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The Changing Nature of Financial Services

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The topic for discussion today is "The Changing Nature of Financial Services". Financial services in one form or another have been provided for centuries so that it is not surprising that they have been subject to many changes over time. You will be relieved to know that I do not propose to discuss changes over the centuries. I will address relatively contemporary influences and changes.

Of course history is important. In a dynamic industry such as financial services it is important to learn from past experience when dealing with contemporary conditions and the changes needed to accommodate them. The basic reasons for the existence of financial services have not changed at all over the centuries. What has changed is the way in which those financial services are packaged and delivered and, more recently, the way that new channels of communication of information have impacted on finance markets.

I propose to deal with these changes from a New Zealand perspective. This does not mean that the New Zealand experience is necessarily different from Australia or from anywhere else in the world. As you are all aware international influences play a large part in the way in which local markets operate and develop. That it probably more true of small markets such as New Zealand. Where there is high use by the public of electronic communication such as the Internet, as is the case in New Zealand, customer expectations about availability of product and levels of service are raised. Local markets must adapt quickly to those world trends if they are to remain competitive. Conversely small, active and efficient markets often develop new products and new methods of delivery of those products more quickly and easily than larger markets. Small markets often lead the world in developing innovation, particularly in industries such as the financial services industries which rely heavily on electronic processing and communication. From the New Zealand perspective changes to the nature of financial services have been influenced by various factors, some purely local and unique to New Zealand, others reflecting world wide trends and influences.

A local influence has been a dramatic change in the political and monetary environment in New Zealand since the early 1980s. In a very short time New Zealand went from one of the most highly regulated and constrained economies to one of the most open and competitive. This change was particularly apparent in the banking and financial services industry. The reaction to changes in the business environment did produce some indigestion in the financial services industry for a period.

Deregulation has also taken place in other countries. This has allowed a trend towards full financial diversification. We now have the combination of commercial bank, investment bank, insurance business, securities broker and mutual fund manager and distributor under one ownership vehicle. Regulators are having to respond to these changes and those regulatory requirements themselves have an impact on the way in which the financial services business is carried on.

Another influence on change is the manner in which the use of technology has impacted on the financial services industry. There is no sign that the extent and pace of change in this area will abate. In future financial products will become more customised and more complex and will be distributed in different ways. The speed of innovative change will accelerate. Customers and clients will have access to increasing amounts of information upon which judgements will be made about investment decisions.

This increased access to information will give rise to heightened customer expectations. Increased global competition will encourage customers to make changes of brand and changes in loyalty to service providers. Loyalty in the competitive market will increasingly have to be earned or bought.

Globalisation of financial markets is a fact of life. National borders are irrelevant in the provision and uptake of financial services provided through electronic communication. That is not to say that there is true globalisation. There are still serious problems in cross-border trade and in the provision cross-border of services. These include the interpretation of rights of parties to transactions, which jurisdiction's law applies and how in the end legal rights or obligations can be enforced and by whom. Regulatory bodies and governments are moving to harmonise laws or at least to provide recognition of acceptable legislative or regulatory rules of other jurisdictions for local purposes. In particular the New Zealand experience is influenced increasingly by the provisions of the CER arrangements with Australia.

The environment in which the New Zealand financial services industry has operated over the last 20 years has changed dramatically. By the early 1980s the banking sector comprised a small number of commercial banks (4 in 1984) and a number of savings banks which offered a more limited range of banking services. In the early 1980s banks and other financial service providers were subject to a wide range of controls over their operations. Deposit rates were fixed by regulation, interest rates on unsecured loans were also fixed by regulation, banks and other institutions were required to invest designated proportions of their funds in different classes of assets including Government loans, housing loans and other specified sectors. Expansion of business was limited to specified percentage increases over assets held at the end of a previous period. Extensive exchange control restrictions were in place so that cross-border competition was virtually impossible. As a result of these restrictions there was little scope for effective competition within the banking sector and not much financial innovation occurred.

However strong competition arose from outside the banking sector. That competition was driven by finding innovative ways to comply with the rigid regulations. These ideas allowed expansion of the financial services while still observing at least the letter of the regulation but often to the detriment of the quality of the product. Once these non-banking organisations captured more of the market, they demanded more access to previously limited licensed areas such as foreign exchange dealing. As the non-banks moved into these areas the distinction between banks and non-banks became blurred.

By the mid 1980s the financial sector reforms in New Zealand swept away all interest rate controls, all ratio requirements and all exchange controls. This introduced much more vigorous domestic competition within the financial sector and also opened the door to the emergence of more active foreign competition. By the late 1980s 21 new banks had been approved.

The opening up of the financial markets coincided with major economic reforms including the floating of the exchange rate, the establishment of new monetary policy frameworks and public sector reform. The Government decided also to withdraw from any direct involvement in the banking sector leading to the sale of the Post Office Savings Bank and in 1992 the Bank of New Zealand.

The sudden opening up of the economy to competitive pressures and the loosening of all financial sector restraints gave rise to some excesses in the business and financial community. There were a significant number of business failures and pressures on banks and financial services providers, many of which were not well prepared to cope with the new freedom and did not have appropriate management skills or risk management practices in place. In some cases they entered into the new era with unsatisfactory portfolio structures and low quality assets as a consequence of the previous regulations.

In parallel with the opening of the market to new banks the Reserve Bank took some steps into formal bank supervision in 1987.

Securities market regulation had in fact been contemplated in an earlier period and the Securities Act 1978 emerged as a result of some very dubious practices which had emerged in the 1970s mainly in the non-bank sector. Other regulatory initiatives included a revamped Companies Act imposing more formalised duties on directors and requiring greater accountability. That accountability for directors of banks in particular now extends to responsibility for the accuracy of quarterly financial disclosure statements required by New Zealand law.

New Zealand has now one of the world's most open and competitive economies. It compares well with Australia. However it is important to note that this situation has been achieved in a relatively short time from a highly regulated and directed economy.

New Zealand has followed the global trends of diversification exemplified by the creation of mega institutions such as Citigroup. A wide range of different products and services can be offered within the one ownership structure. This has been reflected in New Zealand. The acquisition by the Commonwealth Bank of Australia of Colonial is an example of this move. The ASB Group, 75% owned by CBA at the beginning of 2000 included a major insurance company Sovereign Assurance. CBA now owns 100% of ASB and is merging Sovereign with Colonial. ASB is a strong example of a strategy which combines traditional banking services with wealth management services. The move to offer a wide range of financial and brokerage services is seen in the other banks as well. This movement may be influenced in New Zealand by the increasing pressure put on interest margins in the retail sector as noted in the recent KPMG Financial Institutions Performance Survey 2001.

A driver for change in all developed countries is the speed and efficiency of processing data made possible by developments in technology.

I will not dwell too much on changes in processing. Obviously use of computers and electronic communication generally has speeded processing to a point where especially in financial transactions processing can be carried out in real time. This has obvious advantages for both providers of services and their customers in reducing credit risks (or at least those that arise through delay in processing), improving cash flows and in increased efficiency in reducing errors in processing.

The ability to process information at a distance does have implications for financial service providers in small jurisdictions. Increasingly back office processes become centralised and, as noticed in the KPMG Financial Institutions Performance Survey for 2001, wholesale banking and processing and settlement functions are tending to be centralised in an Australian back office hub. Of course this trend is not unique to the financial services industry. Broking firms are increasingly basing advisory and processing functions in larger hubs more often than not in Australia.

The financial services industry is uniquely positioned to take the maximum benefit from the use of electronic processing. Electronic banking has the facility to substitute electronically stored data for what would otherwise be a physical product such as gold, notes, coin or like items. Not only is the product itself reduced to information stored electronically but computers, telephones and other electronic communication have revolutionised the way in which that information can be dealt with. The processing of transactions can now be carried out electronically with a minimum of input from personnel or from physical movement. Processing can be carried out from a remote terminal (which may be a telephone, for example).

Of even more importance in recent times has been the manner in which the customer can be linked directly to the process. Bank customers now have direct electronic access to and can control the financial assets and liabilities held by the bank for that customer. The requirement to have premises in which business is conducted becomes much less important to providers of services as the use of paper and paper-based transactions diminishes and customers are able to deal remotely with the service provider.

The operation of an efficient electronic transfer system requires the provision of an intermediary trusted by all of the parties to the transaction. That is an important intermediary role that can be played by banks.

The efficiency of the electronic transfer system depends also to a large extent on the ability of all parties to the transaction to connect at the same time. New Zealand has one great advantage in the expansion of electronic banking. There has been, since the early 1970s, a centralised processing point for the trading bank system to which all the major trading banks belong. This centralised system provided the means by which centralised ATM and EFTPOS systems have developed. All the major banks have cooperated and participated in ensuring the maximum number of access points common to all customers to this centralised system. Customers of one bank can use ATMs provided by other banks. Retailers installing EFTPOS terminals need install one terminal only. These terminals accept the cards issued by all banks eliminating the need for multiple EFTPOS terminals to be held by retailers in order to provide electronic payment options for all customers. It is even possible for organisations that are not banks and that do not own any terminals to issue cards themselves.

As I have earlier said, EFTPOS, ATMs and telephone banking are now well entrenched means for customers to carry out financial transactions without visiting bank premises. More latterly the major banks have instituted Internet banking. However EFTPOS continues to be the most popular means of payment and the number and value of EFTPOS transactions continues to grow. According to the KPMG's Financial Institutions Performance Survey for 2001, EFTPOS transactions carried out in the year 2000 reached 464 million up from 450 million in 1999. These transactions have a total value of $23.8 billion compared to $20.7 billion in 1999.

The number of available ATM machines increased as did the use of credit cards and telephone banking continues to be an accepted means of carrying out routine banking transactions. According to the KPMG report the major banks report that between 23% and 55% of their retail customers now use telephone banking services.

It is not just the fact that a centralised system is available for EFTPOS which explains the increasing use of this non-cash payment method. Banks themselves offer incentives by way of lower transaction fees for the use of EFTPOS. For merchants the instant confirmation of the availability of customer funds eliminates the risk of being presented with subsequently dishonoured cheques. Immediate real time transfer of funds offer significant cash flow advantages and transaction costs compare favourably with charges levied by credit card companies on the transaction value. There is also significant demand from customers for EFTPOS facilities. Customers can combine their purchasing actions with cash withdrawals saving both time and the additional ATM or teller transaction costs.

The increased use of electronic communication with customers and particularly the use of EFTPOS marks a change in the manner in which banks and merchants view their customer bases in terms of the provision of financial services. An example of this is the ability of customers to access cash as part of a purchase transaction at supermarkets, petrol stations and other retail outlets. The challenge for any provider of goods or services is to obtain the best possible value out of an existing customer base. Banks of course achieve this by offering a wider range of banking and financial services. Banks in New Zealand now routinely provide investment advice, life insurance products, unit trust and collective investment schemes and broking services in addition to banking services.

On the other hand retailers with customer bases are considering offering banking services to customers. Already it is common to obtain cash as part of a purchase transaction. In

March 2001 The Warehouse announced that it intended to offer banking services to customers of The Warehouse. No details of the extent of those services has yet been provided. It is significant that The Warehouse already provides a branded store credit card and will be able to offer the designated banking services through the chain's 74 outlets.

Also earlier this year the Government has announced that it has approved New Zealand Post, a State-owned enterprise, establishing a banking subsidiary. While some of the reason for establishment of a new bank is a perception of dissatisfaction with high bank fees and high bank profits, one of the attractions for New Zealand Post must be its nationwide network of about 320 outlets and a huge customer base.

The announcements from The Warehouse and New Zealand Post do point to the value of an existing customer base especially where financial services not requiring significant physical assets can be provided as an add-on to existing transactions.

Customer expectations also drive changes in the provision of financial services. The KPMG Financial Institutions Performance Survey 2001 noted particularly that "*during 2000 the banks have put a renewed focus on customer satisfaction. This has in part been necessary as the banks have introduced new fees that have not been well received by customers such as ATM interchange fees and honour fees. More importantly customer service has become a point of differentiation*". The report also notes that in spite of the increase in use of electronic banking and a further reduction in the total number of bank branches, that trend of declining branch numbers does not mean that the value of the branch has been forgotten in the push to adopt new distribution strategies. While technology-based channels may be more effective in meeting customers' routine transactional banking needs there is still a high value placed on quality financial advice and personal service. It is notable that the announced new entrants into the bank market in New Zealand namely The Warehouse and New Zealand Post already have strong branch distribution outlets available. In order to counter the entry of other organisations with strong branch networks it is possible that banks in the future might seek to make more use of the physical presence via the branch. Banks are providing a variety of financial services including funds management, life insurance, some broking and other fee earning activities a number of which depend on face to face contact with the customer. This contact does not necessarily have to be provided in bank premises or by bank staff. The contact may be supplied by brokers or other intermediaries.

On the other hand, for routine banking transactions the customers appear to be moving more to a cashless society with increasing reliance on EFTPOS, Internet banking and telephone banking.

Customer expectations will also be driven by customers' ability to easily access alternative means of obtaining financial services. While use of the Internet can facilitate transactions between service providers and existing customers those same customers can quickly and easily access information from competitive sources. The same electronic communications allow for quick and easy change of service provider where advantages to the customer are seen. The heightened competition created from the availability of a wider range of information will continue to be a factor in the provision of financial services.

I had intended to talk about the effect of the globalisation on the provision of financial services. I note there is a separate session on globalisation so I will touch only very briefly on this topic this morning.

various moves to ensure good regulatory practice on a global basis including the formation of the Financial Stability Forum and the carrying out of Financial Sector Assessment Programmes by international financial institutions. These programmes include amongst other things the extent to which different jurisdictions comply with acceptable regulatory principles in the financial and securities markets.

While in banking there is an ongoing iteration of the Basle principles, in the securities markets the International Organisation of Securities Commissions has adopted 30 Objectives and Principles of good regulation. These have been recognised by the international financial institutions as the basis for assessment for the purposes of the Financial Sector Assessment Programme.

The existence of such internationally widely supported rules imposes pressure on jurisdictions to comply with these principles. Lack of compliance may result in the institutions in those jurisdictions being downgraded for purposes of capital risk assessment for bankers. There will be demands for higher risk premiums by investors where securities market regulation does not accord with those world wide principles.

As jurisdictions adopt these principles and objectives the organisations doing business within them will have to comply with different regimes and ways of doing business. Recent examples include the adoption by many jurisdictions of accounting practices and principles promulgated by the International Accountants Society either directly or with modifications necessary to the particular requirements of that jurisdiction. For example, the way in which accounting for financial instruments is dictated internationally can mean different demands on banks by customers who use financial instruments. This can place new or different demands on financial institutions. The same type of thing can be seen in the Basle committee's proposal for different capital risk weightings for banks holding securities of organisations, depending on whether those organisations were within a jurisdiction that complied with the IOSCO Principles of good securities market regulation.

It has been suggested that I should address some trans-Tasman issues in the context of the provision of financial services.

The relationship between Australia and New Zealand is extremely important. New Zealand has a small population and is geographically isolated. Australia is New Zealand's largest trading partner. Quite apart from trading relationships there are the similarities in lifestyles and cultures. There are at present over 300,000 New Zealanders living in Australia and 50,000 Australians who are resident in New Zealand. Well over one million Australians and New Zealanders cross the Tasman in short term visits each year. New Zealand in turn is Australia's largest market for manufactured exports.

It is not surprising that as a result of these relationships there should be moves to facilitate trade in goods and services between the two countries.

In 1982 the governments of Australia and New Zealand signed the Australia and New Zealand Closer Economic Relations Trade Agreement (ANZCERTA or CER for short).

Complete free trade in goods was achieved five years ahead of schedule on 1 July 1990.

New Zealand and Australia are progressively broadening and deepening coordination of their respective legal frameworks for business. This covers not just trade in goods but in the provision of services including financial services.

As part of the process the respective governments signed a Memorandum of Understanding ("MOU") on business law harmonisation in 1988 and a further MOU on business law coordination was signed last year. It is intended to refocus and revitalise the process of integrating two countries' business laws.

The main differences between the 1988 and 2000 memoranda of understanding are that:

- The 2000 MOU establishes a clear and ambitious goal "*that in any given situation a firm will only have to comply with one set of rules and will have certainty as to how those rules will apply and will only have to deal with one regulator*";
- The 1988 MOU established harmonisation as the goal whereas the 2000 MOU acknowledged that there were a range of different approaches to coordinating laws that included harmonisation but also mutual recognition;
- The 2000 MOU establishes a targeted work programme for both countries.

The work programme has particular significance for financial services providers. Included in the programme are the following objectives:

- Seeking to achieve greater compatibility in our disclosure regimes for financial products;
- Managing cross-border insolvency;

Australia for revisiting the CLERP reforms in the immediate future. This means that in some cases the initiative will lie with New Zealand to coordinate. However the converse applies. For example, New Zealand has recently introduced a new comprehensive personal property securities law based on United States and Canadian laws. Should Australia decide to go down this path New Zealand reformers would certainly expect it would look across the Tasman to see what the experience has been in that country.

The fact is that New Zealand and Australia as foreshadowed in the CER Agreement are becoming one market. This is why regulatory cooperation is important. It is economically inefficient in a single market to have different sets of laws that impose significant transaction and compliance costs on business. It is also particularly important to ensure that the law works effectively in relation to transactions that cross national borders in the interests of consumers and investors and the overall integrity of the markets.

The implementation of CER will certainly have an ongoing effect on the changing nature of financial services.

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