

The Parliament of the Commonwealth of Australia

**Review of the Reserve Bank of Australia's  
1993-94 Annual Report  
and  
The Insurance and Superannuation Commission's  
1993-94 Annual Report**

**Report from the House of Representatives Standing  
Committee on Banking, Finance and Public  
Administration**

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## Foreword

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This review of the Reserve Bank of Australia's 1993-94 annual report is the second in a series of reviews which the Committee intends to conduct each year.

Through this process the Committee will continue to provide an accountability mechanism whereby the role and function of the Reserve Bank can be monitored. It will also provide an opportunity for the oversight of issues and developments in the banking industry. The Committee is pleased to note that, during the course of this year's review, the Australian Bankers' Association has taken the opportunity to raise with the Committee a number of matters of concern to the banking industry.

A major subject covered in the review this year was the use of financial derivatives. This is an issue which extends beyond the banking industry and the Committee determined that it would also be appropriate to examine what is happening with regard to the use of derivatives in the insurance and superannuation industries. To do this the Committee utilised its authority to examine the Insurance and Superannuation Commission's 1993-94 annual report. The outcome of the reviews of the annual reports of both the RBA and the ISC are covered in this report.

The Committee also continued to canvass a variety of issues that have been of interest to the Committee for a number of years. They include: monetary policy; the operation of the Australian Banking Industry Ombudsman Scheme; the relationship between banks and small business; bank branch closures; and the role of the Council of Financial Supervisors.

I thank members of the Committee for their valuable assistance in the conduct of the review and in the preparation of this report. The Committee extends its appreciation to the Governor of the Reserve Bank, Bernie Fraser, for his continued and positive support for this process. The assistance of the Australian Bankers' Association and the Insurance and Superannuation Commission is also welcomed.

THE HON DAVID SIMMONS MP  
Chairman



## Members of the Committee

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Chairman: Hon D W Simmons, MP<sup>1</sup>

Deputy Chairman: Mr J W Bradford, MP<sup>2</sup>

Members: Mr A J Abbott, MP<sup>3</sup>  
Mr R A Braithwaite, MP  
Mr B T Cunningham, MP  
Hon M J Evans, MP<sup>4</sup>  
Mr M W Latham, MP  
Hon L R S Price, MP  
Mr S F Smith, MP  
Mr A M Somlyay, MP  
Mr A P Thomson, MP<sup>5</sup>  
Mr H F Woods, MP

Secretary: Mr C Paterson

Inquiry Staff: Ms M Cahill

## Members of the Subcommittee

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The subcommittee appointed to undertake the public hearings with the Reserve Bank of Australia on 20 April 1995 and the Insurance and Superannuation Commission on 1 June 1995 comprised:

Chairman: Mr S F Smith, MP

Members: Mr R A Braithwaite, MP  
Hon M J Evans, MP

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<sup>1</sup> Replaced the Hon R P Elliott, MP as Chairman from 10 February 1994.  
<sup>2</sup> Replaced Mr P K Reith, MP as Deputy Chairman from 13 October 1994.  
<sup>3</sup> Replaced Mr A C Rocher, MP as member of Committee from 5 May 1994.  
<sup>4</sup> Replaced Mr E J Fitzgibbon as member of Committee from 5 May 1994.  
<sup>5</sup> Replaced Mr D F Jull, MP as member of the Committee from 24 August 1995.





## Terms of Reference

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The Standing Committee on Banking, Finance and Public Administration is empowered to inquire into and report on any matters referred to it by either the House or a Minister including any pre-legislation proposal, Bill, motion, petition, vote or expenditure, other financial matter, report or paper.

Annual reports of government departments and statutory authorities tabled in the House shall stand referred to the relevant committee for any inquiry the committee may wish to make. Reports shall stand referred to committees in accordance with a schedule tabled by the Speaker to record the areas of responsibility of each committee.

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## Acronyms and Abbreviations

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ABA	Australian Bankers' Association
ABIO	Australian Banking Industry Ombudsman Scheme
AFIC	Australian Financial Institutions Commission
CASAC	Companies and Securities Advisory Committee
DT	Debits Tax
FID	Financial Institutions Duty
G30	Group of Thirty
ISC	Insurance and Superannuation Commission
NBFI	Non-Banking Financial Institutions
PSA	Prices Surveillance Authority
RBA	Reserve Bank of Australia
RMS	Risk Management Statements
RSA	Retirement Savings Accounts



## List of Recommendations

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1. The Treasurer monitor the implementation of the Insurance and Superannuation Commission's proposals for the use of derivatives by superannuation funds and report to Parliament on progress at the first opportunity in 1996 (Para. 3.41).
2. The Treasurer provide the Standing Committee on Banking, Finance and Public Administration with terms of reference for an inquiry into the effectiveness of alternative dispute resolution in the banking industry, including the role played by the Australian Banking Industry Ombudsman (Para. 4.16).
3. The Treasury examine the proposal by the Australian Bankers' Association for the establishment of Retirement Savings Accounts and provide a response to the Committee when it reviews the 1994-95 annual report of the Reserve Bank of Australia (Para. 4.29).



# CHAPTER ONE

## INTRODUCTION

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1.1 The House of Representatives Standing Committee on Banking, Finance and Public Administration has a long standing interest in the banking and financial services industry. The Committee considers that continued parliamentary oversight of developments and issues in the financial services industry can make a valuable contribution to public debate and policy making. In particular, the opportunity to discuss issues of current concern with the Reserve Bank (RBA) is important from an accountability perspective. While the Reserve Bank publishes its views and comments on a wide variety of matters, the opportunity for scrutiny of the RBA's responsibilities and activities is very limited. The Committee is confident that an annual review, while not exhaustive, is a positive and constructive process which will continue and develop into the future. The Committee appreciates the support of the Reserve Bank and the Australian Bankers' Association (ABA) in the review process.

1.2 The authority for the Committee to inquire into matters arising from the Reserve Bank's annual report derives from standing order 28B(b) whereby the Reserve Bank of Australia's annual report stands referred to this Committee for any inquiry the Committee may wish to make. At a meeting on 25 August 1994, the Committee resolved to undertake an inquiry into the 1993-94 annual report.

1.3 While this examination is a public process, it is not intended to be as comprehensive as an inquiry into a specific reference. The inquiry is not advertised and written submissions are only sought from those organisations directly involved in the review process. The Committee regards this process as a means of monitoring a wide variety of issues. If a particular matter gives cause for serious concern, the Committee has the option of following it up next year, or it can seek a specific reference and conduct a more detailed inquiry. An example of what can come out of this process is the work done by the Reserve Bank on interest rate margins. This has resulted in a more considered approach to the question of comparing interest rate margins and influenced the increased focus on the issue of cost recovery through the use of fees and charges.

1.4 In the course of this review, significant concern developed over the use of financial derivatives following the collapse of Barings Bank in February 1995. Many of the concerns being expressed over the use of derivatives were canvassed in the Committee's last report.<sup>1</sup> Consequently, the Committee considered that due to the close relationship between the banking, insurance and superannuation industries, it would also be appropriate to obtain the views of the Insurance and Superannuation Commission (ISC) on this issue. At a meeting on 9 March 1995, the Committee resolved to examine the ISC's 1993-94 annual report.

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1 House of Representatives Standing Committee on Banking, Finance and Public Administration, 1994, *Review of the Reserve Bank of Australia's 1992/93 Annual Report*, Canberra, AGPS, pp. 34-37.

1.5 In conducting the inquiry, the Committee initially invited the Reserve Bank to attend a public hearing to discuss current issues being dealt with by the RBA as well as more general matters related to the banking industry. Following the Barings collapse, the Committee arranged two further public hearings with the RBA and the ISC. These hearings were conducted by a subcommittee and focussed specifically on the use of financial derivatives in the banking, insurance and superannuation industries, although it should be noted that the Committee's primary focus is on the banking sector.

1.6 In keeping with past practice, the Committee provided an opportunity for the banking industry to respond to matters raised at earlier hearings and also to raise issues which it believes require consideration by government or the Reserve Bank. The Australian Bankers' Association was invited to attend a public hearing to represent the views of the banking industry.

1.7 The Committee considers the contribution of the ABA, on behalf of the banking industry, to be an integral part of this review process. As a consequence, there has been a delay in finalising the consideration of the 1993-94 annual report due to the heavy commitment by the banking industry to the Prices Surveillance Authority (PSA) Inquiry into Fees and Charges. The Committee agreed to delay the review until the PSA inquiry had been finalised. It should also be noted that while there is some consideration of the issue of fees and charges in this report, the Committee chose not to place a strong focus on this issue as it was being dealt with by the PSA. The Committee anticipates that it will examine the outcome of the PSA inquiry as part of its review of the RBA's 1994-95 annual report.

1.8 In addition to the four public hearings, the Committee also received a number of submissions on various aspects of the banking and insurance industries. A list of submissions received is at Appendix 1.

1.9 As with the past review, the Committee took the opportunity to discuss a wide variety of issues related to the economy and monetary policy. While a lot of those issues were of transient interest and are not covered in this report, there were a few matters which are still relevant. They are covered in chapter 2.

1.10 The Committee found that the use of financial derivatives became a major focus of this review. The reason for this was the collapse of Barings plc which generated substantial public comment and disquiet. As noted earlier, the Committee sought comments from both the Reserve Bank and the Insurance and Superannuation Commission. This is dealt with in Chapter 3.

1.11 Finally, a number of other issues were addressed by the Committee including: the operation of the Australian Banking Industry Ombudsman Scheme; superannuation; the relationship between small business and banks, including branch closures; state financial taxes; and the Council of Financial Supervisors. These matters are covered in chapter 4.



## CHAPTER TWO

# THE ECONOMY AND MONETARY POLICY

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### Background

2.1 The Reserve Bank plays an important role in setting and administering monetary policy in Australia. In the course of this review the Committee canvassed a number of matters related to monetary policy and economic conditions. Many of the matters covered were of a general nature and, while relevant at the time, have since been overtaken by changing economic conditions. Those matters that have not been addressed in this report are recorded in the transcripts from the public hearings. There are, however, several points of policy which are worthy of comment.

### Inflation Targeting

2.2 The Reserve Bank's inflation objective is 'to maintain an average rate of increase in underlying consumer prices of around 2 to 3 per cent over a run of years',<sup>1</sup> noting that it is not a range within which inflation should be maintained at all times, but the average over a period. The Bank added that, while this objective was being met, there were two potential areas of inflationary pressure in the period: exchange rate volatility related to uncertainty over the passage of the 1993 Budget; and strong growth in housing borrowing.

2.3 Borrowing for housing grew at more than 20% in 1993-94. The RBA's concern was that continued large capital injections into the housing market would arouse inflationary expectations as well as restrict credit growth for business investment.<sup>2</sup>

2.4 The Committee was interested to discuss the inflation target that had been set by the RBA as there has been extensive debate over the costs and benefits of targeting rates of inflation by central banks.

2.5 The Bank advised the Committee that 'central banks have it as part of their duty statements to pursue low inflation'.<sup>3</sup> With regard to the reasoning behind setting a 2% to 3% objective for the underlying rate of inflation, the Bank's view was that it is a matter of judgement as to how you quantify what is a desirably low rate of inflation, pointing out that zero was too demanding a target and that there are some benefits in having a low positive rate of inflation.<sup>4</sup>

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1 Evidence, p. S60.

2 Reserve Bank of Australia, 1994, *Report and Financial Statements*, p. 4.

3 Evidence p. 15.

4 Evidence p. S. 60.

2.6 The RBA commented on the approach adopted in New Zealand (0%-2%) and Canada (0%-3%) where inflation is expected to be always within the specified range. The Bank's view was that the difficulties associated with forecasting inflation makes such a strict approach inappropriate for Australia. A rate of 2% to 3% would, in the opinion of the Bank, not unduly influence the decisions of investors and householders and would provide a predictable environment. The RBA added that it is a rate that 'one could aim at without having to unduly screw the economy down to deliver lower rates. That can sometimes result in additional costs in terms of lost production and higher unemployment'.<sup>5</sup>

2.7 The RBA maintains that 2% to 3% is consistent with international best practice in terms of inflation. To allow higher rates would result in pre-emptive price rises and wage claims and distorted investment patterns focussing on asset values rather than investment in plant and equipment.<sup>6</sup> In short, 'higher rates of inflation make for less efficient resource use, so that any short-term gains in growth and employment are lost over time'.<sup>7</sup>

2.8 The Committee was also interested to find out whether other government agencies were involved in determining the target rate for inflation. The Governor advised the Committee that, 'we have basically made the running in quantifying what we regard as a low rate of inflation'.<sup>8</sup>

2.9 The Governor also noted the potential importance of enterprise bargaining in keeping inflationary pressures under control. If wage increases are genuinely offset by productivity gains they do not add to inflationary pressures. 'If things work the way they are supposed to, that shift should be conducive to keeping inflation under control; but the jury is still out on all that'.<sup>9</sup>

2.10 The Governor also canvassed an aspect of inflation that has been discussed at past hearings: getting people to think in terms of sustained low inflation. There is a difficulty in keeping a constituency in favour of low inflation; people like to see the value of their house rise and their wages go up. The test is whether the underlying rate can be held in an economy growing strongly.

2.11 The Governor added that he did not believe the banking sector had adjusted to a low inflation environment as yet. He offered the view that the high levels of lending for housing may result in increased defaults in a low inflation environment with low growth in house prices, and furthermore, that banks are yet to factor in lower inflation to the hurdle rates that they set for their lending projects.<sup>10</sup>

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5 Evidence p. 18.

6 Evidence p. S. 60.

7 Evidence p. S. 61.

8 Evidence p. 18.

9 Evidence p. 28.

10 Evidence pp. 16-17.

## Lending for Housing

2.12 There was considerable comment in the annual report in relation to housing finance. The RBA indicated concern over sustained high demand over recent years, pointing out that banks have been able to meet the demand for housing and still maintain relatively profitable margins on housing loans.

2.13 The Bank reported that it had expressed concern to the banks over the inflationary consequences of housing lending continuing to grow at annual rates in excess of 20%, suggesting that while monetary policy can generally be relied on to deal with problems in the housing sector, 'circumstances can arise when specific measures targeted at housing lending may also be appropriate'.<sup>11</sup>

2.14 Banks had a favourable position with regard to the amount of capital they had to hold against housing loans. In 1988, a new approach was instituted regarding the supervision of banks' capital adequacy, whereby allowance was made for differences in the credit risk of different classes of bank assets. The focus of capital adequacy is on credit risk, which is the potential for default by a borrower or a counterparty. The arrangements require that credit exposures be risk-weighted according to three types of counterparty - government, banks and all others. The higher the credit risk, the greater the capital backing required. Risk weights fall into five categories: 0%, 10%, 20%, 50% and 100%.<sup>12</sup> Under the guidelines issued in 1988, a weighting of 50% was applied to loans fully secured by a mortgage on residential housing which are for owner occupation or rental. Loans for business purposes have a 100% weighting.

2.15 The banks had a favourable capital arrangement for housing loans, only having to hold half of the capital they needed to hold for business loans. The Governor advised the Committee that, from a prudential point of view, banks were increasing lending at rates in excess of 20% per year with significant proportions of those loans being for loans at loan to valuation ratios of 90% or more. The Governor's view was that 'there is a risk of sloppiness creeping into housing lending...in the same way that sloppiness crept into business lending in the late 1980s'.<sup>13</sup>

2.16 The RBA advised the Committee that because the risk of default increases as the loan to valuation ratio increases, the amount of capital required to be held was increased from the 50% weight to 100% for lending for more than 80% of the value of a property.

2.17 The Committee had been advised that the Bank was concerned at the total volume of credit extended for housing,<sup>14</sup> yet the annual report suggested that risk weighting probably had a marginal impact. The Governor was asked whether the Bank's action was really a tool for demand management rather than a prudential measure. The response was that 'sometimes the two things can work in the same direction, and it is quite proper to use them in that way. Normally we would shy away from using prudential measures for macro-economic

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11 Reserve Bank of Australia, 1994, *Report and Financial Statements*, p. 27.

12 Reserve Bank of Australia Bulletin, December 1994, *Capital Adequacy of Australian Banks*, p. 21.

13 Evidence pp. 8-9.

14 Evidence p. 8.

purposes...As it happens, the prudential measure reinforces...the macro-economic objective of wanting to slow down housing lending'.<sup>15</sup> The Governor did add that the Bank would not consider lowering prudential standards for macro-economic purposes.

2.18 The ABA took a different view: 'we do not accept that it was a move that was necessary prudentially, given the way in which the banks lend and the way in which they insure any loans over 80 to 90 per cent'.<sup>16</sup> It was also pointed out that AFIC had not seen fit to implement similar measures for building societies and credit unions. The ABA maintained that the RBA should reverse its decision.

2.19 While it may be of little significance whether this measure was taken primarily for prudential purposes or not, it was consistent with the RBA's concern to ensure that investment decisions are not directed toward chasing higher asset values. The Committee has some concern that this decision, while justifiable from a prudential perspective, did have the potential to impact primarily on borrowers who do not have the capacity to save large deposits. This did not appear to be a major consideration in taking this decision.

## Forecasting

2.20 There is a great deal of attention paid to economic forecasting and the Committee raised the matter of the reliability of economic forecasting and what steps the Bank had taken to improve its capacity in forecasting.

2.21 The Bank agreed that if forecasting were better it would contribute to improved economic policy making. It was suggested that forecasts should not be exaggerated in the policy process, forecasting can only be used as a basic framework to assist in assessing pressures building in the economy, but that judgement is still the critical factor in determining policy responses.

2.22 The Bank's aim with regard to economic policy is to smooth out the economic cycle although it was conceded that this had not always been as successful as had been hoped. The Governor did not offer any comments on what steps the Bank had taken to improve the forecasting process.

## Conclusion

2.23 In discussing monetary policy issues with the Reserve Bank, the Committee did not seek to examine any particular issues in detail and consequently has not reported at any length on the matters discussed. While the opportunity the review provides to discuss these issues generally in a public forum is an important factor in this process, the Committee believes that an increased focus on monetary policy issues would be appropriate in future reviews.

2.24 The Committee is of the view that there is an imbalance in parliamentary accountability on the development of monetary and fiscal policy. Through the Appropriation Bills, the Parliament extensively debates fiscal policy; no such scrutiny is afforded to monetary policy.

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15 Evidence pp. 9-10.

16 Evidence pp. 103-104.

2.25 The Committee believes that it can play a valuable role in this process by:

- requiring senior Reserve Bank officials to appear before the Committee regularly; and
- inquiring into and reporting on contemporary issues and debates concerning monetary policy.

2.26 There are a number of issues which are of interest to the Committee which could be considered over the next twelve months including:

- the changing role of monetary policy in an internationally exposed economy (passive versus active use of monetary policy);
- problems with time lags and transmission mechanisms;
- counter-directional outcomes from active use of monetary policy; and
- the effectiveness of monetary policy in dealing with multiple policy goals - inflation targeting, demand management and dealing with the current account deficit.

2.27 The Committee believes that a focus on monetary policy issues would assist in meeting the broader objective of improving the process of accountability to the Parliament.



## CHAPTER THREE

### DERIVATIVES

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#### Background

3.1 The strong growth in the use of financial derivatives was canvassed in the Committee's report on the examination of the RBA's 1992-93 annual report. In that report the Committee indicated that it would continue to monitor developments with regard to the use of derivatives.

3.2 At that time the RBA defined derivatives as financial contracts where the value is dependant on the value of some other asset. They come in three generic forms:

- those which involve an obligation to acquire or sell an asset at a given price in the future (includes forward contracts and futures);
- those that involve the right (but not the obligation) to acquire or sell an asset in the future (options); and
- those involving the exchange of income streams without necessarily involving an exchange of principal (interest rate or foreign currency swaps).

3.3 The issue of derivatives trading has been a matter of concern to financial supervisors for some time. In February 1995 Baring Brothers & Co was put into administration following the loss of 830 million pounds by Barings Futures Singapore, a subsidiary of Barings plc.. These losses were brought about by the unauthorised trading activities of a Baring's employee in Singapore. The unauthorised trading was in financial derivatives in the form of futures and options.

3.4 Following this significant failure resulting from unauthorised derivatives trading, there was a great deal of concern expressed in the media and the general community over the use of financial derivatives. Given the level of concern at the time, the Committee decided that it would be appropriate to examine further the role of the RBA regarding the supervision of derivatives trading in the banking system. The Committee also considered that it would be appropriate to seek the views of the Insurance and Superannuation Commission, which has a supervisory responsibility for superannuation, life insurance and general insurance.

3.5 Derivatives are instruments which are used primarily to manage risk, they are a form of insurance against adverse movements in market prices. The demand for risk-management instruments by both financial institutions and corporate users has lead to the development of more complex derivative products. The high notional principal values involved, together with the potential for volatility, has resulted in public disquiet over the use of derivatives.

## Regulation of the Australian Derivatives Markets

3.6 The derivatives market is an international market and is being closely monitored by supervisory authorities around the world. The Reserve Bank has focussed on the nature and measurement of the risks associated with using these instruments. Due to the growth in the market the Bank has intensified its work in this area over the last year.

3.7 In March 1994 the Reserve Bank surveyed all banks operating in the Australian market on their use of derivatives. The survey sought information on products, the maturity composition of derivatives portfolios, banks' counterparties, their strategies in derivatives markets and risk-management practices. The results of the survey were published in the Bank's September 1994 Bulletin.<sup>1</sup>

3.8 The face value of derivatives contracts outstanding at March 1994 was just under \$2,300 billion, this figure represents the face value for which the derivatives contracts have been written. This is an indication of volume of activity and needs to be considered with caution, for example, when two banks engage each other in a derivatives transaction, the face value of the transaction is counted twice. The credit equivalent value of this figure is just over \$50 billion, which provides a more realistic indication of the potential credit exposure.<sup>2</sup> The credit exposure refers to the risk that the bank may lose money due to the failure of the counterparty. This figure is included in a bank's capital adequacy requirements. They are required to hold capital against this type of exposure.

3.9 At the public hearing with the ISC, the Committee sought more information on the size of the derivatives market in Australia relative to the physical market. The ISC has advised the Committee, based on advice from the Reserve Bank, that annual turnover in Australian financial markets for exchange traded derivatives in 1993/94 was \$6,300 billion.<sup>3</sup> In interpreting these figures, account must be taken of the fact that the actual cash changing hands for most derivatives is only a small percentage of the notional amounts involved. These figures do, however, give some idea of the degree of activity taking place in the derivatives market.

3.10 The report noted that the bulk (80%) of bank activities was in simple forms of derivatives, and most of that business is conducted through organised exchanges rather than as over-the-counter business.<sup>4</sup> The use of exotic derivatives represents only a small proportion of total business and the most sophisticated products are dealt with by a small number of skilled operators.

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1 Reserve Bank of Australia Bulletin, September 1994, *Australian Bank's Activities in Derivatives Markets: Products and Risk-Management Practices*, pp. 1-8.

2 *ibid.*, p. 2.

3 Evidence p. S176.

4 Over-the-counter (OTC) derivatives are derivatives not listed on any security exchange. They are contracts custom tailored to an institution's needs and often specify commodities, instruments and/or maturities not offered on any exchange. The main OTC derivatives include swaps, forwards and options, which are based on interest rates, currencies, equities or commodities.



continue to grow. One point of interest was the view of some banks that involvement would grow due to increased demand from the corporate sector. Commodity markets were cited as a growth area with banks seeking to offer commodity producers derivatives products to manage price risks.

### **Risk Management**

3.12 At the international level, the Basle Committee on Banking Supervision prepared consultative papers on market risk and the RBA prepared a response following consultation with the banks. The Basle Committee released guidelines on best practice in managing the risks associated with derivatives in July 1994. The guidelines covered oversight of the risk management process, and they set out risk management practices with regard to market, credit and other forms of risk.<sup>5</sup> The RBA's survey enabled the Bank to make an initial assessment of the risk-management practices of Australian banks.

3.13 The conclusion was that Australian banks have controls and procedures in place which are appropriate for their derivatives trading.<sup>6</sup> Although the Committee notes that there are significant variations in approach depending on the nature of an individual bank's business.

3.14 The RBA advised the Committee that total losses for Australian banks in relation to their derivatives activities has been quite small. The September 1994 Bulletin reports that losses incurred by all Australian banks over the past five years as a result of counterparty default in derivatives transactions totalled approximately \$12.5 million.<sup>7</sup> It should be borne in mind that this only refers to credit risk. The Committee has not seen any data on losses due to market risk.

3.15 Following the survey, the Reserve Bank was satisfied that banks had reasonable controls in place to manage derivatives activities, but that further work would continue in direct discussions with individual banks.<sup>8</sup> A program of visits to banks commenced in late in 1994. The purpose of the visits was to review banks' derivatives activities and risk management.<sup>9</sup> The Bank set a number of objectives for the visits program: to increase understanding of how banks manage the risks associated with derivatives; to provide a greater insight into the models used by banks to measure their exposure to risk; and to require corrective action if deficiencies were found in those models.<sup>10</sup> The Reserve Bank is focussing the visits on those banks which account for the bulk of derivatives business in Australia and expects to have visited about 20 banks by the end of this year.

3.16 Following these discussions, the RBA is able to advise that arrangements for managing derivatives risk typically specify the type of activities which can be conducted and the limits

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5 Market risk refers to the possibility of loss due to movements in market prices (exchange rates, interest rates); credit risk refers to the risk of loss associated with counterparty failure.

6 RBA Bulletin, September 1994, op. cit., p. 5.

7 *ibid.*, p. 7.

8 *ibid.*, p. 8.

9 Evidence p. S62.

10 Evidence p. 51.

placed on those activities. There is also regular reporting to senior management and boards on derivatives activity which includes exposures and profitability. Since the commencement of the visits program the Bank has not changed its view that banks currently have effective systems and policies to govern their derivatives activities, and is also of the view that the visits program will assist the RBA to identify any potential problem areas.

### Capital Adequacy

3.17 There has been a considerable amount of work carried out at the international level by the Basle Committee, and in Australia by the Reserve Bank, with regard to market risk, which has become more important as the use of derivatives grows. The Basle Committee has developed proposals for capital adequacy risk to be extended to include market as well as credit risk. It is expected that the guidelines will be finalised by the end of 1995.

3.18 The Reserve Bank has actively supported the inclusion of market risk in capital adequacy requirements, and is of the view that banks should be allowed to use their own internal models to measure market risk rather than imposing a standard methodology which may be inferior to internal models. These internal models would have to meet specified criteria and would be subject to approval by the Reserve Bank. The visits program is being used by the Bank to gain a more detailed knowledge of how those systems operate. This matter will be further examined in the Committee's review of matters arising from the RBA's 1994-95 annual report.

### Systemic Risk

3.19 One issue that has been canvassed in the past by the Committee, and has also been noted by the Council of Financial Supervisors, is that of systemic risk.

3.20 Systemic risk is the risk that a shock in one institution or in one market will set off a chain reaction in other institutions or markets. This possibility occurs because derivatives business tends to be concentrated in relatively few firms, leading to concentrations of credit risk and liquidity.<sup>11</sup> With regard to the possibility of a large party failing, the Reserve Bank advised the Committee that there are restrictions in place to guard against a bank developing a large exposure to any one client.<sup>12</sup>

3.21 The Reserve Bank pointed out that derivatives do not create risks - they shift them.<sup>13</sup> The Bank's view was that this risk is overstated as banks usually take very little risk themselves; they intermediate risk between customers. The main risk for a bank is a loss associated with the failure of a customer and exposures to individual customers are monitored closely by banks. Many of the well publicised cases of derivatives losses in recent years have been among companies (Barings being the exception) which have not posed a threat to the financial system as a whole. The RBA also made the point that while derivatives markets can be volatile, trading in these markets is tightly controlled by the futures exchanges with strict

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11 Council of Financial Supervisors, 1994, *Annual Report*, p. 27.

12 Evidence p. 67.

13 Evidence p. S64.

rules for lodgement of margins<sup>14</sup> and for "circuit breakers" in trading. These matters are currently being researched by the Bank for International Settlements.

3.22 The RBA also pointed out that despite recent shocks such as the share market crash in 1987, the fall in bond prices in 1994 and the recent collapse of Barings, the financial markets have held up well and that derivatives have in fact caused fewer problems for banks than some normal business such as lending for commercial property.<sup>15</sup>

### Netting

3.23 The Committee also canvassed the matter of bilateral netting at the hearing with the RBA. Bilateral netting is a means by which amounts owing between two counterparties can be combined into a single net figure payable from one to the other.<sup>16</sup> The view of the RBA was that 'if such obligations could be offset in a legally robust way, it would reduce the total credit risk of banks and the amount of capital required to be held'.<sup>17</sup> This point was also made in the Council of Financial Supervisors annual report: 'if credit exposures between counterparties can be effectively netted or offset, this will reduce the amount of credit that is present in the system, and the amount of capital that banks need to hold against such risks'.<sup>18</sup>

3.24 While the Basle Committee has issued new arrangements which allow a wider range of netting arrangements, there is some doubt over whether netting agreements would be legally sustainable. In some countries legislation has been introduced to cover close-out netting,<sup>19</sup> and the Reserve Bank has suggested that this will probably be required in Australia. This matter is being considered by the Companies and Securities Advisory Committee (CASAC).

3.25 The ABA advised the Committee that it supports bilateral netting and has supported the development of a legislative solution through participation on the netting subcommittee of CASAC.<sup>20</sup> If netting will reduce the amount of credit risk in the system and consequently the amount of capital that banks need to hold against such risks then here is a good case to proceed with appropriate legislative reform. The Committee will be interested to see the CASAC report and any legislative amendments will have to be debated in Parliament.

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14 Margins are security deposits required for exchange traded derivatives to ensure that if the market moves against the derivatives holder during the day, extra backing is provided against potential losses.

15 Evidence p. S65.

16 Gizycki, M., Gray, B., 1994, 'Default Risk and Derivatives: An Empirical Analysis of Bilateral Netting', Research Discussion Paper, RDP 9409, Economic Research Department, RBA, p. 1.

17 RBA, 1994, *op cit.*, p. 37.

18 Council of Financial Supervisors, *op cit.*, p. 32.

19 Close-out netting is an agreement between two counterparties such that if one defaults, all contracts between them are closed out. This is done by payment of an amount equal to the net market value of all contracts, by one to the other.

20 Evidence p. S181.

## Insurance and Superannuation

3.26 Controls on the derivatives activities of Non Bank Financial Institutions (NBFIs) are the responsibility of their respective regulators. For this reason the Committee sought the advice of the Insurance and Superannuation Commission (ISC) with regard to the use of derivatives products in the insurance and superannuation industry

3.27 The ISC is responsible for the prudential supervision of the insurance and superannuation industries in the interests of policyholders and fund members. In developing its approach to regulation, the ISC has adopted a market oriented approach to supervision which is intended to minimise interference in commercial activities 'except for sound prudential and other public interest reasons'.<sup>21</sup>

3.28 In March 1994 the ISC issued discussion papers on derivatives for life insurance, general insurance and superannuation. These papers were developed following consultations with industry, the Reserve Bank and the Australian Financial Institutions Commission. The discussion papers represent the ISC's preferred approach.

3.29 The ISC's view was that derivatives offer industry the opportunity to reduce risk and maximise investment returns. It also recognises the potential for losses if derivatives are used improperly and therefore has adopted a similar emphasis to the Reserve Bank of seeking to ensure that proper risk management practices and procedures are in place.<sup>22</sup>

3.30 The main emphasis in the discussion papers is on the preparation of Risk Management Statements (RMS). The RMS will be required to meet a standard set by the ISC and external auditors will be asked to report on compliance with the RMS. The ISC has identified what it considers to be the essential elements of an RMS. They are based on the Basle Committee's report, *Risk Management Guidelines for Derivatives*.<sup>23</sup>

3.31 The Committee was advised that the use of derivatives in the insurance and superannuation industries varies between sectors. The ISC receives quarterly returns from life companies which identifies their exposure to derivatives investments. Those returns suggest that life companies use derivatives minimally and mainly for hedging purposes. The situation with regard to general insurance companies is similar.<sup>24</sup>

3.32 With regard to superannuation, the situation is less clear as the funds themselves tend not to use derivatives; they tend to be used by the pooled investment trusts. Superannuation funds have not been required to report on the use of derivatives in the past and the ISC is unable to quantify the use of derivatives in the superannuation industry. When asked if the ISC was satisfied that there is no evidence of dangerous use of derivatives, the Commissioner said:

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21 Council of Financial Supervisors, op cit., p. 45.

22 Evidence p. 3.

23 Insurance and Superannuation Commission, March 1995, *Derivatives for Superannuation*, pp. 7-8.

24 Evidence p. 5.

Satisfied is too strong a word because we do not have the information that is that good. But what I put to you was that people who have written to us in response to that request, some of whom know that part of the industry better than we do have made those comments - that they did not think the use of derivatives was all that widespread, although there was significant use by some, and that probably, on the whole, those people who were significant users had some idea what they were doing.<sup>25</sup>

3.33 One particular feature of the ISC's proposal with regard to superannuation funds is that 'derivatives should not be used in a way which results in the entity's total portfolio being geared up'.<sup>26</sup> The Commissioner advised the Committee that superannuation funds should not gamble with members' money. It was acknowledged that it is difficult to distinguish between speculation and hedging, but as superannuation funds are not allowed to gear up and as some derivatives are associated with gearing, the Commission did not want derivatives used as a means of avoiding that requirement and so decided to include a restriction on the use of derivatives for speculative purposes in the superannuation paper. The Commission offered the following comment on the speculative use of derivatives: 'superannuation funds should not use derivatives in a way which creates risks above and beyond the risk return objective set out in the fund's investment strategy'.<sup>27</sup>

3.34 The ISC also advised the Committee that in addition to limits on the use of derivatives as part of a fund's investment strategy, funds should not gear their portfolios through the use of derivatives.

3.35 The *Superannuation Industry (Supervision) Act 1993* places the responsibility for superannuation funds entirely in the hands of trustees.<sup>28</sup> Trustees are not able to delegate responsibility and so it is essential that trustees ensure that investment strategies are sensible and that risk is properly controlled. The purpose of the RMS is to ensure that trustees focus on these matters.

3.36 The ISC has set the 1995-96 financial year as the target for putting the new arrangements in place.

3.37 The Committee is concerned at the lack of knowledge about the use of derivatives in the superannuation industry in particular. The ISC advised that 'the use of derivatives by life insurance companies, superannuation funds and general insurance companies in an overall context is relatively small. Apart from a general feeling, I cannot give you any further guidance'.<sup>29</sup>

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25 Evidence p. 7.

26 ISC, March 1995, op cit., p. 10.

27 Evidence p. 8.

28 Evidence p. 9.

29 Evidence p. 18.

3.38 The ISC's market oriented approach is probably the only practical means of regulating superannuation funds given that there are some 80 000 superannuation funds, although assets and membership is concentrated in around 1 500 to 2 000 of those funds.<sup>30</sup> The requirement to produce an RMS will only apply to the corporate and public offer funds. The majority of funds have four or less members and are excluded from the requirement to produce an RMS. The logic for this being that the members are fully aware of what is happening in those funds, whereas in larger funds, trustees are making decisions about which members may have little or no involvement or knowledge.

3.39 The Committee considers that the ISC should place a high priority on finalising the new regulatory approach for the use of derivatives by superannuation funds. The emphasis now placed on superannuation means that it may represent the life savings of many Australians and those savings need to be afforded the maximum possible protection. The ISC does not guarantee the funds of members, although the Treasurer does have the power under the SIS legislation to require a levy from other superannuation funds if a particular fund gets into difficulties. The ultimate responsibility lies with trustees and it is important that the ISC be satisfied that trustees are aware of their responsibility to ensure that sensible investment strategies are being followed and that appropriate risk management strategies are in place.

3.40 The present lack of information regarding the investment activities of superannuation funds is a cause for concern and it needs to be addressed as soon as possible.

3.41 **The Committee recommends that:**

**the Treasurer monitor the implementation of the Insurance and Superannuation Commission's proposals for the use of derivatives by superannuation funds and report to Parliament on progress at the first opportunity in 1996.**

## **Conclusion**

3.42 Derivatives are risk management instruments and are an essential tool in the financial services industry. The responsibility of the Reserve Bank, and other financial supervisors, is to ensure that the risks associated with derivatives are properly managed.

3.43 The Reserve Bank has acknowledged that supervisors will never be in a position to be thoroughly familiar with all of the new products being developed in the field of derivatives, nor can they guarantee that a Barings type-situation could not develop in Australia. All that can be done is to develop regulatory responses that minimise the risk of such a situation occurring.

3.44 The Reserve Bank has been monitoring the involvement of banks with derivatives since 1986 and over recent years has intensified that monitoring and developed a comprehensive approach to regulating their use. The thrust of the RBA's approach has focussed on ensuring that adequate capital is being held against risk and ensuring that banks have appropriate risk management regimes in place.

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30 Evidence pp. 11-12.

3.45 The Committee is satisfied that the Reserve Bank has adopted a responsible and thorough approach in dealing with the potential risk that derivatives could pose to the stability of the financial system. The Committee also acknowledges that this process is on-going and that it is essential that the supervisory response continues to evolve to meet the changing nature and growing use of derivatives instruments.

3.46 However, supervision of the banking industry is much more detailed than that of the insurance and superannuation industries. While the Committee endorses the approach of the ISC, the regulatory regime with regard to superannuation and insurance is still being formulated. The growing importance of superannuation requires that the ISC ensure that the process initiated with the release of the discussion papers be advanced as a matter of priority. The Committee was particularly concerned at the lack of data available on the use of derivatives by superannuation funds and will consider further examining the ISC's progress in this matter when it receives the ISC's 1994-95 annual report.

3.47 The Committee would also like to see continued consultation and coordination between the main supervisors of the financial system through the Council of Financial Supervisors. The Council provides a vehicle that can ensure that there is effective cooperation in dealing with matters such as derivatives. The Reserve Bank's view is that the Council is operating effectively and because it meets at the most senior levels, it can be decisive. The Committee will continue to monitor the role of the Council, not just in relation to derivatives, but also in dealing with the growth of financial conglomerates.





## CHAPTER FOUR

### OTHER MATTERS

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#### Australian Banking Industry Ombudsman Scheme

4.1 The Australian Banking Ombudsman Scheme (ABIO) was set up in 1989 to provide a dispute resolution scheme for users of bank services who have disputes with their banks. Using the criteria of law, good banking practice and fairness in all the circumstances the Scheme aims to provide independent and prompt resolution of disputes. The Scheme is free to consumers and is funded by participating banks on a 'user-pays' basis, i.e. the bank with the most disputes registered with the Ombudsman contributes most to the maintenance of the Scheme.

4.2 The current Ombudsman, appointed in May 1994, is Ms Sue Brooks. The Scheme's offices are located in Melbourne.

#### Jurisdiction

4.3 Not all banking disputes fall within the Ombudsman's jurisdiction. The Scheme can only deal with matters which have arisen, or have come to the consumer's attention, since 9 May 1989, the date of the Scheme's inception. The case must not involve sums over \$100 000 in direct financial loss and the complainant must allege that the bank has made an error or failed to do something it ought to have done. The Scheme does not handle complaints from companies nor does it intervene in 'policy matters', for example, interest rates or customers being categorised as a bad risk.

4.4 Complaints to the Ombudsmen generally involve such bank products as variable and fixed home loans, credit cards, statement saving accounts, business term loans and personal loans. Problems include transaction and calculation errors. It is the Ombudsman's view that most problems stem from a "failure in communication" between the bank and the customer.

4.5 In *Checking the Changes*<sup>1</sup> the Committee recommended that an increase to \$200 000 in the monetary limit applied to the Scheme be implemented immediately. The Committee also recommended that the scope of the Scheme be extended to include the complaints of small incorporated bodies and farmers. Both recommendations have been opposed by the banks.

4.6 The Committee took these matters up with the Reserve Bank which is a member of the Board. The Bank advised the Committee that extending the terms of reference (TOR) would need to be considered by the Board which would have to take account of increased costs and the Scheme's capacity to handle the different sorts of disputes that would arise if the TOR were extended. It was also put to the Committee that there is no logical case for automatically aligning the TOR with those of similar schemes operating overseas. The Committee suggests

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1 House of Representatives Standing Committee on Banking, Finance and Public Administration, 1992, *Checking the Changes*, Canberra, AGPS, p. 50.

that there is no logical case for dismissing such a suggestion when it appears that similar schemes operating overseas have the potential to provide a more effective dispute resolution mechanism than exists in Australia.

4.7 The Committee also understands that the Board is reviewing the TOR to take account of implications of the uniform credit legislation and the code of banking practice. At the hearing with the ABA, the Chairman of the Board of ABIO undertook to take into account the previous sentiments of the Committee in the course of the review.<sup>2</sup>

## Results

4.8 Since commencing operations, the Ombudsman's office has received in the region of 30 000 enquires a year. As the Ombudsman believes that solutions reached by direct negotiation between the bank and the client are more likely to be acceptable to both parties, most callers are, in the first instance, encouraged to negotiate directly with the bank concerned.

4.9 In 1993/94 there were 3 180 cases closed. Of these complaints 73.7% were judged to fall within the Ombudsman's terms of reference. About 11% of closed cases in that year were resolved in favour of banks, 6.3% were settled to the satisfaction of both parties and 5.9% were settled in favour of the consumer. Of all written complaints closed which were within the terms of reference, 77.1% were resolved after the matter was referred to the bank.

4.10 As the ABA pointed out there were only 26 cases rejected in 1993-94 as a consequence of the \$100 000 limit, although they also conceded that it is possible that individuals with complaints where the amount in dispute exceeds \$100 000 may not bother to approach the Ombudsman, particularly as this is explicitly stated in the information pamphlets provided in all bank branches.<sup>3</sup>

4.11 The annual report also includes statistics on cases rejected where they involve an incorporated body, of which there were 160 such cases, representing 19.4% of all rejected cases.<sup>4</sup> In the past the ABA has opposed allowing an extension to cover small business, claiming that it would have an adverse effect on retail customers' access to the Scheme and the speed of dispute resolution.

## Conclusion

4.12 The Committee agrees with the views expressed in the ABIO annual report, that the Scheme's effectiveness can be measured by the high number of complaints settled to the consumer's satisfaction. As well, the number of new inquiries has fallen, indicating that the Scheme's existence and success has encouraged banks to pay greater attention to customer relations. The Ombudsman's office also fulfils an educational and 'trouble-shooting' role by providing member banks with a breakdown of cases in respect of their organisation. This

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2 Evidence p. 140.

3 Evidence p. 140.

4 The Australian Banking Industry Ombudsman Limited, *1993-94 Annual Report*, p. 48.

feedback allows banks to compare their performance with that of other banks and to analyse trends and identify potential problem areas early. This should go some way towards ensuring that the number of complaints received by the Ombudsman continues to fall.

4.13 However, the Committee has not changed its view that the scope of the Scheme is too limited. The argument that very few complaints are rejected because they fall outside the TOR and therefore there is no real need to extend the TOR, can be just as easily used to support an extension because the small numbers would require little extra effort.

4.14 The Committee has had discussions with Ombudsmen from the United Kingdom, Ireland and New Zealand and is impressed with the way those schemes operate. The Committee is also concerned that small business operators and farmers who are incorporated have limited access to alternative dispute resolution procedures. While the Committee is of the opinion that an industry run scheme is the most desirable option, the Committee is convinced that a significant number of bank customers' needs are not being met.

4.15 The Committee has concluded that sufficient time has elapsed since the banking inquiries in 1991 and 1992 for the ABIO Scheme to have bedded down and for the banks to have developed their policies and processes for utilising alternative means for resolving disputes. It is now time for a re-examination of the extent to which banks are using alternative dispute resolution mechanisms.

4.16 The Committee recommends that:

**the Treasurer provide the Standing Committee on Banking, Finance and Public Administration with terms of reference for an inquiry into the effectiveness of alternative dispute resolution in the banking industry, including the role played by the Australian Banking Industry Ombudsman.**

## **Superannuation**

4.17 In its last report, the Committee briefly dealt with the restrictions imposed on banks with regard to offering superannuation products. In the course of this review the ABA presented the Committee with a proposal that banks be allowed to offer Retirement Savings Accounts (RSA).<sup>5</sup>

4.18 The ABA supports the objective of increasing national savings but has expressed concern that the banking industry has been excluded from offering a retirement savings product. Based on recent surveys, the ABA claims strong consumer demand for freedom of choice in selecting superannuation and for security and simplicity. The point was also made that risk averse investors have not been served well by the recent poor performance of superannuation funds. It is claimed that RSAs would offer such an investor stable returns in a cost effective manner. The ABA suggests that over the last ten years an RSA structured as a twelve month term deposit would have outperformed the average return of managed funds in five of those years.

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5 Evidence pp. S155-161.

4.19 The Committee was advised that current policy which relies on mandated contributions and then restricts investment choice may secure compliance, but will fall well short of securing self-provision for retirement.<sup>6</sup>

### Main Features of an RSA

4.20 The main difference between the proposal put by the ABA and a trustee type investment is that with the latter, the interest rate is contractually agreed before the investment occurs, thus protecting capital value. In addition, an RSA would be either statement or passbook based, subject to depositor protection under the *Banking Act*, and subject to identical tax treatment to other superannuation products. Consistent with government policy, there would also be no erosion by fees for balances less than \$1 000<sup>7</sup>.

4.21 The ABA proposal views RSAs as a short term management tool with depositors having the option to move to another form of investment after two years, provided minimum balance requirements are met. There is also no need for a trustee under these arrangements, as the individual is undertaking the investment directly.

### Benefits

4.22 The principal argument is that of freedom of choice. The ABA suggests that the investment strategies followed by trustees may not suit the needs of individual fund members, particularly those that may wish to have a more conservative investment strategy. The ABA's view is that individuals should choose how their funds are invested, and that choice should include the right to have all or part of their funds invested in a bank through an RSA.

4.23 It was put to the Committee that 'if banks are denied direct access to the growing pool of retirement savings, our ability over the longer term to continue to provide finance to households and small business on the favourable terms they have come to expect will be seriously constrained'.<sup>8</sup> It is suggested that budget estimates that 30% of compulsory superannuation savings will be offset against non-superannuation savings clearly demonstrates the potential impact on the banking system.

4.24 The ABA offered the example of a registered retirement savings plan system in Canada which they claim has resulted in increased private savings ratios. In addition it is claimed that banks, life insurance companies and other providers have all benefited from the scheme and that it has expanded the market.

### Conclusion

4.25 The Committee views the ABA proposal as worthy of further consideration. It is a simple product and it provides for a high degree of control over the investment by the investor. It would not appear to be an alternative to existing forms of superannuation; rather it might complement existing arrangements by expanding the range of options available.

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6 Evidence p. 94.

7 Evidence p. S158.

8 Evidence p. 95.

4.26 The fact that it is a conservative, low risk investment with a guaranteed rate of return and protection from erosion by fees would appear to be a further solution to the difficulties experienced with low balance superannuation accounts. It may also provide a convenient and cost effective solution to difficulties experienced by casual and contract workers.

4.27 The Committee also believes that the concern by banks that current superannuation arrangements limit the opportunity to compete for those funds, raises questions of economic efficiency related to the redirection of a large pool of funds from one part of the financial services industry to another part of the industry.

4.28 The Committee has not been in a position to examine this matter in any detail, nor has it been in a position to seek the views of other interested parties, however, it is a matter that warrants further detailed consideration.

4.29 **The Committee recommends that:**

**the Treasury examine the proposal by the Australian Bankers' Association for the establishment of Retirement Savings Accounts and provide a response to the Committee when it reviews the 1994-95 annual report of the Reserve Bank of Australia.**

## **Small Business**

4.30 The Reserve Bank collects statistics from the banks on their lending to small business. This is done on a quarterly basis and the results are published in the Reserve Bank Bulletin. The RBA noted in the annual report that small borrowers are tending to incur interest rates in the order of 1.5 to 2% higher. The Bank suggests that this is not unreasonable given that lending to small business tends to involve higher risk and that establishment costs of small loans are not much lower than large loans and that those costs have to be recovered.

4.31 The risk premium being charged to small business is an aggregate figure and the Committee is interested to get a clearer picture as to premiums being charged to various business sectors, especially rural producers. While the RBA expressed sympathy for the plight of farmers, its view was that premiums should reflect risk.<sup>9</sup> At the public hearing with the ABA, the Association undertook to contact member banks to determine on what basis they might be able to provide the Committee with comparative data on the risk premium for rural producers compared to other business sectors and between states.<sup>10</sup> The Committee will be following up on this matter.

4.32 The Bank also consults with small business through the Small Business Advisory Panel, which was established in mid 1993 to provide the Bank with a better understanding of the problems of small business, their financing needs and problems in the relationship between small business and the banks. The Panel consists of representatives from each state and covers a range of industries.

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9 Evidence p. 19.

10 Evidence pp. 131-132.

4.33 In the annual report the Bank noted concern by small business over deficiencies in understanding of customers' business operations by banks. It also noted that it is clear that many small businesses do not appreciate the information requirements of banks in assessing loan applications.<sup>11</sup>

4.34 One interesting development noted by the RBA related to security for small business loans. A perennial complaint from small business is that banks often require applicants to put their house up as security for a loan. While the RBA suggests that if someone thinks they have a good proposal and are not prepared to put their house up as security, 'one can understand the bank being a bit dubious about putting its money up'<sup>12</sup>, although it did advise the Committee that banks are now beginning to look at alternative forms of security such as cash flows. A cynical observer might suggest that the preference banks show for the house as security is an indication of banks taking the easy option and avoiding the effort required to really understand a business.

4.35 It has to be acknowledged, though, that the banking sector has made substantial efforts to improve its relationship with and understanding of small business. In its submission to the review, the ABA noted the continuation of a number of consultative processes and advised that since the last review:

- a committee comprising representatives from the Small Business Coalition and bank representatives had been established;
- assistance had been provided to the Department of Industry, Science and Technology in the development of an export self help manual; and
- that a publication designed to assist with loan applications had been developed jointly with the Australian Society of Certified Practicing Accountants and the Institute of Chartered Accountants.

4.36 In addition the ABA advised that a recent survey had indicated that very few small businesses were experiencing difficulty in accessing finance and in fact that this was one of the lesser concerns indicated by respondents to the survey.<sup>13</sup>

## Exports

4.37 The Committee was interested to note the ABA's assistance with the preparation of the export self help manual. When the Committee raised the subject of providing finance to export oriented business, the Governor commented that 'there is not great export financing culture or expertise in most banks at the present time, and I think that has been a legitimate complaint of many small businesses'.<sup>14</sup>

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11 RBA, 1994, op cit., p. 28.

12 Evidence p. 24.

13 Evidence pp. S165-166.

14 Evidence p. 35.

4.38 The Committee also raised the broader issue of banks' direct involvement in exporting their own services, especially in light of Westpac selling off its overseas network. The Governor responded that 'there has not been a great push by the Australian Banks to become more involved in Asia in the provision of banking services ... it is disappointing that , at least to this time, we have not seen a more concerted effort by the major banks to follow the trade growth with Asia, to follow their customers into Asia and to service their customers in Asia'.<sup>15</sup>

4.39 The ABA expressed the view that banks are focussing on ensuring that their primary businesses are sound and that if there are opportunities in Asia, they will go after them. The difficulties of doing business in Asia were noted and the view was expressed that the Committee would have reason to worry if banks were 'rushing willy nilly into Asian economies'.<sup>16</sup>

4.40 The Committee has not suggested that banks should rush into Asia in an irresponsible manner. The Committee is of the view that if business is focussing on the trade opportunities in Asia, then Australian banks ought to be seriously examining how they can assist. The anecdotal evidence has been that while business is moving into Asia, the Australian banks are moving out. The Committee will be interested to learn more about the strategies being developed by Australian banks to service Australia's trade relationship with Asia.

### Branch Closures

4.41 One issue that has been a major concern for many consumers of banking services has been the closure of branches, especially in rural communities. The Committee took this up with the Reserve Bank and the ABA.

4.42 The Reserve Bank suggested that there are sound economic reasons for the rationalisation of the branch structure. While not critical of network restructuring, the Committee is concerned to get a picture of what is happening. Further, it is very difficult to make any assessment of the impact of branch closures when there is little hard data around to indicate what changes are taking place.

4.43 The Reserve Bank does not collect any meaningful data on bank branch/agency networks, noting that it is of little value to the RBA from a prudential or monetary policy point of view. The Committee contends that it is important from the customers' point of view. The RBA suggested that the ABA would be a better source of such information.

4.44 The Committee has written to the ABA (as well as the Credit Union Services Corporation and the Association of Permanent Building Societies) on this matter.

4.45 The Committee understands the sensitivity of branch closures matter and in order to widen the scope of the issue, sought some material from the Reserve Bank on international comparisons of bank branch numbers and facilities. The RBA provided some very useful statistics which indicates that, of the countries surveyed, Australia:

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15 Evidence pp. 36-37.

16 Evidence p. 114.

- had the third highest number of bank branches per million inhabitants;
- ranked fourth in terms of the entry points to the payments system;
- ranked seventh with respect to ATM numbers, but third in terms of usage; and
- ranked sixth in terms of access to EFTPOS terminals.<sup>17</sup>

4.46 The RBA also noted that the trend towards a decline in branch numbers is an international one and is not restricted to Australia.

4.47 The ABA contends that the closure of branches is not as high as many would suggest; that it is extremely rare for services to be completely withdrawn; and that other forms of access are being provided. The ABA also provided some detail on the consultation process that banks go through when a closure is being considered.<sup>18</sup>

4.48 With specific regard to business access to banking services, there was some discussion of the regionalisation of specialist business banking services. The Committee agrees that a major criticism in the past has been the lack of expertise of local managers with regard to particular business needs. The banks have now moved to establish specialist business banking units and when a client needs finance advice or assistance, a small business specialist can be provided by appointment.<sup>19</sup> The Committee will be interested to monitor the progress of this approach to servicing small business, particularly in regional Australia.

4.49 The question of branch closures and the introduction of new technology is an emotional issue. The arguments put forward by the RBA and the banks are quite rational, but the Committee believes that there is a need for a more comprehensive picture of what is happening with regard to branch closures and the strategies for the future in terms of new forms of access to banking services. The Committee will continue to pursue this matter.

### **Interest Rate Margins and Fees and Charges**

4.50 As has been noted earlier, the Committee did not pursue this matter in any detail due to the PSA's inquiry. That report has now been finalised and the Committee will be taking up with the banks as part of the next review the PSA's conclusions and recommendations, as well as other recent developments.

4.51 There is one point that is worth noting in this report. The RBA provided the Committee with a comparison of international interest rate margins which broadly concluded that the net interest margin in Australia was in the top range of the countries considered. However, it also noted that income is also derived from fees and charges and that when they

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17 Evidence pp. S51-58.

18 Evidence pp S169-172

19 Evidence p. 137.



are taken into account, Australia was in the middle of the field. The Bank finished off by noting that the scope for interest margins to fall in Australia is constrained 'because interest income has been used to subsidise under-priced services'.<sup>20</sup>

4.52 The Committee took this point up with the ABA, which responded to the perception that margins should have fallen in response to the introduction of fees on transaction accounts. The ABA advised the Committee that fee income was small relative to interest earnings and that 'even if you had full or even greater contraction of net interest margins as a consequence of fees, it would hardly be visible to the naked eye'.<sup>21</sup>

4.53 It would appear to the Committee that the banks have encountered a lot of controversy, for very little gain, through the introduction of transaction fees. This should make for an interesting discussion at our next round of hearings, especially in light of the Reserve Bank's view that it accepts the banks' strategy for imposing transaction fees to the extent that 'any increase in fee income is matched by a narrowing in interest margins of banks in the period ahead and does not just reflect in increased profitability'.<sup>22</sup>

### **Financial Institutions Duty/Debits Tax**

4.54 The ABA raised the issue of Financial Institutions Duty (FID) and Debits Tax (DT) with the Committee, recommending that they should be abolished as they are 'distortive, regressive and inefficient'.<sup>23</sup> These taxes are levied by state governments.

4.55 The ABA claimed that companies modified their cash management practices to minimise FID and that FID is a major impediment to electronic banking in the corporate sector. It was also claimed that the DT is a disincentive for payment of accounts by cheque and encourages customers to operate a stand alone cheque account and a separate savings account.

4.56 The Committee was advised that transactions are being moved to lower tax jurisdictions and that this will worsen as communications becomes more sophisticated. It was even suggested that this may result in transactions moving offshore. It was noted that Australia's major trading partners have no such taxes and they put exporters at a disadvantage. The NSW Government's decision to grant a Boston-based investment bank an exemption from FID/DT liability was cited as an example of the competitive disadvantage imposed by these taxes.

4.57 The matter of compliance costs was also raised. There are eight tax jurisdictions, thirty pieces of legislation and differing rates of FID and DT.<sup>24</sup>

4.58 The ABA advised the Committee that, according to their research, the impact of FID and DT is borne primarily by households, particularly low income households and families.

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20 Evidence p. S16.

21 Evidence p. 130.

22 Evidence p. S 67.

23 Evidence p. S161.

24 Evidence pp. S161-164.

4.59 The Committee has requested additional material from the ABA on the impact of these taxes, compliance costs and the total value of deposits into the banking system which relate to these taxes. The Committee is concerned about the issues raised by the ABA and when the additional information requested is received, the Committee will further examine the concerns raised by the ABA.

### **Council of Financial Supervisors**

4.60 The Committee has a long standing interest in the role of the Council of Financial Supervisors. The Council is comprised of the Reserve Bank, which chairs the Council; the Insurance and Superannuation Commission; the Australian Securities Commission; and the Australian Financial Institutions Commission. The aims of the Council are:

- *facilitating exchanges of information bearing on the efficiency and health of the financial system;*
- *assisting each supervisor to be aware of, and to understand, developments in parts of the financial system outside his particular area of responsibility;*
- *identifying important issues and trends in the development of the financial system as a whole; and*
- *avoiding unintended gaps, duplication or inconsistencies in regulation.*<sup>25</sup>

4.61 The Committee's concern has been, and still is, that Australia's regulatory framework continues to ensure the stability and reliability of the financial system. There have been suggestions recently that the continued growth of financial conglomerates may lead to a need for a fundamental reconsideration of the supervisory framework. The Council itself is of the view that such a change is unnecessary.<sup>26</sup>

4.62 This matter was taken up with the RBA. The Governor expressed the view that current arrangements are functioning effectively and that the Council is 'keeping up with the extent of diversity in the financial system'.<sup>27</sup> The Committee was also advised that the activities of institutions were still fairly clear cut and current arrangements are appropriate but that as things change and institutions become more intertwined, it may be necessary for the Council to make its arrangements more formal than they are at present.

4.63 The role of the Council is important, as can be seen by the need for a coordinated approach to the derivatives issue. The Committee will continue to monitor the role and responsibilities of the Council.

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25 Council of Financial Supervisors, *op cit.*, p. 5.

26 *ibid.*, p. 7.

27 Evidence p. 39.

## CHAPTER FIVE

### CONCLUSION

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5.1 The review of the Reserve Bank of Australia's 1993-94 annual report is the second inquiry into matters arising from the RBA annual report. The Committee has continued this process as it considers the opportunity to oversight issues and developments in the banking industry to be an important development in the relationship between the central bank and the Parliament. This process also provides a valuable opportunity for continued parliamentary oversight of more general developments in the financial services industry. In addition, the Committee considers that an annual review provides an opportunity for the Committee to continue to pursue the interests of consumers of financial services.

5.2 As with the first review, the Committee canvassed a number of general matters related to the economy and monetary policy. This was not the primary focus of the review, however it did provide an opportunity to canvass matters of interest at the time of the public hearing. The Committee does not consider that many of these matters warrant coverage in this report as they were comprehensively reported in the media at the time of the public hearing and their relevance has declined over the period of time taken to conclude the review process.

5.3 Two matters canvassed by the Committee that are still of interest are inflation targeting and developments in housing finance. The Committee used the opportunity of this review to gain a better understanding of the reasoning behind the RBA's 2% to 3% inflation target and of the factors influencing the inflationary outlook. The points made by the RBA are still relevant and the observations on the difficulties both the banking industry and the community are experiencing in coming to grips with a low inflation environment are significant. The Governor demonstrated sound judgement in his comments on borrowing and lending on the expectation of rising house prices.

5.4 In relation to housing finance, the Committee was concerned over the use of prudential controls to restrict lending for housing where loan to valuation ratios exceed 80 per cent. The Committee accepted that measures taken for prudential purposes can also have a macro-economic objective. The concern that the Committee has with this measure is that it has the potential to penalise those in the community who are not able to save large deposits. It is not clear whether this was given due consideration when the decision was taken to alter the risk weighting for such lending.

5.5 While the review process has provided an opportunity generally to discuss monetary policy issues in a public forum, the Committee is of the view that there is an imbalance in parliamentary accountability on the development of monetary and fiscal policy. Increased emphasis will be placed on this aspect of the RBA's responsibilities in future reviews.

5.6 A central aspect of this review was the use of financial derivatives and in this regard the Committee sought the views of the Reserve Bank and the Insurance and Superannuation Commission. The Committee is satisfied that the RBA and the ISC are properly carrying out their responsibilities to ensure that the risks associated with the use of derivatives are properly

managed. The Committee does have some concern in relation to the use of derivatives by the superannuation industry. This concern stems from the less detailed supervision by the ISC and the fact that the proposed supervisory framework is yet to be finalised. The Committee will continue to monitor developments in relation to superannuation.

5.7 The Committee also concluded that the response by the various financial supervisors to this issue demonstrates the value of the Council of Financial Supervisors. It is becoming increasingly important to ensure coordination between supervisors. The role of the Council in dealing with issues which cross the increasingly artificial barriers between sectors of the financial services industry will continue to be monitored by the Committee.

5.8 The resolution of customer complaints was discussed with both the Reserve Bank and the Bankers' Association. This is a long standing issue and the Committee has concluded that it is now time to review the effectiveness of dispute resolution procedures, including the role played by the Australian Banking Industry Ombudsman Scheme. The Committee considers that the scope of the complaints that the Ombudsman can deal with is too restrictive and does not meet the legitimate needs of a great many customers. The Committee has also advocated the increased use of alternative dispute resolution mechanisms. This has been accepted by the banks and the Committee believes that it is time to have a closer look at the processes the banks have developed and the extent to which they are used.

5.9 The ABA raised a number of issues with the Committee which will be taken up in the course of the next review. In particular, the Committee will examine the proposal for retirement savings accounts and will also focus on the impact of the Financial Institutions Duty and the Debits Tax. The Committee is pleased that the ABA has used the review process to raise issues of concern to the banking industry and considers this to be an important aspect of the Committee's activities.

5.10 The Committee has sought further information related to small business and the impact of branch closures in rural Australia. Both of these matters will be pursued in the next review.

5.11 Members of the Committee have received numerous complaints regarding the closure of Australian banking operations in Asia. The Committee is disappointed at the apparent lack of interest the banking industry has shown in becoming involved in the provision of banking services in Asia and this view is supported by the RBA. The ABA does not believe this to be a problem and has assured the Committee that all banks have strategies for increasing their business in Asia. The Committee will be pleased to obtain more details on those plans at our next round of hearings.

5.12 Finally, the Committee has not sought to pursue the issue of interest rate margins and fees and charges in this review. The reason for that was the fact that the Prices Surveillance Authority was conducting its inquiry into fees and charges and the Committee did not wish to impede that process. The Committee expects these matters to be a major focus of the next review.

5.13 There were a number of matters which the Committee raised with the Australian Bankers' Association after the last public hearing. The response to those matters was received too late for the Committee to consider as part of this report. The response has been published as a submission and will be considered in the next review.

5.14 The review of matters arising from the Reserve Bank's 1994-95 annual report will commence in October and, in addition to following up matters raised in this report, the Committee will be ensuring that there is continued public discussion of developments in the banking industry and continued parliamentary oversight of the RBA.

THE HON DAVID SIMMONS MP

Chairman

18 September 1995



## Appendix 1

### List of submissions

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No.	Name of person/organisation
1	Reserve Bank of Australia
2	Reserve Bank of Australia
3	Reserve Bank of Australia
4	Australian Bankers' Association
5	Insurance and Superannuation Commission
6	Australian Bankers' Association





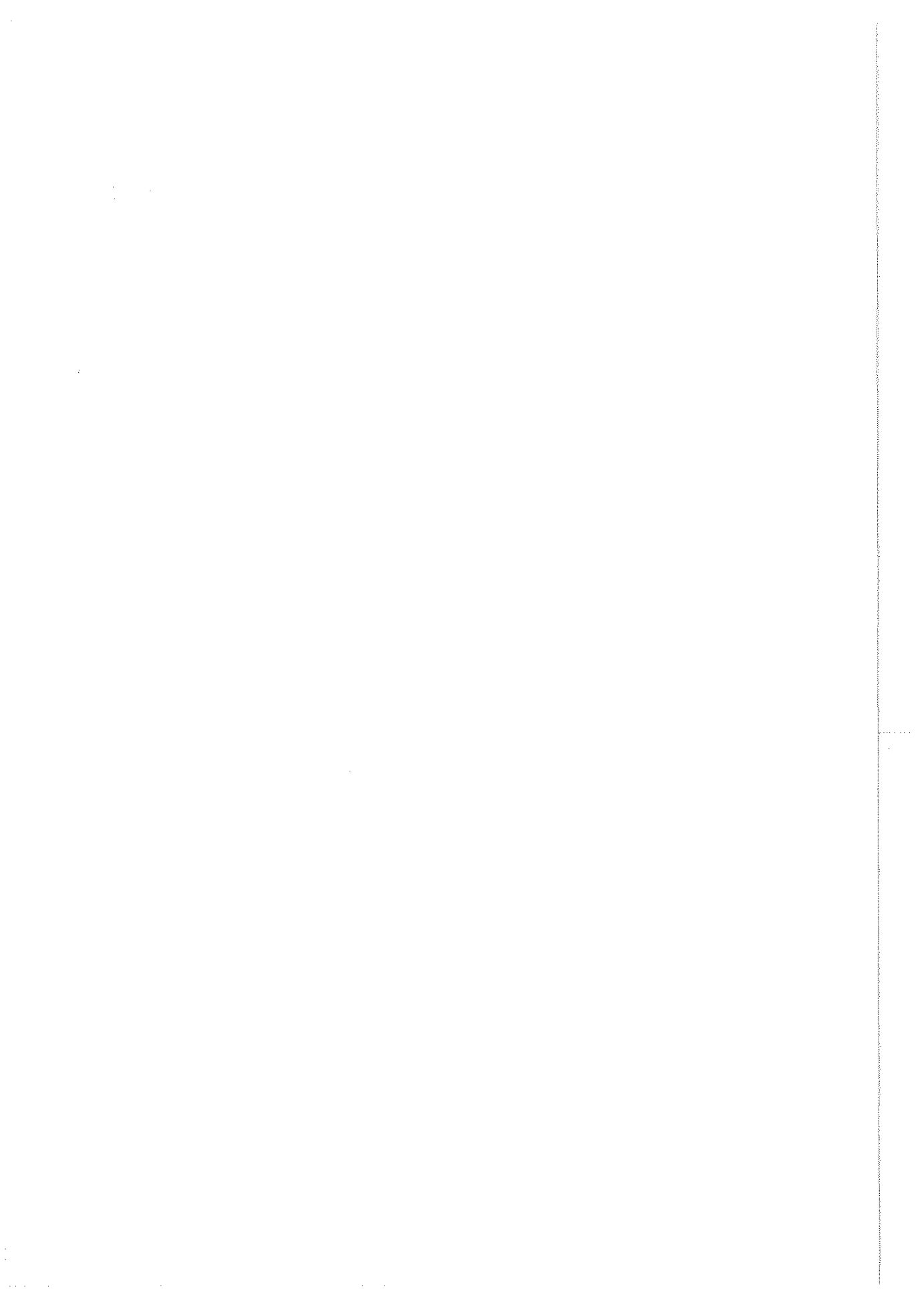
## Appendix 2

### Program of activities undertaken by the Committee

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#### Public hearings

Canberra	19 October 1994
Sydney	20 April 1995
Canberra	1 June 1995
Canberra	26 June 1995



## Appendix 3

## List of witnesses appearing at public hearings

Witness/organisation	Date/s of appearance
<b>Reserve Bank of Australia</b>	
Mr Bernie Fraser Governor Reserve Bank of Australia	19 October 1994 20 April 1995
Mr Ian Macfarlane Deputy Governor Reserve Bank of Australia	19 October 1994
Mr Graeme Thompson Deputy Governor Reserve Bank of Australia	19 October 1994 20 April 1995
Mr Leslie Austin Assistant Governor Reserve Bank of Australia	20 April 1995
<b>Insurance and Superannuation Commission</b>	
Mr Frederick Pooley Commissioner Insurance and Superannuation Commission	1 June 1995
Mr Michael Burt Actuary Office of the Australian Government Actuary	1 June 1995
Mr Thomas Karp First Assistant Commissioner Insurance and Superannuation Commission	1 June 1995
Mr Eric Chalmers Assistant Commissioner Insurance and Superannuation Commission	1 June 1995
Mr Keith Chapman Assistant Commissioner Insurance and Superannuation Commission	1 June 1995

**Australian Bankers' Association**

Mr Alan Cullen  
Executive Director  
Australian Bankers' Association

26 June 1995

Mr Paul McCarthy  
Chairman  
Executive Committee  
Australian Bankers' Association

26 June 1995



