

INTEGRATION OF FINANCIAL SERVICES: EVIDENCE FROM AUSTRALIA

Elisa A. Bain* and Ian R. Harper†

ABSTRACT

This paper examines convergence in the Australian financial services industry. It traces the emergence of financial conglomeration in Australia from its origins in the 1950s. The institutions involved, their market shares, and their mix of financial activities are described. The causes of financial conglomeration in Australia are discussed, noting that conglomeration has occurred in two main phases in Australia. The regulatory treatment of financial conglomerates in Australia is described, including recent changes to the Australian regulatory framework following the 1997 Financial System Inquiry. The paper concludes with some speculation as to the likely future of financial conglomeration in Australia.

Over the past three decades, financial convergence has become a feature of the Australian financial system, as it has of most other developed financial systems. The term refers to “an existing financial service provider diversifying its business to offer a broader range of financial services, such that its business begins to encroach on areas traditionally the preserve of other financial institutions” (Australian Financial System Inquiry 1996, p. 73). An institution that diversifies through subsidiaries becomes a “financial conglomerate,” pursuing activities involving two or more of banking, insurance, and funds management. Financial conglomeration is not a new feature of the Australian financial system, having emerged initially in the 1950s.

This paper examines convergence in the Australian financial services industry. It commences with an overview of the Australian financial system and proceeds in Section 2 to examine the trend toward financial conglomeration, focusing on the institutions involved, their market shares, and their mix of financial activities. The causes of financial conglomeration are considered in Section 3, while Section 4 examines the regulation of Australian financial con-

glomerates, including the most recent regulatory changes implemented after the 1997 Australian Financial System Inquiry. The paper concludes with some speculation as to the likely future of financial conglomeration in Australia.

1. INTRODUCTION TO THE AUSTRALIAN FINANCIAL SYSTEM††

The 1980s and 1990s have been amongst the most eventful decades in Australian financial history—rivaled only by the financial crises of the 1890s and the Great Depression of the 1930s. The 1980s began with the widespread deregulation of the Australian financial system, ending most controls over bank lending, permitting the entry of foreign banks, and floating the Australian dollar. Financial deregulation spawned new institutions and new markets, and transformed most of those already in existence.

Today the Australian financial system has many new institutions (investment banks and specialised foreign exchange dealers, bond traders, new types of trusts and managed funds) and new markets (a competitive foreign exchange market, swaps, options, and other derivative markets). The system has been liberalized in several respects: new entry of domestic and foreign enterprises is now easier

* Elisa A. Bain is a research assistant in the Melbourne Business School, University of Melbourne, 200 Leicester Street, Carlton, Victoria 3052, Australia.

† Ian R. Harper is Professorial Fellow in the Melbourne Business School, University of Melbourne, 200 Leicester Street, Carlton, Victoria 3052, Australia, e-mail, iharper@hotmail.com.

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(and domestic firms have moved offshore), increased capital mobility means that funds move freely between Australian and overseas financial markets, and both businesses and consumers can obtain financial services on a global basis.

There has also been a gradual shift away from intermediaries in favor of markets. This has occurred through the disintermediation of credit and risk management services, as well as the spread of securitization (Australian Financial System Inquiry 1996, p. 8). Large firms increasingly raise funds directly from financial markets. Securitization, the process whereby loans are on-sold and traded in secondary markets, is a growing phenomenon in Australia, especially in home mortgage finance (Australian Financial System Inquiry 1996, p. 9). Although these developments are not as advanced as they are in some overseas markets, especially the U.S., the share of financial intermediaries in total financing has nevertheless fallen in Australia, from 74% in 1980 to 62% in 1996 (Reserve Bank of Australia 1996, p. 1). Concurrent with this decline has been the growth in off-balance-sheet activity of financial intermediaries. This shift in core business is reflected in the increasing volume of financial derivatives, including futures, swaps, and options on underlying financial assets.

The major types of financial institutions operating in Australia and their activities are outlined in Sections 1.1 through 1.3 (Council of Financial Regulators 1998; Lewis and Wallace 1997).

1.1 Banks

There were 45 banks active in Australia as of December 1998 with domestic assets totaling A\$621 billion (excluding nonbank subsidiary activities). Three types of banks operate in Australia:

Major banks. The Australian banking sector is dominated by four major banks: Australia and New Zealand Banking Group (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB), and Westpac Banking Corporation (WBC). They each provide the full range of financial services to all sectors of the economy. On the retail side, they provide housing and personal loans, checking and savings accounts, credit cards, term deposits, cash and funds management, and insurance and superannuation. On the commercial side, they offer loans of varying maturities, overdraft facilities, foreign exchange and other market trading

services, and international trade finance. Each of the major banks maintains offshore offices and representation, with NAB and ANZ both operating subsidiaries in foreign locations.

Regional banks. The regional banks were established as building societies and retain their original retail focus, with particular emphasis on home mortgage lending. The activities of regional banks were traditionally limited to a specific geographic area, such as a single state, with their competitive advantage being the service of local communities. However, regional banks increasingly conduct business across state boundaries.

Foreign banks. There are 12 licensed foreign banks operating in Australia with a further 14 represented through branches (these tend to be large multinational banks). Collectively, foreign banks and branches account for 17% of Australian banking system assets. Foreign banks authorized to operate as branches in Australia are required to confine their deposit-taking activities to wholesale markets. Since entering the market following deregulation in 1985, foreign banks have retreated to niche areas of the market. Most have opted for corporate finance and advisory services and have declined to establish retail branch networks.

1.2 Nonbank Financial Institutions (NBFIs)

Building societies. Twenty building societies currently operate in Australia, with assets totaling A\$12 billion. Building societies raise funds primarily from household deposits. They provide loans for housing and a limited amount for commercial residential development. They also provide payments services to depositors. Building societies have traditionally operated as cooperatives but, with the trend towards demutualization in Australia over the last 15 years, they are increasingly issuing shareholder limited capital.

Credit unions. There were 234 credit unions operating in Australia as of December 1998, with assets totaling A\$19 billion. Credit unions are cooperatives that take deposits and make personal or housing loans to their members. They are usually organized on the basis of common employment or from a common or community "bond." Credit unions are service-oriented organizations and derive their competitive advantage from flexible trading hours and more personalized service.

Money market corporations (MMCs). There were 98

money market corporations in Australia as of December 1998, with assets totaling A\$68 billion. MMCs do not lend money of their own but specialize in corporate advisory services. They operate primarily in wholesale markets and serve large corporations and government agencies. Their principal activities include structuring and arranging corporate finance, foreign exchange transactions, underwriting of debt and equity issues, trading in cash, securities and derivatives, and developing innovative financial products. The MMC sector tends to be dominated by branches or subsidiaries of foreign banks, which control around 70% of the sector's assets.

Finance companies (including general financiers). There were 98 finance companies and general financiers in Australia as of December 1998, with assets totaling A\$62 billion. Finance companies raise funds at both wholesale and retail levels through the issue of debentures and unsecured notes. They principally supply short- to medium-term credit to households and small businesses through products such as lease financing, hire purchase, and consumer loans. Finance companies typically service the higher end of the risk-return spectrum. Large finance companies have been owned by banks since the 1950s.

Securitizers. There were 58 securitizers in Australia as of December 1998, with assets totaling A\$37 billion. Securitizers are special purpose vehicles that issue securities backed by pools of assets (for example, mortgage-based housing loans). Securities are usually credit enhanced, for example, through guarantees issued by third parties.

Other nonbank intermediaries. These include pastoral finance companies, special service providers, cooperative housing societies, and intragroup financiers. Collectively they hold around A\$10 billion of assets.

1.3 Fund Managers and Insurers

Life insurance companies. There were 45 life insurance companies in Australia as of December 1998, with assets totaling A\$166 billion. Life insurance companies provide life, accident, and disability insurance, as well as annuities, investment, and superannuation (pension) products. Assets are managed in statutory funds on a fiduciary basis, and are invested largely in equities and debt securities.

Superannuation and approved deposit funds (outside

life insurance companies). There were 179,509 superannuation and approved deposit funds in Australia as of December 1998, with assets totaling A\$241 billion. Superannuation funds accept and manage contributions from employers and employees to provide retirement income benefits to the latter. Funds are controlled by trustees, who often employ professional funds managers.

Public unit trusts. There were 501 public unit trusts in Australia as of December 1998, with assets totaling A\$110 billion. Public unit trusts pool investors' funds, usually into specific types of assets including equities, property, money market investments, mortgages, and overseas securities. Most unit trusts are managed by subsidiaries of banks, insurance companies, or MMCs.

Trustee companies (common funds). There were 14 trustee companies in Australia as of December 1998, with assets totaling A\$8 billion. Trustee companies pool funds received from the general public or held on behalf of estates or under power of attorney. Funds are usually invested in specific types of assets, including money market investments, equities, and mortgages.

Friendly societies. There were 74 friendly societies in Australia as of December 1998, with assets totaling A\$7 billion. Like credit unions, friendly societies began as cooperatives formed along lines of common craft or community interest by workers who wished to pool savings into a joint fund to be called upon in times of need, such as funerals and ill health. Today they provide a similar array of services, including health and funeral insurance and retirement savings products.

General insurance companies. There were 110 general insurance companies in Australia as of December 1998, with assets totaling approximately A\$79 billion. General insurance companies provide insurance for consumer and business assets, such as housing and motor vehicles, and insure businesses against legal liability. Assets are invested mainly in deposits and loans, government securities, and equities.

Table 1 illustrates the changes in market shares of the major types of Australian financial institutions over the last two decades.

Banks dominate the Australian financial system in a number of respects. As shown in Table 1, banks' share of the total assets of financial institutions (excluding their subsidiary activities) has grown from 41% to 46% over the decade to 1995, and currently

Table 1
Assets of Financial Institutions (Percentage of Total)

	1980	1985	1990	1995	1999
Banks	42%	41%	44%	46%	47%
NBFIs	30	28	19	14	12
Life and superannuation	19	19	22	27	28
Other managed funds	1	4	6	6	9
Other	8	8	8	7	4

Source: Kent and DeBelle (1999) and Reserve Bank Bulletin (1999).

stands at 47%. As a share of the assets of credit institutions, banks now hold around 80%, their largest share since the 1950s. The four major banks are the four largest financial institutions in Australia and collectively hold around two-thirds of the total assets of the Australian banking system. They each provide the full range of financial services, from traditional banking functions to insurance, superannuation, and funds management. While financial intermediation has declined over the last couple of decades, banks have become the dominant players in financial markets, accounting for around 90% of foreign exchange dealing and 80% of over-the-counter derivatives (Reserve Bank of Australia 1996, p. 2). Further, Australian banks have a central position in the noncash payments system. The four major banks plus Colonial State Bank also operate the Banks Interchange and Transfer System, the largest of the three high-value electronic payments systems in Australia.

The life and superannuation sector currently accounts for around 28% of total financial system assets compared with 19% in 1980. Other managed funds account for 9% of total financial system assets, compared with only 1% in 1980. The funds management and insurance sectors were the fastest growing group of financial intermediaries over the 15 years to 1996 (Reserve Bank of Australia 1996, p. 1).

Table 1 illustrates the marked sectoral shift in the Australian financial services industry over the past two decades. Banks, funds managers, and insurance companies have expanded at the expense of non-bank financial intermediaries, in particular, building societies, MMCs, and finance companies. For the most part, this shift is explained by competition in a deregulated financial system; however, other forces were also at work. Many foreign banks converted their representative offices to full branches in order to benefit from bank status. Additionally, beginning

in 1985, most of the larger Australian building societies demutualized and converted themselves into banks, with the consequence that over three-quarters of the assets of that sector were transferred to the banking sector.

Despite the significant loss in market share of the nonbank financial intermediaries, it is too early for them to be written off as mere bit players in the Australian financial system. The remaining building societies and credit unions have, as a group, around three million members, and provide strong competition for banks in particular segments of the personal finance market. Both groups are restructuring operations through mergers with other societies, and building societies are strengthening their balance sheets by demutualizing and issuing permanent share capital. In addition, growing public dissatisfaction with the large banks in Australia leaves ample scope for NBFIs to gain market share at the banks' expense. In the short term, however, banks are expected to remain the dominant institutional type within the Australian financial system.

2. THE EXTENT OF FINANCIAL CONGLOMERATION IN AUSTRALIA

Financial conglomerates are not a new feature of the Australian banking and financial system. The Campbell Committee, an official committee of inquiry into Australia's financial system, noted in 1980 that "the different institutional groups are extending the boundaries of their operations and conventional distinctions are now less sharp" (Australian Financial System Inquiry 1980, p. 6). Describing the extent of financial conglomeration in Australia in the late 1970s and early 1980s, the Committee noted that banks had become associated with a range of nonbanking business activities through the ownership of significant equity interests in finance companies, money market corporations, superannu-

ation fund managers, and insurance brokers. The Committee reported that in mid-1978 Australian banks controlled 43% to 45% of total financial system assets (inclusive of the assets of their finance company and MMC subsidiaries), representing an asset share five to seven percentage points above that held by banks alone; including assets in property companies and funds management held by banks added a further 0.6% to the banks' consolidated market share (Australian Financial System Inquiry 1980, p. 187). Nonbank financial institutions had also formed conglomerate groups, with life companies holding building society and general insurance subsidiaries (Australian Financial System Inquiry 1980, p. 190).

Even though financial conglomeration has been a feature of the Australian financial system since at least the 1950s, its nature and extent has changed over time. Until the mid-1980s, conglomerate activity was generally on a small scale, with traditional activities dominating the core business of banks, life insurers, and funds managers. But, by the early 1990s, the Martin Parliamentary Committee of Inquiry recognized the emergence of "financial supermarkets" offering a broad range of financial services including traditional banking, insurance and superannuation, funds management, investment advice, foreign exchange trading, and stockbroking (House of Representatives Standing Committee on Finance and Public Administration (Martin Committee) 1991, p. 161). The Committee noted the growth in conglomeration by banks: In 1990, banks controlled 20% of the managed funds sector, having doubled their share during the 1980s (p. 163). The four major Australian banks at this time each owned a subsidiary finance company. Together, the bank-owned finance companies accounted for 43% of the finance company sector (p. 171). Banks' share of money market corporations' assets was just below 10% in 1991 (p. 171).

By the beginning of the 1990s, financial conglomeration, led by the banks, had emerged on a much broader scale, with a wider range of financial activities conducted through subsidiaries of mainline financial institutions.

The early experience of conglomeration was not without its problems. The tribulations of a number of bank-owned finance companies in the early 1990s highlights this point. The finance company subsidiaries of the State Bank of Victoria and the State Bank of South Australia both suffered losses in the

early 1990s collectively amounting to A\$3.7 billion (Reserve Bank of Australia 1996, p. 54). One of Australia's major banks, WBC, suffered losses amounting to A\$726 million through its finance company subsidiary, Australian Guarantee Corporation (p. 55). Lessons were learnt during this period and the degree of oversight exercised by parent companies was increased (p. 55). Despite these experiences, the pace of financial conglomeration did not slow but accelerated.

Financial conglomerates have become the most dominant institutional form in Australia, accounting for around 80% of total financial system assets. (Council of Financial Regulators 1998, p. 17). In 1996, the largest ten financial conglomerates accounted for approximately 50% of Australian financial system assets, the largest 20 for 65%, and the largest 30 for 75% (Westpac Banking Corporation 1996, p. 69). Of all financial conglomerates, those headed by banks are the most significant, accounting for approximately 56% of financial system assets at 1996, while those headed by insurance companies accounted for only 15% (Reserve Bank of Australia 1996, p. 3).

The most common form of financial conglomerate in Australia combines banking and insurance under common control. In 1996, seven banks owned life insurance companies and one life insurance company owned a bank; collectively, they controlled more than 38% of financial system assets (Reserve Bank of Australia 1996, p. 3). The remaining assets of financial conglomerates are held under various combinations of banking, insurance, and funds management.

Activities conducted by a typical Australian financial conglomerate include the full range of financial services. The four major banks in Australia are financial conglomerates operating in the areas of retail and investment banking, funds management, superannuation, general and life insurance, finance company functions, stockbroking, and underwriting. Banks have further encroached upon the market share of stand-alone funds managers, and had increased their share of funds under management to 41% by 1996 (National Australia Bank 1996, p. 18). The increase in banks' share of total Australian superannuation assets under management has also been significant, growing from 1.2% to 17.7% between 1986 and 1995 (Australian Mutual Provident Society 1996, p. 4). Similarly in insurance, banks have increased their share of life office assets from

1% in 1980 to around 13% in 1995 (National Australia Bank 1996, p. 18). As of June 1996, 11 banks owned finance companies, representing 50% of total finance company assets in Australia, and 25 owned money market corporations, representing 22% of the MMC industry (Reserve Bank of Australia 1996, p. 55).

Australian financial conglomerates typically originated as traditional institutions, most commonly banks or insurance companies. Among these groups, their traditional financial activity has continued to dominate their core activities. Table 2 illustrates the degree of diversification of Australian financial conglomerates, classified by their traditional financial activity. In 1997, 11 out of the 30 largest financial conglomerates in Australia contained a bank or insurance entity that accounted for more than 75% of the group's total assets (Council of Financial Supervisors 1997, p. 24). The major banks in Australia each have more than 75% of their assets in banking. Funds management led the second tier of activities of major banks, with other functions—such as insurance or stockbroking—each occupying less than 5% of total assets. Insurance conglomerates tend to be more balanced between insurance and funds management activities. Currently, only two Australian insurance companies conduct banking operations through their subsidiaries, Colonial and AMP. AMP was granted a banking license in 1998; Colonial acquired its banking arm by merging with the State Bank of NSW in 1994.

Table 2 illustrates that, in most cases, the traditional activity of a conglomerate institution remains its dominant activity. Some observers expect these so-called “unbalanced” financial conglomerates to persist, at least in the short term. In its submission to the 1997 Financial System Inquiry, the Australian Bankers' Association argued that “while convergence and disaggregation are occurring in the financial system, nevertheless at present, and for a considerable time to come, most banks and indeed most other distinct types of financial institutions (such as insurance companies) will most likely continue to be identifiable in terms of which is their dominant business” (Australian Bankers' Association 1996, p. 3). Contrary to this prediction, however, financial conglomerates are currently moving closer to the point where it is difficult to identify a dominant business. The Colonial Mutual Limited/State Bank of NSW merger is a notable case in point. Its banking and insurance assets are of a

similar size. Section 2.1 describes the evolution of the Colonial Group. Section 2.2 provides an overview of a major Australian banking financial conglomerate, the CBA.

2.1 Colonial Group Limited

Colonial commenced business as a life insurer in 1873 and expanded into general insurance in 1958. Since then the company has entered into funds management, superannuation, and funds administration. Colonial, although based in Australia, is a multinational company operating in several overseas markets including the United Kingdom, New Zealand, and more recently Asia.

Colonial acquired the government-owned State Bank of New South Wales in 1994, merging the third-largest insurance group in Australia with the fifth-largest bank. Colonial brought 1.84 million customers and A\$13.4 billion in assets to the merger, while State Bank of NSW brought 1.1 million customers and A\$19 billion in assets. The merger marked the first significant bank acquisition by a nonbank financial institution in Australia. Colonial's conglomerate structure was also unique—it was the first major Australian financial conglomerate to operate within a non-operating holding company structure. After acquiring the State Bank of New South Wales, Colonial evolved from a mutual life office to a listed company on the Australian and New Zealand Stock Exchanges, demutualizing in 1997. This was a condition imposed by the regulatory authorities prior to approving the merger.

With the acquisition of a banking arm in 1994 and the establishment of a stockbroking arm in 1997, Colonial Group currently covers the full spectrum of retail financial activities: banking, insurance, superannuation, funds management, funds administration, and investments. It is the only financial conglomerate in Australia to have banking and insurance arms of roughly equal size. Its banking arm, Colonial State Bank, is a major contributor to profit, and its funds management business is now the fourth largest in Australia. As of June 30, 1999, Group assets held under management totaled A\$75.8 billion.

Colonial is the first financial conglomerate in Australia to introduce a large-scale *allfinanz* strategy, integrating the production, distribution, and marketing of its banking, insurance, and funds management products. Colonial is still in the process of

Table 2
Assets of Financial Conglomerates by Industry Type—1996–97
 (Percentage of Assets Managed on Australian Books at Date of Most Recent Annual Report)

	Financial Intermediaries			Insurers			Friendly societies	Other managed funds	Stock-brokers	Futures brokers	Non-financial enterprises
	Banks	Building Societies	Other	Life	General	Health					
Banks											
Advance Bank	█		█					█			
ANZ Bank	█		█					█			
Bankers Trust Australia	█		█					█			
Bank West	█		█					█			
Banque Nationale de Paris	█		█					█			
Barclays Bank	█		█					█			
Citibank	█		█					█			
Commonwealth Bank	█		█					█			█
Deutsche Bank	█		█					█			█
Hong Kong Bank Australia	█		█					█			
Macquarie Bank	█		█					█			
Morgan Guaranty	█		█					█			
National Australia Bank	█		█					█			
NatWest Markets Australia	█		█					█			
St George Bank	█		█					█			
Suncorp-Metway	█		█					█			
Westpac Banking Corp	█		█					█			
Other Financial Intermediaries											
ABN Amro Australia	█		█					█			
Rothschild Australia			█					█			
SBC Australia			█					█			
Schroders Australia			█					█			
Insurance Companies											
AMP			█					█			
Colonial	█		█					█			
GIO Australia			█					█			
Lend Lease Corp			█					█			█
Mercantile Mutual Holdings	█		█					█			
National Mutual			█					█			
Norwich			█					█			
NRMA		█	█					█			█
Prudential Corp			█					█			

█	More than 75% of assets managed on Australian books
█	50% to 75% of assets managed on Australian books
█	25% to 50% of assets managed on Australian books
█	5% to 25% of assets managed on Australian books
█	More than 0%, but less than 5% of assets managed on Australian books
□	Not active in this area

Source: Council of Financial Supervisors 1997.

rolling out this strategy, which began in 1997. Sales channels, marketing, and information technology systems are being integrated across its financial businesses, and restructured into an *allfinanz* net-

work. The *allfinanz* strategy is combined with a franchise system of product and service distribution with individual owners of retail outlets.

Colonial sees the *allfinanz* strategy as a way of

increasing revenues from its existing customer base, through bundling and cross-selling financial products. When the Group introduced its bundled *allfinanz* “box” products in 1997, they were the first of their kind in Australia. The products combine insurance, banking, and investment products in one package. The proportion of customers purchasing products from two or more of the Group’s major businesses (banking, insurance and superannuation, and funds management) increased from 15% in 1998 to 17% by June 1999.

Colonial is currently the only *allfinanz* organization operating in Australia and continues to proceed down this integrated path. The evolution of the Colonial Group into a widely diversified and balanced provider of financial services is illustrated in Figure 1.

2.2 The Commonwealth Bank of Australia

The CBA was established in 1911 by the federal government as a commercial and savings bank. It later took on the function of Australia’s central bank until the establishment of a separate central bank, the Reserve Bank of Australia, in 1959. It was converted into a public company in 1990 with the Commonwealth government retaining a majority of its shares. The government sold off its remaining shareholding in the CBA in 1996.

The CBA began to diversify its activities beyond traditional banking in the 1970s, beginning with

home insurance and travel in 1974. In 1975 the CBA established its own finance company (CBFC Ltd). In 1988 life insurance and managed investments were added to the array of services provided with the establishment of wholly-owned subsidiaries, Commonwealth Life Ltd. and Commonwealth Management Services Ltd.

It was not until 1993, however, that the strategy was defined to reposition the Commonwealth Bank as a full financial services provider. This strategy was devised in response to a number of trends occurring in the Australian financial system at that time, including a decline in the growth of traditional banking, customer demand, and changing distribution channels. Consistent with this objective, the CBA further diversified into general insurance, retail stockbroking, and other nonbank financial activities.

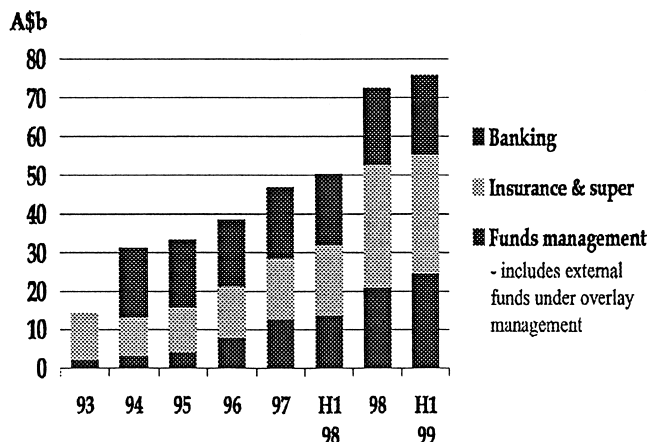
Today the CBA is a large integrated financial services provider offering the full range of banking and financial services, with consolidated total assets of A\$138 billion and the largest customer base of any financial institution in Australia. Its current range of activities includes:

- traditional banking functions
- investment banking
- finance company
- stockbroking and underwriting
- funds management—including superannuation and unit trusts
- life insurance
- general insurance.

The CBA’s activities, like those of the other major Australian banks, continue to be dominated by banking. The group’s banking operations contributed 92% of revenue and approximately 88% of its total net profit in 1998/99. Banking represented 95% of the group’s total assets as of 30 June 1999. Despite the dominance of banking, the CBA foresees its activities becoming more diversified in the future, consistent with its 1993 strategy. Fee-based activities including insurance, funds management, and finance operations continue to represent a growing proportion of revenue, currently around 12% of net profit. Total funds under management grew by 24% in 1998/99 and sales of life insurance were up by 28%. The CBA is currently the fifth-largest funds manager and the second-largest retail funds manager in Australia. It is also has the sixth-largest life insurer in Australia.

The CBA has taken advantage of its vast branch

Figure 1
Colonial Group Assets Held and Under Management (as of June 1999)



Source: Colonial Limited Interim Result 1999.

and agency network—the largest of any financial institution in Australia—to market and sell the products and services from its nonbank subsidiaries, particularly retail funds management and life and general insurance products. The group's general insurance subsidiary gains the majority of its revenue from cross-sales through the group's banking subsidiary, with two-thirds of its business generated in this way. Currently, the CBA is seeking to increase the percentage of customers who purchase products from two or more of the group's major businesses. Cross-selling among businesses is an important part of this strategy, particularly through the branch and agency network. Despite extensive back-office integration, the CBA has not followed Colonial's path of instituting an *allfinanz* strategy, preferring at this stage to continue to rely on cross-selling.

In addition to a vast branch network, the CBA has various alliances with nonfinancial companies. The CBA recently formed an alliance with a major Australian retailer, Woolworths Limited, under which it will offer co-branded financial services through Woolworths' extensive store network. Through this alliance, the CBA will achieve wider exposure and offer increased convenience to customers. It has also formed an alliance with a telecommunications provider, Vodafone, to extend channels of financial services information supply.

With the largest branch and agency network of any Australian financial institution, the CBA is seeking to further expand its nonbanking financial activities using its banking network. A key part of the group's future vision is to provide more financial services to its existing customer base. Although it has not yet pursued an *allfinanz* strategy, this may emerge as a new direction for the CBA in the near future.

3. CAUSES OF FINANCIAL CONGLOMERATION IN AUSTRALIA

Financial conglomeration in Australia has occurred in two main phases. The first, which marked the initial emergence of financial conglomerates in the Australian financial system, commenced in the 1950s and was led by banks. The second phase, characterized by the current trend toward financial conglomeration, reflects a different set of forces and has produced the dominance of financial conglomerates that we see within the Australian financial system today.

3.1 Phase I

Monetary authorities imposed stringent regulation on the banking system beginning in the 1950s. Banks were restricted in their lending by interest rate controls that set loan rates below market clearing levels. Bank balance sheets were also heavily proscribed by asset requirements and maturity restrictions. In contrast, NBFIs were lightly regulated. NBFIs began to provide mortgage loans, installment credit, and other specialist finance, satisfying the demand that banks were unable to meet on account of regulatory constraints. As a result, from the 1950s up until the 1980s NBFIs were able to increase their market share at the expense of banks. Those deriving the most benefit were building societies, finance companies, and money market corporations (Edey and Gray 1996, p. 5).

Table 3 illustrates the change in market shares of various credit institutions over this period. It illustrates the U-shaped course of bank market share from the 1950s up to the present. The parallel development of nonbank financial intermediaries during this period is evident from their rapid gain in market share—initially the finance companies, then

Table 3
Assets of Credit Institutions (Percentage of Total)

	1929	1936	1953	1970	1980	1985	1990	1995	1999
Banks	94%	95%	88%	70%	58%	59%	69%	77%	80%
Building Societies	2	2	3	5	12	10	5	2	2
Credit Unions	—	—	—	1	1	2	2	2	2
Money market corporations	—	—	—	3	6	11	11	9	8
Pastoral financiers	4	3	4	3	1	2	0	0	1
Finance companies	—	1	3	15	18	13	9	6	6
Other	—	—	1	3	4	3	4	3	2

Source: Reserve Bank of Australia (1996) and (1999).

the building societies, money market corporations, and credit unions.

In this environment, regulatory arbitrage became a profitable strategy for banks. A conglomerate structure provided a convenient framework to effect such a strategy. The larger banks circumvented the tight regulation by establishing nonbank subsidiaries to conduct business under an alternative financial guise. Finance company subsidiaries were particularly effective vehicles for avoiding quantitative and maturity controls on lending. Like other NBFIs, finance companies were only subject to comparatively light levels of regulation (Australian Financial System Inquiry 1997, p. 577).

The Campbell Committee of Inquiry into the Australian Financial System summed up the first phase of financial conglomeration in Australia, reporting in 1980 that "... while differentially heavy regulation on banks has undoubtedly limited the potential role of banking in the financial system, the banking groups have been able to increase considerably their influence and control in non-bank areas" (Australian Financial System Inquiry 1980, p. 186). Although not insignificant, the degree of financial conglomeration during this period was nevertheless on a small scale. The heavy regulation of banks relative to NBFIs persisted up until the early 1980s when the Campbell Committee recommended that the controls be lifted as part of deregulation of the Australian financial system. The newly deregulated financial environment created a more even playing field between banks and NBFIs, lessening the pressures for regulatory arbitrage and the associated formation of financial conglomerates. The conclusion of the first phase of financial conglomeration was marked by the rapid regaining of market share by banks, increasing from 41% to 46% between 1985 and 1995 (Kent and DeBelle 1999, p. 12).

3.2 Phase II

In the mid-1980s financial conglomerates began to emerge on a much broader scale, conducting a wider range of financial activities, including banking, insurance, superannuation, funds management, investment advice, foreign exchange trading, and stockbroking. They more closely resembled financial supermarkets, providing the full range of financial services. Unlike with the first phase of financial conglomeration, there was no dominant or overrid-

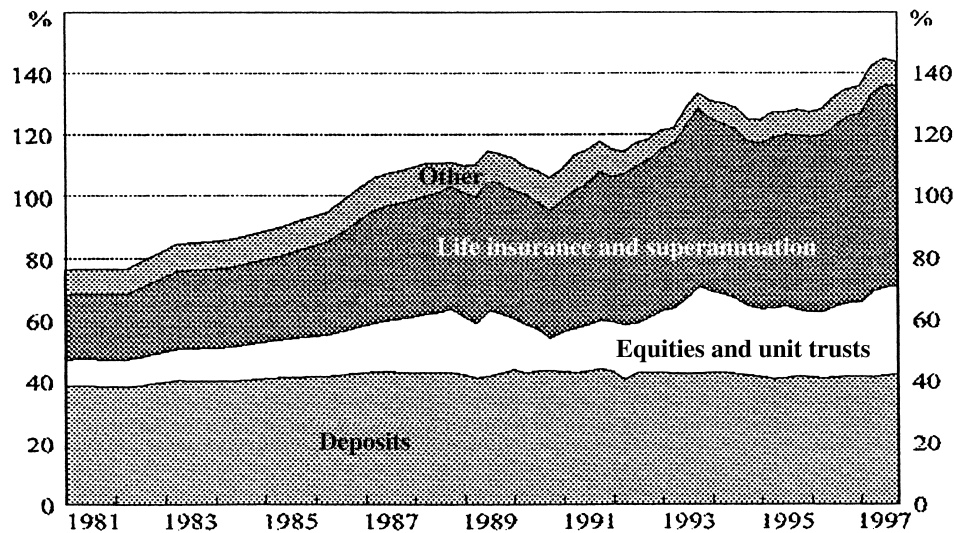
ing explanation for financial conglomeration. It occurred in response to a number of interacting domestic and international forces that changed the competitive landscape of the Australian financial system. Some were unique to the Australian financial system, for example, government regulation, while other forces were global in scope, reflecting technological advance and globalization. The major drivers of financial conglomeration are outlined below.

Shift in household savings. Ever since the early 1980s there has been a continuing shift in household savings away from traditional bank deposits toward superannuation and other collective investments. A major contributor to this development was Australian government regulation of the mid-1980s mandating minimum contributions to superannuation. Successive governments have remained committed to this scheme and encouraged superannuation savings by affording favorable tax treatment. Concurrent with these policy changes has been the wider recognition by households of the need to provide for their own retirement rather than relying on the public social security system (Kent and DeBelle 1999, p. 7).

Figure 2 illustrates the shift in household financial assets towards superannuation over the last twenty years. While bank deposits have remained steady in terms of their share of household assets, growth in the life insurance and superannuation sectors has been significant throughout the past two decades. Compulsory superannuation is expected to continue to affect the shape of the financial system in the future. With further increases in compulsory superannuation anticipated, forecasts indicate that Australia's superannuation sector may double in size in relation to GDP over the next 25 years (Reserve Bank of Australia 1996, p. 104). Households' diminished reliance on bank deposits has provided a strong impetus for banks to establish or acquire financial subsidiaries in order to participate in life insurance and superannuation activities.

Regulatory arbitrage. The institutional basis of financial regulation in Australia has encouraged regulatory arbitrage, which has in turn encouraged financial conglomeration. As witnessed in the first phase of financial conglomeration, different financial products can be moved among the subsidiaries of a conglomerate toward the subsidiary bearing the lowest regulatory burden. For example, lending activity may be transferred from a banking subsidiary

Figure 2
Household Financial Assets (percentage of GDP)



Source: Kent and Debelle (1999).

to an insurance subsidiary. A 1996 Australian study into regulatory arbitrage showed that an Australian bank holding a typical life company portfolio would be subject to lower capital requirements than a life company holding the same portfolio (Australian Mutual Provident Society 1996, p. 13).

The practice of regulatory arbitrage has accelerated during the 1990s as a result of advanced product innovation, eroding the distinction between products provided by banks, insurance and funds management institutions. Virtually identical products can be produced through alternative subsidiaries, incurring lower regulatory costs without sacrificing unique features of the products. The most recent inquiry into the Australian financial system (in 1997) specifically addressed the issue of blurring boundaries between different types of financial institutions and their products. On the committee's recommendation, the Government reconfigured Australia's regulatory framework in 1998 so as to achieve a more consistent treatment of like products. The change is expected to limit opportunities for regulatory arbitrage in the future. The latest regulatory changes are discussed in greater detail in Section 4.

Technological advances. Technological progress has promoted the formation and growth of financial conglomerates, both in Australia and internationally. It has reduced the costs of providing a wide range of

financial services. The production, marketing, and distribution of diverse product mixes would have been impossible without recent advances in information technology.

Advances in technology have also enabled the development of alternative delivery channels for financial services. Electronic funds transfer at point of sale, automatic teller machines, telephone banking, and now Internet banking have reduced the need for traditional branch networks. This has produced considerable excess capacity in bank branch infrastructure. To use their capital more efficiently, banks have expanded into insurance and funds management, marketing and delivering these additional financial services through their existing branch structures. Insurance, superannuation and funds management products gain considerable exposure through the traditional banking services network, creating opportunities for cross-selling. Each of the four major banks in Australia offers the full range of financial services through its branch network. The implementation of this strategy by banks has also encouraged conglomeration by NBFIs. Colonial Group's acquisition of the State Bank of New South Wales in 1994 is an example, with Colonial using the State Bank's established branch network to deliver its insurance and funds management services.

Liberalization of ownership restrictions. Australia has

never prohibited cross-shareholdings among banks, insurance companies, and funds management institutions, although some restrictions of degree did exist prior to the 1980s. The Banking Act 1959 (Cth) has never imposed limitations on bank involvement in nonbank activities through subsidiaries; however, the Reserve Bank did place some restrictions on bank involvement in MMCs and property subsidiaries from the 1950s to the 1980s (Australian Financial System Inquiry 1980, p. 287).

Increased competition. Competition in financial services has intensified over the last two decades, both in Australia and globally. This has been driven by a number of factors, including economic globalization, technological advances, and widespread financial deregulation. Increasing competitive pressures appear to be polarizing the financial services industry into specialists at one extreme and financial conglomerates at the other. The push toward financial conglomeration reflects the need to cut costs and increase revenues in a highly contestable financial services market. On the revenue side, conglomeration provides opportunities to cross-sell products, particularly through bank branch networks. The aim is to expand the number of products purchased by existing customers. Colonial Group has adopted this strategy with the bundling of products from its banking, insurance, and funds management subsidiaries. Cost reduction is sought from the increase in scale and scope that conglomeration allows. Major cost savings arise from the rationalization of infrastructure and administrative operations, as well as the exploitation of information technology and marketing synergies (Australian Financial System Inquiry 1997, p. 344). As competitive pressures intensify through globalization and technological advances, polarization of the financial services industry is expected to continue, leading to further conglomeration.

Changing consumer preferences. On the demand side, changing consumer preferences have been a strong driver of financial conglomeration in Australia. Households are demanding a more sophisticated range of financial products than ever before (Kent and Debelle 1999, p. 6). Such “financial deepening” occurs as real incomes and household wealth increase, causing a shift in household preferences away from bank deposits and other low-risk investments toward the higher end of the risk-return spectrum, including managed funds and market-linked investments (Australian Financial System Inquiry

1997, p. 86). This development has driven banks into funds management, stockbroking, and other nonbanking activities.

Consumer attitudes toward and preferences for the delivery of financial services have also changed. Consumers have traditionally maintained relationships with many different financial services providers, but throughout the 1990s have sought ways to simplify their financial relationships and consolidate their use of services. The demand for one-stop financial supermarkets has grown as consumers opt for increased convenience and cost savings. The response to such market forces has been an increase in both financial conglomeration and the range of financial services conglomerates provide.

A variety of interacting forces underlie the trend toward financial convergence in Australia. The first phase, which occurred from the 1950s onwards, produced a small-scale diversification of activities, mainly by the major banks in response to regulatory disadvantage relative to NBFIs. The second phase, driven by a different set of forces, has seen the development of highly diversified and sophisticated financial conglomerates conducting activities across the full spectrum of financial services. This trend is expected to continue, with financial conglomerates becoming even more widely diversified in the future.

4. THE REGULATION OF FINANCIAL CONGLOMERATES IN AUSTRALIA

4.1 Evolution to the Present Approach

Australia has never imposed statutory restrictions explicitly preventing the formation of financial conglomerates. With the exception of some restrictions on cross-shareholding in financial institutions prior to deregulation, the formation of financial conglomerates has been relatively unfettered by regulation.

The first formal consideration of the regulation of financial conglomerates was undertaken by the Campbell Committee of Inquiry into the Australian Financial System in 1981. Specifically, the Committee examined the involvement of banks in life and general insurance, an emerging trend at the time. The Committee concluded in its Final Report that there were no economic objections to the involvement of banks in insurance, subject to the conglomerate meeting appropriate prudential requirements (Australian Financial System Inquiry 1981, p. 534).

The Committee went further and conceded that such institutions may benefit consumers through the realization of “marketing and technical economies” (p. 534). Similarly, the Committee did not object to the involvement of NBFIs in banking.

As well as sanctioning the formation of financial conglomerates, the Campbell Report marked a turning point in the evolution of the Australian financial system. Its recommendations paved the way for deregulation of the Australian financial system and the introduction of a regime of prudential supervision. The system of prudential supervision was administered on institutional lines—in other words, different types of financial institutions came under the authority of different regulators. The rationale for such an arrangement was that there are different types of financial risks associated with different financial activities.

The Reserve Bank of Australia (RBA), Australia’s central bank, was responsible for the prudential supervision of banks; the Insurance and Superannuation Commission (ISC) was responsible for insurance and superannuation companies; and the Australian Financial Institutions Commission (AFIC) was responsible for building societies, credit unions, and friendly societies. Under this system, the separate subsidiaries of a financial conglomerate were supervised by different financial regulators. For example, the insurance arm was supervised by the ISC and the banking arm by the RBA. The RBA had neither the responsibility nor the powers to supervise nonbank subsidiaries of banks (Reserve Bank of Australia 1996, p. 56). The regulatory framework at this time contained no formal arrangements among regulators governing the supervision of conglomerates.

The formation of financial conglomerates through merger was also subject to antitrust legislation under the Trade Practices Act 1974 (Cth). The Act prohibits mergers that “substantially lessen competition” (Trade Practices Act 1974, section 50). A proposed merger between ANZ and National Mutual (a major Australian life insurance company) in 1990 to form what would at the time have been the largest financial conglomerate in Australia was rejected on anticompetitive grounds by the Commonwealth Government. On a broader level, in 1990, the government announced a policy that came to be known as the “six pillars policy.” The policy prohibited mergers among any of the four major banks or between them and either of the two major life

insurance companies (NAB, WBC, CBA, and ANZ being the four major banks, and AMP and National Mutual the two major life offices) (Australian Financial System Inquiry 1996, p. 161).

A further inquiry into Australia’s financial system took place in 1991, known as the Martin Inquiry. The regulation of financial conglomerates was a major issue on its agenda. The Committee made two significant recommendations regarding the regulation of financial conglomerates. The first was the establishment of a “lead regulator” system. Under this model, individual supervisors would continue to oversee a conglomerate’s separate arms, with the lead regulator taking responsibility for overall supervision. The Committee considered the introduction of a “mega-regulator” (combining the existing financial supervisors into one body), but found that it was not warranted “at this time” (House of Representatives Standing Committee on Finance and Public Administration (Martin Committee) 1991, p. 237). The Committee did note that the case for a mega-regulator would need to be reconsidered in future, especially if the trend toward financial conglomeration continued.

The second recommendation concerned the establishment of a body to facilitate closer coordination between the separate prudential supervisors. The Committee found a clear case for closer liaison among regulators in view of the continuing trend of financial conglomeration. Closer liaison had, in fact, already begun to occur (Council of Financial Supervisors 1996a, p. 1). But the Committee considered that a coordinating body would strengthen these ties. The body would also assume responsibility for appointing lead regulators.

The Council of Financial Supervisors (CFS) was established in 1992. The CFS included the RBA, the AFIC, the ISC, and the Australian Securities Commission (responsible for unit trusts, MMCs, and finance companies). One of the CFS’s primary objectives was to “promote regular, high level liaison among the various regulatory agencies in the financial sector” (Council of Financial Supervisors 1996a, p. 2).

The recommendation to establish a lead regulator system was not formally adopted into policy following the Committee’s report. The proposal was considered by the CFS in 1993 but was again rejected in favor of a less formal, cooperative approach (Australian Bankers’ Association 1996, p. 153).

In the aftermath of the 1992 Martin Report, the overall framework for the regulation of financial

conglomerates remained largely unchanged. Solo supervision of the different arms of financial conglomerates continued, following the rejection of the formal lead regulator model. However, the establishment of the CFS was expected to facilitate closer liaison between the different regulators of financial conglomerates by encouraging the sharing of information among supervisors and providing a forum for consultation.

The regulation of financial conglomerates became a key focus of the CFS following its establishment in 1992. The CFS followed international developments, including the work of the Tripartite Group of Securities, Insurance and Bank Regulators and the Joint Forum on Financial Conglomerates. Its most significant contribution to the regulation of financial conglomerates came with the development of a set of guidelines facilitating cooperation among its member financial regulators. The final guidelines were as follows (Council of Financial Supervisors 1996b, p. 21):

- the various agencies will, through the Council or bilaterally, as appropriate, liaise with each other on prudential supervision issues and potentially significant developments affecting financial institutions which are members of a financial conglomerate.
- the supervisory agencies will share information with each other, as necessary and practicable, on entities in a financial conglomerate for which they have responsibility.
- the agencies will pursue changes to legislation to remove impediments to such information sharing.
- the agencies will, in particular, liaise with each other when a problem affecting any entity in a financial conglomerate is judged to have the potential to impact on other members of the group; the supervisor of the parent (or largest) entity will normally act as co-ordinator in this process.

The guidelines reflected the CFS's informal, cooperative approach to the regulation of financial conglomerates.

In 1996, the CFS went further, proposing that a new conglomerate structure be introduced into the Australian financial system. Government policy at that time prohibited a financial conglomerate involving a bank from being headed by a non-operating holding company. The CFS proposed that financial conglomerates headed by a non-operating holding company be allowed under a new regulatory scheme. Under the proposal, one CFS member regulator would be appointed to be the "convenor" of

the conglomerate and would be responsible for overseeing the holding company, the dissemination of information to other supervisors, and coordinating supervisors in the event of problems with the conglomerate (Council of Financial Supervisors 1996b, p. 21). The model marked a shift toward a lead regulator system. The government deferred comment on the model until the Final Report of the Wallis Inquiry, yet another official inquiry into the Australian financial system established in 1996.

The Wallis Inquiry was charged with reconfiguring financial regulation to increase efficiency while preserving system safety and market integrity. Ongoing product innovation enabled different types of financial institutions to offer essentially identical financial products while being subject to different degrees of financial regulation. The traditional division of responsibility amongst financial regulators along institutional lines was becoming increasingly outmoded. As discussed in Section 3 above, one of the primary causes of financial conglomeration in Australia is regulatory arbitrage. A key aim of the Wallis Committee was to increase competitive neutrality in the Australian financial system. Specifically on the issue of financial conglomerates, the Committee aimed to "provide more effective regulation for financial conglomerates which also facilitate competition and efficiency" (Australian Financial System Inquiry 1997, p. 2).

The Wallis Committee addressed both positive and negative aspects of financial conglomerates. Positive aspects included economies of scale and scope in the areas of infrastructure and administration, information technology, and marketing, while negative aspects included contagion risk, conflicts of interest within the conglomerate, and confusion in market perception of the risk in a conglomerate's individual entities (p. 344). The Committee concluded that "these concerns are not sufficient to stand against the general acceptance of conglomerate structures, given their considerable benefits. In any event . . . there is no practical way of preventing their further growth . . . the regulatory framework must adapt to them" (p. 346).

As a "considerable" first step in this process of regulatory adaptation, the Committee recommended the establishment of a single integrated prudential regulator subsuming the current duties of the separate regulators.¹ This new regulator would be separate

¹An integrated prudential regulator is defined as a regulator that

from Australia's central bank. The Committee saw a strong case for regulatory amalgamation—particularly with regard to the regulation of financial conglomerates—stating in its Final Report that “amalgamation would provide a regulatory structure that more closely reflected the industry's preferred corporate structure and would avoid the need to pursue potentially inconsistent artifices such as lead regulator arrangements” (Australian Financial System Inquiry 1997, p. 310). The Committee concluded that a single regulator “provides a sounder basis for regulating conglomerates” (p. 312). The establishment of an integrated prudential regulator was expected to provide a more consistent regulatory framework, treating like products produced by different financial institutions in like manner. Regulation would be conducted on a functional rather than an institutional basis, thus reducing the opportunities for regulatory arbitrage. The Committee also cited economies in regulatory implementation and promotion of a better understanding of regulatory assurances as further economic justifications for an integrated regulator (p. 310).

4.2 The Current Regulatory Framework

Australia's new integrated prudential regulator, the Australian Prudential Regulation Authority (APRA), was established in 1998, separate from the Reserve Bank of Australia. It subsumed the supervisory responsibilities of the RBA, the ISC, and the AFIC. APRA now has responsibility for the prudential supervision of banks; life, general insurance, and superannuation companies; and building societies, credit unions, and friendly societies. All deposit-taking institutions in Australia are now regulated and prudentially supervised by APRA.

With the establishment of an integrated regulator, the role of the CFS in the regulatory framework was modified. Renamed the Council of Financial Regulators in 1998, its primary task now is to facilitate cooperation among the main regulators under the new regulatory framework—the RBA, APRA, and the Australian Securities and Investments Commission (a separate regulator established to deal with market integrity and consumer protection). Coordination between these agencies was still deemed

necessary, as they each have regulatory interests in financial conglomerates.

Consistent with the recommendations of the Committee, APRA now undertakes the regulation of financial conglomerates. APRA released a policy discussion paper in March 1999 containing draft policy proposals for the prudential supervision of financial and mixed conglomerates (Australian Prudential Regulatory Authority 1999b). The proposal is limited to financial conglomerates that contain an authorized deposit-taking institution (ADI) together with one or more other financial enterprises. Financial conglomerates that do not contain an ADI are to be considered at a later date.

The proposal is broadly consistent with guidelines issued by the international Joint Forum on Financial Conglomerates, of which APRA is a member. The draft proposal sets out standards governing the following issues in relation to financial conglomerates: ownership and structure, size relativity, composition of boards, fit and proper tests, group external auditor arrangements, holding company requirements, ADI dealings with related entities, group badging, capital adequacy, and risk concentrations. The new proposal gives APRA considerable powers in relation to financial conglomerates, including the power to require changes to the structure of a conglomerate group or to deny authorization of a holding company or ADI if the group structure is such as to impair effective supervision. APRA will also have the power to force divestiture of an unregulated entity within a financial conglomerate if it deems that the entity poses material risk to the safety or soundness of the conglomerate.

Proposed guidelines relating to mixed conglomerates are the most stringent, particularly in relation to commercial activities. The unregulated business of the mixed conglomerate must be small relative to its ADI business, and the commercial arm may have to provide financial guarantees to the group's ADI. The proposal also contains measures to enhance consolidated supervision of conglomerates. APRA proposes that each conglomerate should appoint a group external auditor to provide the regulator with an overview of the whole group.

APRA is expected to finalize its proposal in 2000. The APRA recommendations are the first set of comprehensive standards for the regulation of financial conglomerates in Australia, four decades after financial conglomerates first emerged in the Australian financial system. When finalized, they will be

combines prudential regulatory responsibility for the three main groups of financial institutions: banking, insurance, and funds management.

incorporated into legislation within the Banking Act.

As a part of the new regulatory framework, the Australian Government has cleared the way for the formation of financial conglomerates within a non-operating holding company structure. As described earlier, government policy had until this event prohibited the use of the non-operating holding company structure for conglomerates involving a bank.² The Wallis Inquiry recommended the repeal of this policy (as the CFS members had proposed in 1996) provided that the conglomerate satisfied certain requirements relating to capital, management, adequacy of “firewalls,” reporting of intra-group activities, and independent board representation on subsidiary entities (Australian Financial System Inquiry 1997, p. 347).

Government policy has also been relaxed with respect to the mixing of financial and nonfinancial activities within the same conglomerate. Leading up to the Wallis Inquiry, there had been mounting pressure from nonfinancial companies seeking to participate in the provision of payments services and other financial services. The Committee found their exclusion to be damaging to competition and innovation in the Australian financial system (p. 340). Despite this finding, the Committee agreed with separation as a broad principle but recommended flexibility in its application, being of the view that the prudential regulator should consider applications to mix financial and nonfinancial activities within the same conglomerate on a case-by-case basis. The government has since adopted this recommendation, opening the way for the formation of mixed conglomerates in the Australian financial system.

The “six pillars” policy prohibiting mergers among any of the four major banks and two major life companies hindered the formation of large combined banking and insurance conglomerates during the 1990s. The policy was repealed in 1998 as recommended by the Wallis Inquiry. However, the government continues to prohibit mergers among the four major banks. It is now possible for a financial conglomerate to be formed by merger of a major bank with a major life office, but the formation of such a conglomerate would be subject to scrutiny

and possible rejection under trade practices legislation.

4.3 Integrated Prudential Regulation

The Australian approach to regulation of financial conglomerates has evolved in response to the nature and extent of financial convergence. In the past, most industrial countries operated an institutionally based system of prudential regulation, along the lines of the former Australian system. Many countries have since diverged from this framework, including Sweden, Denmark, Norway, and Singapore, and more recently the United Kingdom and Canada, amalgamating supervisory responsibilities to form integrated prudential regulators. The Scandinavian integrated regulators were established in the 1980s and early 1990s, in response to the emergence of financial conglomerates and increasing competition across traditional institutional boundaries (Reserve Bank of Australia 1996, p. 112).

The International Monetary Fund (IMF) has encouraged the formation of integrated prudential regulators in several Asian countries in the aftermath of the Asian financial crisis. In April 1998, the Korean government established an integrated financial regulator, the Financial Supervisory Commission, responsible for the prudential regulation of banks, NBFIs, insurance, and securities markets. Prior to amalgamation, Korean supervision of financial institutions had been organized on an institutional basis under four separate regulators: the Banking Supervisory Authority, the Securities Supervisory Board, the Insurance Supervisory Board, and the Non-Bank Supervisory Authority. Continuing convergence of financial services and the blurring of distinctions between different financial sectors were the primary justifications for integration of the existing supervisors [Financial Supervisory Commission (Korea) 1999].

An institutionally based system of financial regulation had created difficulties in achieving efficient cooperation among regulators and in developing consistent supervisory policies to ensure competitive neutrality in the Korean financial sector [Financial Supervisory Commission (Korea) 1999]. This lack of unification led to widespread regulatory arbitrage and was seen to be a major contributor to the spread of the Asian crisis to Korea (Balino and Ubide 1999, p. 16). The establishment of an integrated prudential regulator was an integral part of a

²An exception was the merger of Colonial and State Bank of NSW (see Australian Financial System Inquiry 1996, p. 215).

series of reforms negotiated as part of an IMF support program in 1997. The amalgamation process was completed in January 1999 with the establishment of the Financial Supervisory Service, which formally integrated the four existing supervisory bodies. The Financial Supervisory Service is responsible for the enactment and implementation of the regulatory policies of the Financial Supervisory Commission [Financial Supervisory Service (Korea) 1999].

Japan established an integrated prudential regulator in June 1998, the Financial Supervisory Agency (FSA), separate from the Ministry of Finance and the central bank. It is responsible for supervision of all private financial institutions in Japan, including banks, insurance companies, and securities firms. Prior to the establishment of the FSA, Japan's prudential regulator was already integrated and distinct from the central bank but was a part of the Ministry of Finance (International Monetary Fund 1998, p. 131). The separation of prudential supervision from the Ministry of Finance was considered necessary, as bank supervision had been assigned a low priority compared with other important functions undertaken by the Ministry, such as budget making and taxation (Amyx 1999, p. 1). By contrast, bank inspections are now the primary function of the FSA (p. 2).

Among the stated advantages of an integrated prudential regulator are improved regulation of financial conglomerates, better facilitation of competitive neutrality, economies of scale in regulatory functions, and improved public understanding of regulatory assurances (Australian Financial System Inquiry 1997, p. 310). A single regulator is in a better position to coordinate the regulation of financial conglomerates on a consolidated basis and to regulate all aspects of a conglomerate's activities as a single agency. The principle of competitive neutrality dictates that like products offered by different types of financial institutions should be treated in like manner, that is, within the same framework with the same regulatory objectives (p. 306); clearly a single prudential regulator is in a better position to achieve this than a system of separate regulators. A single regulator has all available information on the regulation of different financial products and, as a single body, has the necessary power to effect competitive neutrality in the financial system without objections from separate regulatory bodies. The amalgamation of existing regulators into one regu-

latory body can yield economies of scale in the implementation of regulation and result in increased allocative efficiency within a regulatory system (p. 310).

In May 1999, APRA hosted a conference of integrated prudential regulators from Canada, Denmark, Japan, Korea, Norway, Singapore, Sweden, and the United Kingdom. It was agreed that the dominant reasons for introducing integrated supervisory agencies were similar in each of these countries: convergence in financial markets and the need for consistent policy application across financial industries (Australian Prudential Regulatory Authority 1999a, p. 30). Each of the regulators shared similar goals for developing their supervisory frameworks, including competitive neutrality and more integrated organizational structures (p. 31).

5. THE FUTURE

In outlining its vision for the future of the Australian financial system, the Wallis Committee predicted that "[t]he emergence of new players will be matched by the continued evolution of large financial conglomerates, using their brand and other strengths to provide a wide range of financial services" (Australian Financial System Inquiry 1997, p. 13). As part of this vision, competitive pressures are expected to polarize the industry into two main groups: specialist providers at one extreme and large, highly diversified financial conglomerates—providing the full range of financial services—at the other, with relatively few participants of intermediate size (p. 13). The Committee sees continued financial convergence in Australia, but as part of a wider movement toward polarization of industry players.

The diversification of financial conglomerates noted above has been occurring in the Australian financial system throughout the last decade. As noted in Section 2, financial conglomerates in Australia remain largely "unbalanced" in terms of assets dedicated to their various financial activities. Notwithstanding this imbalance, it is important to recognize that they are still widely diversified in terms of the scope of their activities, while, in most cases, retaining a dominant core business.

Globalization and technological progress have lowered the costs of entry into financial activities, thus increasing the potential for industrial and other nonfinancial companies to enter financial services.

Telecommunications and information technology companies may contemplate entering financial services provision, being able to utilize new technology in financial services production and distribution. Retailers may use their wide distribution networks in providing financial services. Nonfinancial companies who engage in risk assessment and management may also be contenders (Australian Financial System Inquiry 1996, p. 223).

There has been widespread convergence in the financial services market in Australia, but not between the financial and nonfinancial sectors. The primary reason is the regulatory barrier prohibiting combined ownership of financial and nonfinancial companies within the same conglomerate. As discussed in Section 4, the Wallis Committee recommended in its Final Report that separation of ownership be maintained as a broad principle but relaxation be allowed, at the discretion of APRA, on a case-by-case basis.

While this recommendation was adopted, both the government and APRA continue to approach the issue with caution due to the risk to financial safety that mixed conglomerates pose. APRA has stated that it will be guided by future global and market trends, indicating a desire to proceed on a wait-and-see basis (Council of Financial Supervisors 1997, p. 26). The government has also adopted a conservative approach, indicating that for the time being it will not accept any proposal by an industrial company to acquire a preexisting licensed entity (p. 26). As a result, in the short term at least, it is unlikely that mixed conglomerates will become a feature of the Australian financial system.

If mixed conglomerates become widespread in other markets, it is arguable that the government and APRA will be forced to relax their current stance. Additionally, with further advances in technology, synergies are expected to develop between financial and nonfinancial activities, strengthening the case for mixed conglomerates. In the meantime, the formation of alliances between financial and nonfinancial companies is expected to continue as an imperfect substitute for mixed conglomeration, with major bank conglomerates aligning themselves with major retailers and telecommunications companies.

Finally, the structure of financial conglomerates in Australia is expected to undergo fundamental changes. As discussed in Section 4, prior to 1997 a financial conglomerate could not be headed by a

non-operating holding company. Following the Wallis recommendations, non-operating holding companies are now permitted to head financial conglomerates in Australia. This is consistent with the approach in the U.S., United Kingdom, Canada, and the Netherlands. The change will likely result in an array of conglomerate group reconfigurations. A non-operating holding company will allow conglomerates to structure their operations more efficiently to minimize the burden of financial regulation, including capital requirements. Other benefits include greater autonomy for the conglomerates' various arms and a clearer view of the independence of subsidiaries (Insurance and Superannuation Commission 1996, p. 42). The new flexible structure is expected to encourage the formation of financial conglomerates in Australia.

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