



OPINION PIECE

Markets Central to the Financial System Inquiry

By David Lynch

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It is widely accepted that efficient and well-managed financial markets are central to a competitive economy. What is not so obvious to many is that our economic prosperity will depend even more on financial markets in the future, as landmark regulatory and economic change takes effect. Senior regulators and industry figures are alive to this issue and have pointed out that structural change in the financial system is pushing towards greater reliance on market-based financing as a source for funding our economic growth.

This should give the Treasurer, Joe Hockey, food for thought as he contemplates the promised financial system inquiry, because he needs to design a terms of reference that will enable it to draw out these issues and the measures required to ensure our markets are up to meeting this challenge.

The good news is that the recent report card on Australia's financial markets for 2013 released by the Australian Financial Markets Association shows that markets are performing solidly and contributing to the competitiveness and stability of the Australian economy. Turnover across Australia's exchange and over-the-counter markets grew by 5 per cent in 2012/13 and more than A\$100 billion in long term finance was readily raised on the markets for Australian companies and governments.

Financial markets both complement and compete with financial institutions. While they provide a venue for lenders to raise finance and manage risk, they also provide competition within the financial system by providing an alternative source of finance for Australian companies. Similarly, financial markets provide investment diversification opportunities for savers and essential tools to manage risk.

Competition drives down the cost of financial services and, more importantly, the amount of economic resources that they tie up, which is a litmus test for the effectiveness of the financial system. This was demonstrated vividly in the mid-1990s, when the wholesale markets funded mortgage originators who brought down margins on housing loans by more than two percentage points.

The challenge for the Financial System Inquiry is to place the financial system in a position whereby it can generate these benefits going forward. The first step will be to understand how policy should adjust to ensure the financial system responds effectively to economic factors such as demographic

change, increased domestic savings, the infrastructure deficit, productivity under-performance and China's economic rise, which are shaping the future financial needs of Australians.

The impact of change within the financial system itself also needs to be considered. In particular, the banking system has become more concentrated post-global financial crisis and new global bank regulation reduces the capacity of the banking system to provide credit required for investment and economic growth in the future. Funds in superannuation meanwhile are expected to double in size to \$3 trillion by the end of the decade. Against this backdrop, the case for a deeper more vibrant domestic corporate bond market has never been stronger, as it can provide an outlet for growing superannuation savings and help to meet our economic growth financing needs.

The Financial System Inquiry is well-timed as we need to check the capacity of the financial system to meet the needs of businesses and households in a time of significant change. The inquiry needs to be forward looking by anticipating the financial services required to support our economy and by identifying the features of a financial system that will meet these needs in the most effective and lowest cost way. A broad-based inquiry that encompasses all facets of the financial system including institutions, markets and infrastructure is the only way to achieve this.

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