes introduced in the 1980s have also had a lasting impact. Taxation of inflation-adjusted realised capital gains (but with one's principal residence excluded) was introduced in 1985, and the dividend imputation tax system introduced in 1987. The ability to negatively gear investment property purchases (such that interest on borrowed funds in excess of rental income received is deductible against other income) with an objective of generating concessionally taxed capital gains, has stimulated investment in real estate by individuals. This has been compounded by the non-taxed status of capital gains on owner-occupied dwellings. Bank willingness to lend for such investments may have been increased by a potential reduction in prime business lending opportunities due to the effect of imputation in largely removing the tax shield associated with debt finance. In aggregate, leverage of Australian companies declined somewhat following the introduction of imputation, and increased dividend payout ratios were accompanied by use of dividend reinvestment schemes to offset reduced retained earnings.

A concurrence of events in the first half of the 1990s significantly shaped the subsequent development of the financial sector. The introduction of compulsory superannuation led to an increase in household wealth (Connolly, 2007) and in the share of it held in collective savings vehicles (rather than bank deposits) seeking investment opportunities in the form of traded securities. The banks, seeking to restore profitability following the disasters of the late 1980s, maintained relatively high margins on housing lending and cut back on staffing, branches and customer service. This provided the opportunity for the emergence of specialist mortgage originators and for securitization to flourish and meet demand for securities by the growing superannuation sector.

A further substantial round of regulatory change occurred following the report of the Wallis Committee in 1997, directed primarily at improving the core financial infrastructure. At one level, strengthened supervisory arrangements were sought by a restructuring of regulatory arrangements. A specialist prudential regulator (APRA) was established in 1998, and ASIC was given responsibility for capital markets, corporate conduct, and consumer protection in matters related to the finance sector.

Also particularly relevant was the commencement of the Corporate Law Economic Reform Program (CLERP) in 1997 which, following consultation processes, led to the introduction of a number of legislative changes over the subsequent seven years designed to improve the financial infrastructure. Changes included reforms to accounting standard setting arrangements, audit independence, directors' duties and corporate governance requirements, fundraising and takeover procedures, corporate disclosure requirements, compliance arrangements, provisions for electronic commerce, and shareholder rights.

While all of these changes are relevant to the finance sector, two others had particular direct impact. The Managed Investments Act of 1998 replaced the role of independent trustees for managed funds and introduced the concept of a "responsible entity", thereby facilitating the growth of fund management companies. Investment banks, such as Macquarie and Babcock and Brown, have been at the forefront of developing and managing innovative structures such as infrastructure (and property) funds, often involving issuance of stapled securities of a non-operating trust and an operating company.[x] Until recently this business model has proved highly successful in generating substantial annuity style fee income for the sponsoring companies. But it relied on substantial leverage and upward revaluations of the untraded assets enabled increased borrowings to generate cash which could be distributed to investors in the fund. The increased cost of debt, market distrust of leveraged structures, and concerns about overvalued assets arising from the sub-prime crisis have seen a number of large investment-finance companies operating such business models lose market confidence and struggle for survival.

The other component of the CLERP reforms directly affecting the financial sector was the Financial Sector Reform Act (2001). This introduced a single licensing regime for financial products and a single regime for regulating financial services (investment advice), and licensing of exchanges and clearing and settlement facitlities. It also imposed requirements for disclosure of fees, and introduced a national dispute resolution system.

An important determinant of the institutional structure of financial development is government competition policy towards financial markets. Establishment of (stock) exchanges requires approval by ASIC, and while several small exchanges have been approved (NSX, APX) the virtual monopoly of the ASX in shares and futures trading has not been seriously challenged (until recent applications by potential competitors). Entry into non-prudentially regulated activities (including lending) is relatively straightforward, requiring primarily the holding of an AFS Licence and, in the case of responsible entities for collective investments, some minimum level of capital. Prudentially regulated institutions must have some minimum level of capital, and directors and senior management are required to meet appropriate “fit and proper” standards. In the case of banking, foreign banks are effectively precluded from entering the retail market as branches of the foreign parent, but can do so by establishing a separately capitalized subsidiary. While, in principle, entry to the ADI sector is feasible for Australian entities, minimum capital requirements make it difficult for new mutual organizations (such as building societies and credit unions) to be established. Combined with increased regulatory requirements and apparent benefits from increased scale, mergers within this sector are rapidly reducing (despite foreign bank entry) the number of institutions operating in the ADI sector.

The policy of restrictions on mergers in banking has been contentious. The "Four Pillars" policy, in operation since 1990 (originally as "six pillars") and reaffirmed several times by successive Governments, prevents mergers between the four major banks. Argued by executives of the major banks to inhibit overseas expansion (because of a lack of domestic scale), its role in ensuring effective competition in domestic banking (and the other parts of the financial sector which the banks dominate) is uncertain. Whether foreign takeover of one of the four majors would be permitted by the Treasurer under national interest considerations has yet to be tested. To date, however, the combination of these policies has ensured that Australia has a core of large banks headquartered in its major financial cities – arguably generating agglomeration economies and consequent benefits for the development of the Australian financial system.

A further area of competition policy action has been the efforts by the Reserve Bank (via the Payments System Board) over the past decade to reform the interchange arrangements for credit and debit cards, EFTPOS and ATM.

6. Lessons from the Australian Experience

This section attempts to draw some broad lessons from the Australian experience of financial development over the past several decades which may be of relevance to other countries in the Asia-Pacific region. It is convenient to present them under a number of distinct headings.

Compulsory Retirement Savings

The introduction of compulsory superannuation has had a major influence upon the structure of the Australian financial sector. The (not for profit) industry-based superannuation funds have become significant sized financial institutions (and are gradually expanding their range of ancillary financial services). The need for specialised fund management services by these funds has encouraged the growth of specialist fund managers including hedge funds and private equity managers. While the question of whether fund managers can outperform the market to add value (and justify the fees received) is subject to ongoing debate, their increased role should, a priori, improve financial market efficiency.

More generally the introduction of compulsory superannuation has increased household savings and wealth as Connelly (2007) shows, as well as changing its mix towards managed funds at the expense of bank deposits. (These trends are likely to have been reinforced by the "Simple Super" changes announced in the 2006 budget which provided greater opportunities for tax-effective contributions and removed tax on retirement phase withdrawals (post age sixty).) The increased demand for traded securities by the funds has encouraged the development of capital markets.

But not all aspects of superannuation policy should necessarily be viewed so positively. Tax incentives have underpinned much of the growth of the sector (beyond the compulsory contribution component – which also gets favourable tax treatment). Whether those tax incentives excessively distort the functioning of the financial market, excessively favour the wealthy, or are sustainable for the Government budgetary position in the long run are questions warranting further attention. Whether according equivalent tax benefits to allocated pensions and lump sum withdrawals as to lifetime annuities will create future social problems from "longevity risk" is also an issue of some concern.

Finally, as Covick (2007) points out, the growing popularity of self managed super funds (although creating a demand for financial advisory and outsourced management and accounting services) may generate problems as these funds move into the retirement phase. Ageing or ill health (or death) may reduce the competence of the "lead" trustee to provide effective management (which the other trustee members may not be able to effectively undertake), and administration costs will increase substantially in relative terms as balances decline.

The main lessons from this experience would appear to be that: introducing compulsory retirement savings can contribute substantially to financial sector growth and development; the particular institutional arrangements can lead to the creation of new and important types of financial institutions; but that careful attention should be paid to the longer run retirement phase arrangements.

Capital (Bond and Stock) Market Development

Australia's experience reinforces the message from elsewhere of how difficult it is to develop a domestic corporate bond market,[xi] particularly in a "bank-dominated" economy, and where there is no tax advantage to debt finance because of the imputation tax system. There are relatively few non-financial corporates sufficiently large and with high ratings, to provide regular bond issues of a scale sufficient to develop a liquid market sufficiently attractive to potential domestic investors to make this preferable to bank financing. For large corporates, issuing in existing overseas bond markets is preferable because of the market depth. In contrast, credit enhancement for securitizers, and high standing of issuers of Kangaroo bonds have meant that their highly rated issues have been attractive to institutional investors required to operate under "prudent man" requirements.

Australia's experience with the growth of the hybrid market (converting/convertible bonds/preference shares etc) is also instructive, since this might be interpreted as a partial substitute for a corporate bond market. One characteristic of this market has been the listing and trading of such securities on the stock exchange. The resulting liquidity, allied to their equity like characteristics (via conversion arrangements) has perhaps made them more familiar and attractive to both retail and institutional investors. However, three features of the market warrant noting. First, a dominant proportion of the issuers have been financial institutions. Second, the motivation for many of those issues appears to be regulatory arrangements which permitted such securities to qualify as regulatory capital. Third, many other issues appear to have been motivated by tax considerations, including the ability to construct securities which would be attractive to investors seeking franking credits. The hybrid market should not, thus, be seen as a substitute corporate debt market which has grown organically, rather than as the result of market imperfections.

The main lesson of this experience would seem to be that Say's Law does not apply in the development of corporate bond markets. Supply (of debt securities) does not create its own demand, and development of debt markets is more likely to be stimulated by the development of demand for such securities, such as through the development of institutional investors by compulsory superannuation.

The dominance of financial institutions in bond and hybrid markets is also relevant to the development of equity markets. Financial institutions (and particularly the major Australian banks) account for a significant part of the ASX market capitalization. Having large domestic financial institutions, listed on the local stock exchange, may aid the development of that market by attracting retail investors familiar with those institutions and, arguably, more subject to “home bias” than institutional investors.

Consumer Protection in the Financial Services Sector

The approach to consumer protection in financial services reflected in the CLERP program and adopted by ASIC has focused upon the three-pronged approach of enhancing standards of financial education, disclosure, and advice, and applying caveat emptor. Although such an approach aims to provide consumers with appropriate incentives, there is mounting evidence, in the form of consumer losses through inappropriate investments (often made under specialist advice) that it is inadequate.

Indeed, no matter how desirable in principle, such an approach fails to recognise the realities of the incompatibility of financial product complexity and levels of consumer financial competence. Product disclosure documents are generally acknowledged to be rarely read, and presenting complex financial information simply and succinctly without omitting material information appears infeasible. Consumer reliance on advisers is fraught with difficulties, because of their links to financial institutions manufacturing financial products and/or reliance on commissions rather than up front fee for service. The dominance of the commission based approach (despite the inherent conflicts of interest) should hardly be surprising. Consumers are unlikely to be able to identify high quality from low quality advisers ex ante creating something of a “lemons” problem for a market based on payment by up front fees.

Campbell (2006) in his American Finance Association Presidential Address notes that given information imperfections and differences in consumer financial literacy, retail financial products may emerge which involve a pooling equilibrium in which wealthy (financially literate) consumers are cross subsidized by the less wealthy and less financially literate. For example, the former group may be able (and the latter group unable) to recognize and appropriately exercise future options inherent in some financial products (eg refinancing when introductory low “teaser” loan rates expire).

Consequently a major lesson for policy makers would appear to be that efforts to improve financial literacy, disclosure, advice, while necessary for consumer protection in the financial services sector, are not sufficient. Such initiatives may need to be supplemented by policy makers considering such things as: tax/subsidy incentives for suitably designed products; specifying appropriate default options for financial products; restrictions on sale of certain financial products to households perceived to have low financial literacy.

Taxation Policy and Financial Sector Development

One of the most significant ways in which financial sector development can be influenced is via the structure of the domestic tax system. Arguably, the dominant factor influencing the asset portfolio composition of the Australian household sector is the preferential tax treatment given to two asset classes – residential and investment properties and superannuation.

But the effect of taxation arrangements on financial sector development is much more pervasive. Financial service providers will seek to exploit any opportunities provided by inconsistencies in the tax treatment of financial products and services. There is a wide range of financial products on offer in Australia which, arguably, have as their main rationale for existence, wealth transfer from taxpayers to financial institutions and their customers. The most blatant of these are seen in the proliferation of end-of-tax-year offerings of managed investment schemes. But many other products and structures have been developed to exploit the differential tax treatment of capital gains and interest or dividend income, or differences in international and domestic taxation, or difference tax treatment of different institutional forms.[xii] The Australian Government's attempt to develop a consistent framework for taxation of financial arrangements (TOFA) begun in 1999 in response to the Review of Business Taxation has progressed slowly, and is still underway.

Similarly, differences between domestic and international taxation arrangements can create impediments for the development of the domestic financial services industry. One example, in Australia, has been the tax treatment of managed funds, whereby withholding tax arrangements have inhibited the export of funds management services (i.e. Australian managers managing offshore financial assets for foreign investors). Changes to these arrangements were announced in May 2008 which should enhance the competitive position of Australian based fund managers in competing for international business.

The main lesson from this experience would seem to be the need for Governments to carefully design and continuously review the structure of taxation arrangements, such that distorted financial sector development is not induced.

Foreign Ownership and Financial Sector Concentration

Since 1990, the Australian Government has imposed restrictions on mergers between Australia's four major banks and, while allowing for the possibility of their acquisition by a foreign owner since 1997, has made it clear that any such proposal would need to pass a national interest test. Over the past decade, a significant number of “mid-size” domestic and foreign owned competitors have emerged, although rationalization among small ADIs via mergers is reducing the number of institutions. Evidence on the degree of effective competition in Australian banking is mixed (Davis, 2007b), but there seems little reason to doubt (given pronouncements of bank executives) that without strong anti-merger policy, increased concentration would occur. While there are ongoing concerns about the large domestic banks exploiting their market power and dominating the financial system, they have been significant financial innovators and product developers, and hence important contributors to financial sector development and sophistication.

Perhaps the major lesson from Australia’s experience is that having head offices of financial institutions located domestically, aids the development of local financial centres with the (albeit difficult to measure) agglomeration benefits and financial dynamism they bring.

Depositor Protection

For many years, Australia has held out against the international tendency towards introduction of a deposit insurance scheme, arguing that depositor preference (where depositors rank ahead of all other claimants on a failed bank) has provided sufficient protection. Despite repeated statements of no government guarantee of bank deposits, widespread belief in an “implicit guarantee” (particularly for large banks) would seem to have existed,[xiii] and been reinforced by the Government’s introduction of a compensation scheme for policy holders of the HIH insurance company which failed in 2000.

The announcement in June 2008 of the planned introduction of a Financial Claims Scheme (providing rapid access to a maximum of $20,000 for depositors in a failed bank) left New Zealand as the only OECD country without some form of deposit insurance scheme.[xiv] In the event, this was overtaken by the blanket guarantee of bank deposits and debt announced in October 2008 in response to similar, crisis induced, announcements by a number of other countries. That response has reinforced the perception that customers of depository institutions are protected by government, with one important potential side effect being an improvement in the competitive position of smaller and younger retail depository institutions – since perceived safety advantages of larger older institutions (where the perception of an implicit guarantee was strongest) may be reduced.

There are three significant lessons from these developments. First, concerns about moral-hazard associated with limited deposit insurance may be overstated, given the financial understanding and expertise of most retail depositors. Second, perceptions of implicit government support, particularly for large "too big to fail"' institutions can influence the pattern of development of the financial system.

Financial Sector Reform Processes

Regulatory change in Australia's financial sector has occurred in various ways as a result of Government responses to: recommendations of formal inquiries; crisis events; and extended consultation processes. The amount of change has been substantial, causing many in the sector to complain of "regulatory fatigue" in adapting to changed requirements, and of a cumulative effect of excessive regulation (reflected more generally in the 2007 report of the Regulation Taskforce (2007).

One consequence of regulatory change is that, by changing feasible or optimal product offerings by financial institutions, there is the potential for the emergence of substantial "legacy" products operating at inefficient scale and creating additional costs. Finding ways to facilitate the transition of customers from those old to newer products in fair and efficient manner is an important ingredient in regulatory change proposals, and an important lesson from Australia's experience.

Corporate Law Economic Reform and the Subprime Crisis

The apparent causes of the recent woes of a number of large Australian financial / investment companies, stock market disruption and securities lending debacle, cast some doubt on the overall success of the CLERP program in enhancing Australia's financial infrastructure. Complex, opaque, corporate structures have been allowed to flourish, involving poor governance arrangements, accounting arrangements less than optimal, and auditors' judgements called into question. Regulatory oversight of securities firms engaged in margin lending and stock lending has been inadequate, and stock market investors have, for a long time, been un(mis)informed about the incidence or level of short selling because market practice was to ignore disclosure requirements if short sales were effected by borrowing stock.

The reforms of the CLERP program have been widely advertised as delivering a "best practice" corporate law structure. There has, however, been very little serious empirical research aimed at identifying what the outcomes and economic benefits of the CLERP reforms have been. Ideally, in undertaking such reforms, a priori cost benefit analysis should generate testable hypotheses about expected changes in particular economic (or social, environmental, or other) variables, which can ultimately be (however imperfectly) tested. In that respect, the decision in 2007 by the Australian Government to require explicit cost-benefit analysis of regulatory changes is welcome both for its effects in enhancing ex ante reform analysis and in potentially facilitating the specification and conduct of ex post tests of the effects of regulatory change, from which we can gain valuable lessons.

7. Conclusion

The preceding analysis has focused upon the longer run development of the Australian financial system in order to identify important contributing factors to that development. The onset of the global financial crisis in 2007 has prompted dramatic changes in the financial sector worldwide, major policy and regulatory initiatives, and reassessment of the optimal balance of financial regulation and liberalization. The implications of these developments for the future development of the financial system will take some time to emerge, although short term regulatory responses such as blanket deposit guarantees and banning of short-selling have adversely affected the business of financial institutions such as mortgage trusts (not covered by the guarantees) and long-short hedge funds (reliant on short-selling) respectively. More generally, some of the innovative financial products and business models have been shown to be founded upon opaque information and optimistic projections such that commission based (or profit sharing) sales representatives were able to sell such products to investor /customers lured by the promise of high return and unaware of the risks involved.

Although the crisis will undoubtedly have a significant influence on future financial sector development, many of the lessons from the longer run experience outlined in the preceding section remain relevant. In particular, the pervasive messages of the difficulties of balancing consumer and investor protection and regulations promoting market integrity with financial innovation and competition remain relevant. So also does the importance of improving economic analysis of regulatory changes and requiring such analysis for assessment of regulatory proposals.

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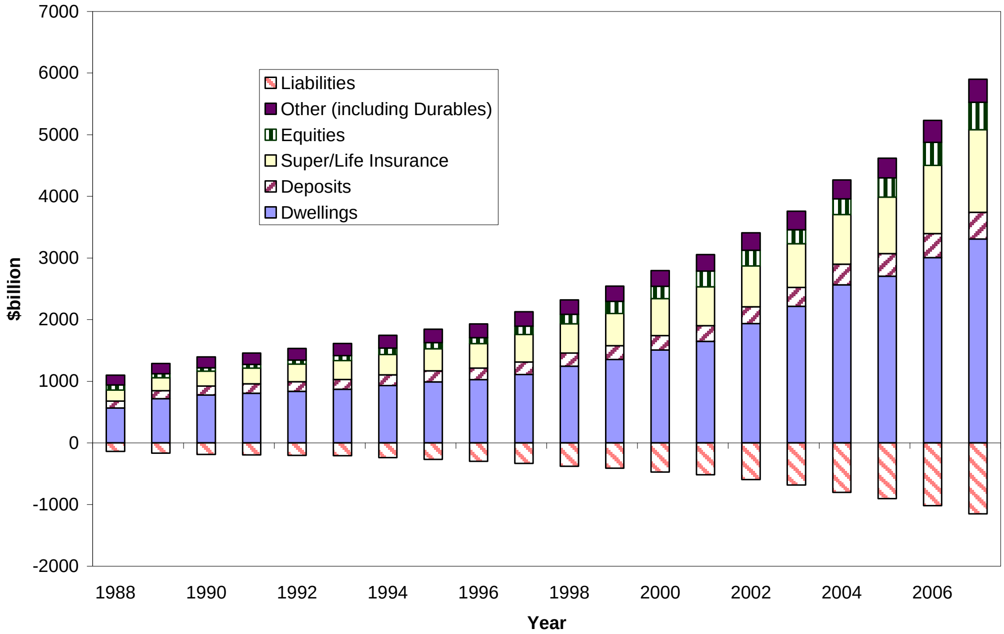
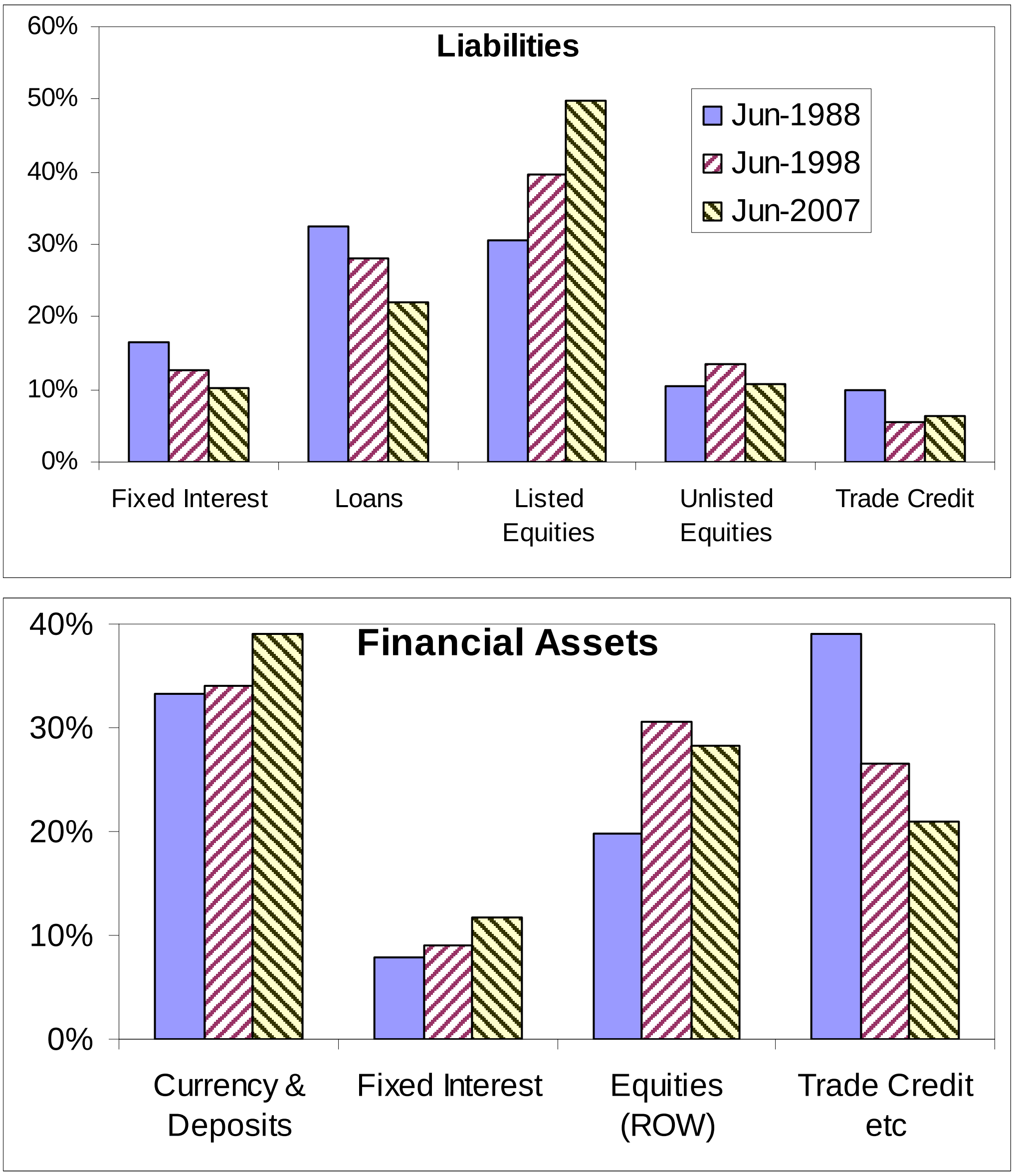
FIGURE 1: Household Sector Assets



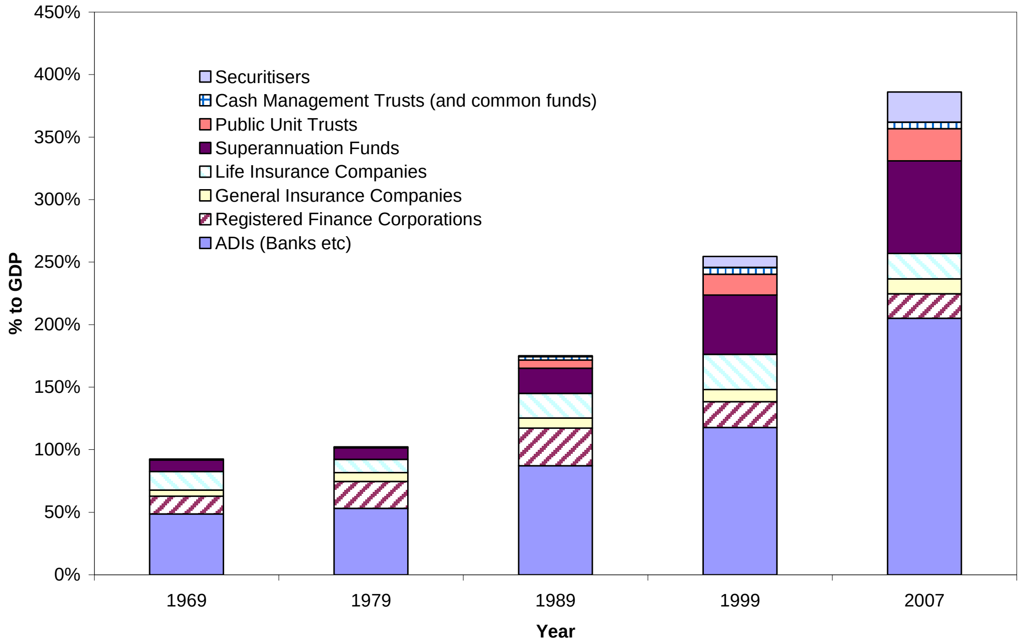
Source: Reserve Bank of Australia Bulletin, Table B20

FIGURE 2: Corporate Balance Sheet Trends



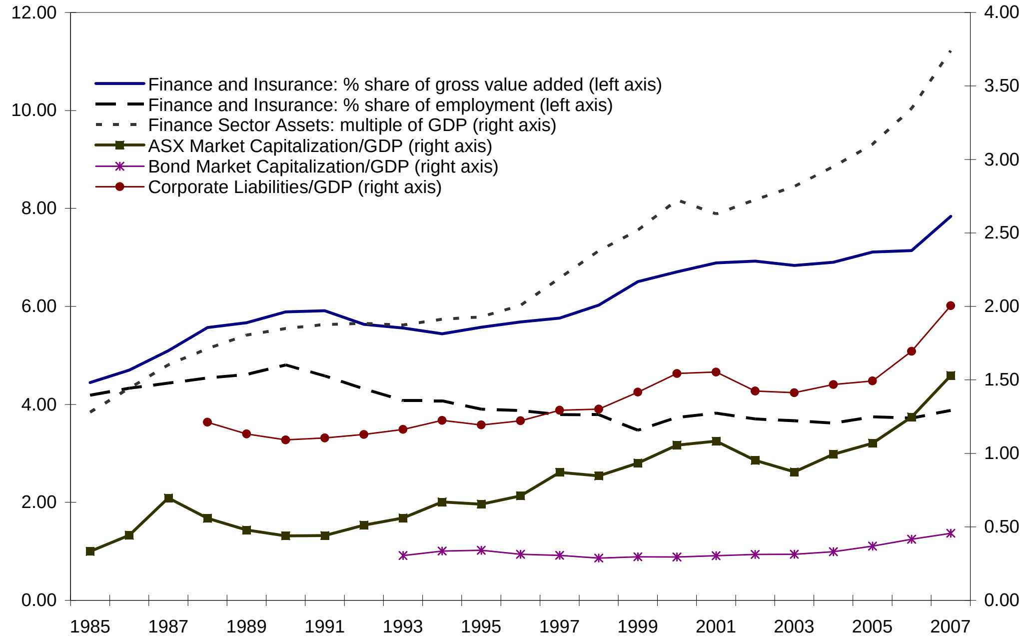
Source: ABS 5232.0 National Accounts, Financial Accounts, December 2007

FIGURE 3: Financial Sector Assets/GDP - Australia



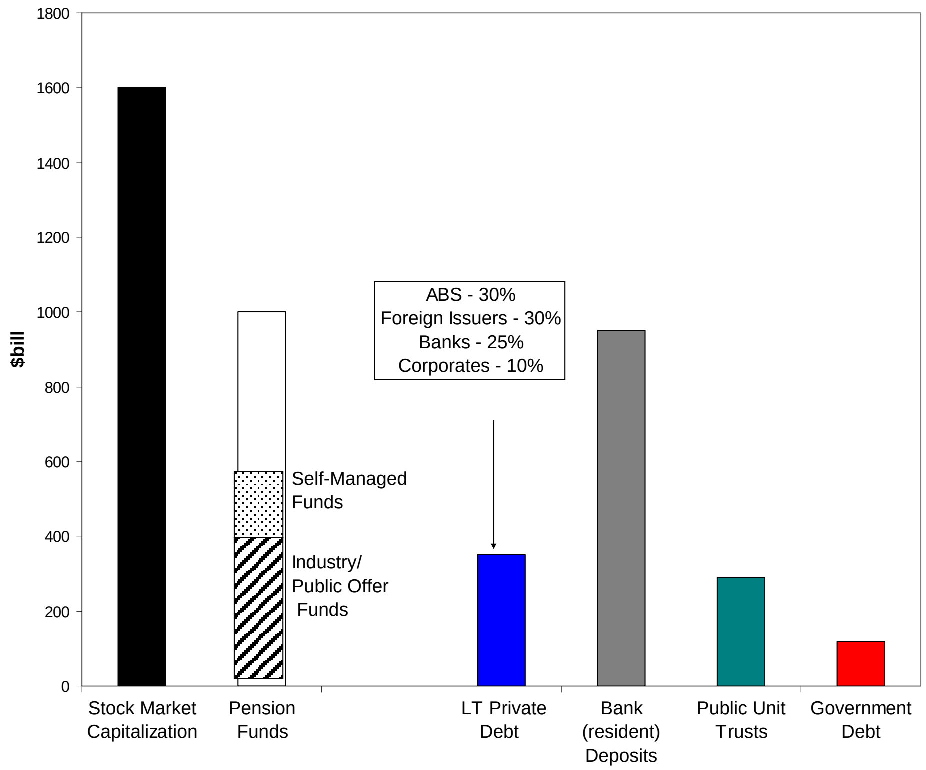
Source: Reserve Bank of Australia Bulletin, Table B01

FIGURE 4: Finance Sector Indicators - Australia



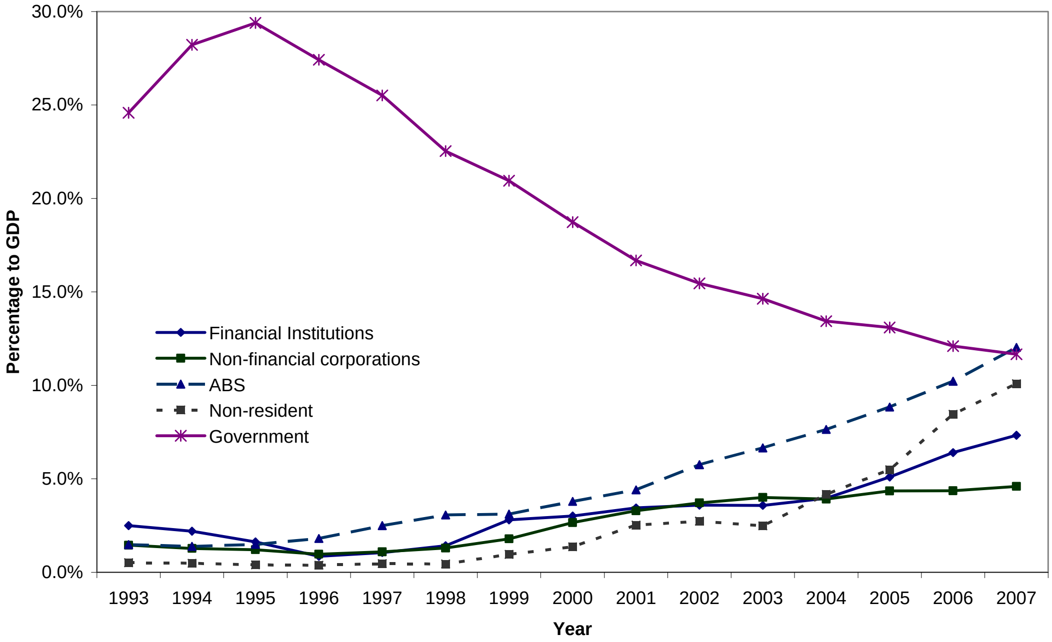
Source: Reserve Bank of Australia Bulletin, Table B01, F7, G11; ABS, 5206.0 Table 6, 6291.0.55.003 Table 04, 5232.0 Table 2.

FIGURE 5: Finance Sector – Australia: Indicators of Relative Size, 2007



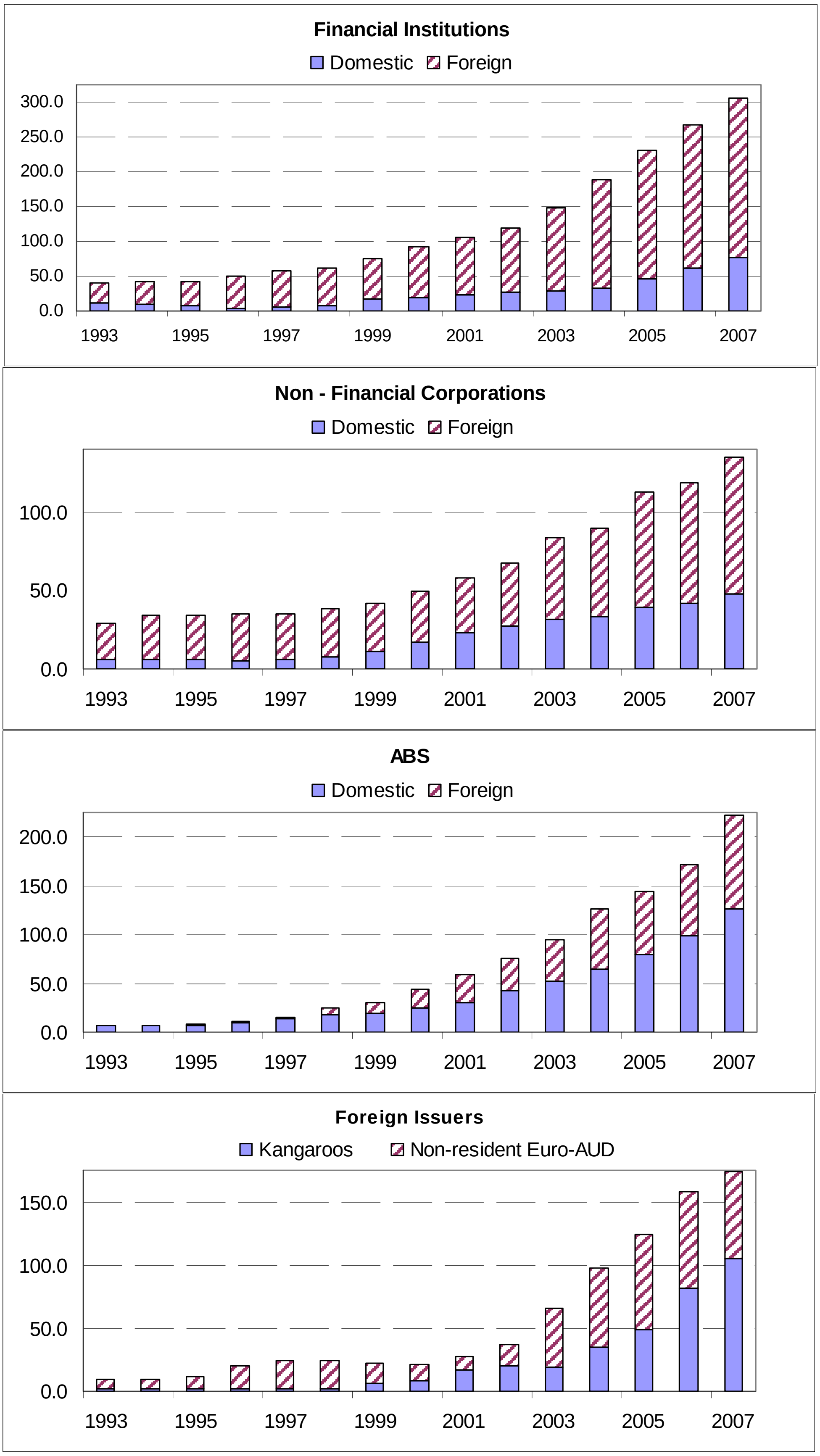
Source: Reserve Bank of Australia Bulletin

FIGURE 6: Australian Debt Markets: Long Term Debt/GDP



Source: Reserve Bank of Australia Bulletin, Table D04

FIGURE 7: Australian Bond Markets: Amounts on Issue



Source: Reserve Bank of Australia Bulletin, Table D04

TABLE 1: Financial System Functions, Institutions and Markets

Function	Institutions and Markets Involved
Payments systems for the exchange of goods and services	Central Bank depository and settlement services, base money provision, bank provided payments and settlement arrangements, securities settlements services, credit card and EFT services, foreign exchange markets
Mechanisms for the pooling of funds to undertake large-scale indivisible enterprise	banks and depository institutions, institutional investors and mutual funds, stock exchanges, capital markets, investment banks, private equity firms .
Ways to transfer economic resources through time and across geographic regions and industries	savings, depository and other financial intermediaries, pension funds, foreign exchange markets, capital and money markets
Way to manage uncertainty and control risk	insurance companies, financial intermediaries, forward markets, options and other (including credit) derivatives markets
Generation of price information which helps coordinate decentralized decision-making in various sectors of the economy	money and capital markets, stock exchanges, foreign exchange markets.
Mechanisms for dealing with asymmetric information problems when one party to a financial transaction has information that the other party does not	ratings agencies, credit bureaus, banking relationships, collateral, security, and guarantee arrangements, auditing, disclosure requirements

Table 2
Recent Financial Sector Development in Australia: A Chronology and Classification of Major Influences

	Principal Area				
Years	Financial Institutions	Financial Markets	Business, Tax etc	Regulatory Agencies	Other
l979-84	Banking largely deregulated; new domestic bank entry permitted; portfolio deregulation of life offices	Govt bond markets reformed; deregulated forex market established; deregulation of stockbroking			
l985-86	Foreign bank subsidiary entry, banking further deregulated (removal of remaining interest rate and asset portfolio controls), NBFI’s permitted to participate in payments system.	ASX formed by merger of state exchanges	Tax on (inflation adjusted) capital gains introduced.		
1987-90	Risk weighted capital requirements introduced for banks; “Six pillars” policy on bank mergers introduced		Dividend imputation tax system commenced; National Corporations Act to replace cooperative state legislation	Insurance and Superannuation Commission (ISC) established	Banking Industry Ombudsman scheme introduced
1991-96	Part privatisation of Commonwealth Bank; Foreign bank branch entry permitted; risk weighted capital requirements applied to building societies and credit unions; first “bancassurance” group created; Risk weighted capital requirements applied to life companies; Accounting Standard		National Competition Policy adopted	ASC established; AFIC established; Council of Financial Supervisors formed; bank on-site inspections commenced; Continuous disclosure for listed companies regime introduced by ASX; Life Insurance Act passed	Life and general insurance complaints schemes introduced; Banking, general insurance and life insurance codes of practice

	AAS32 addressing disclosure standards for financial institutions released			ACCC created; Central Bank independence affirmed	released; Uniform Consumer Credit Code introduced
1997-2000	Wallis Inquiry reports; "four pillars" policy towards bank mergers adopted, Bank capital requirements for market risk introduced; Financial Sector (Shareholdings) Act passed; Payments System (Regulation) Act passed; replacement of minimum liquidity requirements for banks with "agreed liquidity policy" based approach, access to exchange settlements account facilities at RBA widened; Uniform prudential standards for ADIs announced by APRA Collapse of HIH	Financial Sector Reform Act passed, Managed Investments Act involves removal of trustees and introduction of "responsible entities" system for managed funds; ASIC announces tighter guidelines for financial forecasts in prospectuses	CLERP (Corporate Law Economic Reform Program) announced; Capital Gains tax changed such that half of nominal realised capital gain taxable; Corporations Act. Incorporating CLERP 1 (arrangements for accounting standard setting), CLERP 2 (fundraising), CLERP 3 (directors' duties and corporate governance), CLERP 4 (takeovers), CLERP 5 (electronic commerce); TOFA (Taxation of Financial Arrangements) reform process commenced.	APRA created, ASIC replaces ASC and given responsibility for consumer protection in financial services, Payments System Board established within Reserve Bank, Council of Financial Regulators replaces Council of Financial Supervisors; ASIC Act	Privacy Act
2001-05	New prudential standards for general insurers life insurers introduced, RBA announces credit card reforms; APRA licensing of	Policy decision to maintain Government Bond market viability; FSRA implemented via ASIC policy statement on	CLERP 6 (Financial Services Reform Act - FSRA) - new regulatory regime for financial	ASIC powers, product disclosure statements, introduction of concepts of financial services and	FSRA commenced requiring licensing of

	Superannuation Trustees	improved information disclosure in prospectuses etc	markets and investment products); ASX "Principles of Good Corporate Governance" released.; CLERP 7 (simplified lodgement and compliance); CLERP 9 (enhanced auditor independence, disclosure (including remuneration), improve shareholder activism)	financial products	Financial Advisers; Uniform Credit Code enacted by States
2006-8	Introduction of "Simple Super" – changes in tax arrangements and limits on contributions and benefit limits; Basel 2 implementation process underway; Announcement of Financial Claims System	ASX-SFE merger, Government's Future Fund established.	"Sons of Gwalia" judgement regarding priority ordering in bankruptcy permitted	Introduction of "Government Statement of Expectations" for regulatory agencies; Announcement of transfer of State based credit regulation to Federal system	

[i] See for example, Levine (2005) and Sylla (2006).
[ii] Rajan and Zingales (2003) suggest that opposition to financial development by incumbents who stand to lose from such development is an important consideration, and that opening up of cross-border trade and capital flows mutes the effectiveness of such opposition and facilitates development.
[iii] Levin (2005) and Merton (1995) provide slightly different lists of financial system functions.
[iv] Brown and Davis (2008) provide an analysis of how the subprime crisis was transmitted to Australia and its effects.
[v] The proportion increased from around 0.55 at the end of the 1980s to a peak of 0.60 in 2004 and has since declined to 0.56.
[vi] For example, superannuation funds hold as assets both equity and debt securities issued by banks which, in turn, finance the asset holdings of the banks.
[vii] Kangaroo bonds are bonds denominated in AUD, issued in Australia by foreigners (primarily financial institutions and government or multinational agencies).
[viii] Australia underwent an FSAP in 2006, and New Zealand in 2004
[ix] Davis (2008) provides a brief overview of the proposed changes in the introduction to a special issue of *Economic Papers* focused on the process of changes to financial regulation
[x] This type of vehicle purchases or develops a number of different operating infrastructure assets (using funds subscribed to the trust plus additional borrowings) with (for example) the assets owned by the trust but leased to and operated by the company whose shares are stapled to the units in the trust. (The operating company outsources management responsibility to a specialist management subsidiary of the sponsoring company). Tax benefits flow from this structure (due to the pass-through nature of trust taxation), while the limited effective governance rights of the fund's investors means that the assets can be operated largely along a private equity type model.
[xi] While the conventional wisdom appears to be that development of a corporate bond market is a desirable objective, there appears to be little evidence to indicate that it has any inherent advantage over an institutional structure based on bank debt finance, or that there are particular unwarranted impediments preventing the development of such a market.
[xii] A recent Australian example is Deferred Purchase Agreements, whereby (for example) the gross return on a five year investment in a managed Asian equity fund is received in the form of an equivalent value of (say) BHP shares, with the objective of claiming that because no cash is received at that time, capital gains tax is deferred until such later time as the shares are sold.
[xiii] A survey commissioned by the RBA in 2006 found that 60 per cent of respondents believed that there was a guarantee or that the government would step in to protect depositors at a failed bank. (RBA, 2006)
[xiv] In developing and announcing the Australian proposal, officials have emphasized its "rapid access" feature rather than any insurance or guarantee feature.