SECTION 1

BACKGROUND

Background

1.1 Introduction

National Mutual welcomes the Wallis Inquiry and in particular its broad terms of reference. These allow the Board of Inquiry to fully examine the issues of major strategic importance to the Australian financial services industry and, most importantly, the consumers it serves.

The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980's. The forces driving further change are to be analysed, in particular technological developments. Recommendations will then be made on the nature of regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness. National Mutual submits that improving the international competitiveness of the Australian financial system for the benefit of consumers is of overriding importance for the Inquiry.

The Inquiry is timely in view of major and rapidly accelerating changes in the finance sector since the Campbell Inquiry some 15 years ago. The rate of change is such that we expect that a 'Grandaughter of Campbell Inquiry' will be required in substantially less than 15 years time unless the future regulatory structure is sufficiently flexible to accommodate change while continuing to ensure the stability and soundness of the financial system and protecting consumers' interests and needs.

It is encouraging that the Inquiry is being held at a time when many of Australia's financial institutions are enjoying strong balance sheet growth and high capital ratios and in an environment of overall financial stability. However, increasing globalisation of the industry is heightening competitive pressure and financial institutions in Australia must be prepared to take up the challenges this presents. This Inquiry represents an excellent opportunity to build on the current position of strength to develop an internationally competitive financial system.

Above all, however, this Inquiry is about the consumer, ranging from large corporate and government bodies to individuals and their families. It must ensure that consumers continue to be appropriately protected whilst receiving diversity of choice to meet their increasingly complex financial needs. The regulatory structure that arises following this Inquiry must therefore embrace innovations driven by emerging technologies and concepts, and ensure that these are directed towards the ultimate benefit of consumers. The Inquiry must also facilitate an appropriate level of healthy competition in the market to ensure that consumers receive the best possible service and price for financial products and to encourage Australian financial companies to become competitive on a global scale.

These are enormous challenges, but should be welcomed. We are confident that the Inquiry will be visionary in its outlook, pushing beyond the traditional boundaries of the financial system. In the words of the Federal Treasurer The Honourable Peter Costello, MP:

"This, I believe, will be a changing experience for Australia and for its financial system. This, I believe, will lead to enormous changes for the better which will shape the future of our economy and our financial system for decades. We can, I believe, get it right and I think we have an opportunity to do it better than anywhere else in the world. And, if we can do it better than anywhere else in the world it is an opportunity for us to become a financial centre, not just for Australia but for the region and beyond." [1]

[1] COSTELLO, Peter The Honourable MP, Treasurer. Transcript: Press Conference, Thursday, 30 May 1996.

It is important, that in looking forward the Inquiry recognises the many positive features of the Australian financial system and its regulatory structure which has served consumers particularly well over the last 15 years since the Campbell Inquiry. Indeed, in many respects our financial system has out-performed those of our significant international competitors, and whilst there have clearly been some failures the financial incidents experienced elsewhere, for example in the Nordic, Japanese and US banking systems, have not been mirrored here.

Whilst the relatively short time frame set for the Inquiry adds to the challenge, it reflects the rate of change in 1996 compared to that when the Campbell Inquiry began. In the context of today's rapidly changing financial markets and the need to make the Australian financial system competitive on an international scale, the luxury of leisurely debate cannot be afforded.

1.2 National Mutual

The challenge for this Inquiry does not rest with its Board and Secretariat alone. It is beholden on all participants in the industry to contribute positively to the development of a world class Australian financial system.

National Mutual is one of Australia's oldest, largest and best known financial institutions. It started life on 12 August 1869, with the incorporation of The National Mutual Life Association of Australasia Limited. Its operations currently include a full range of life, health and disability insurance products, as well as superannuation and investment products, funds management and lending.

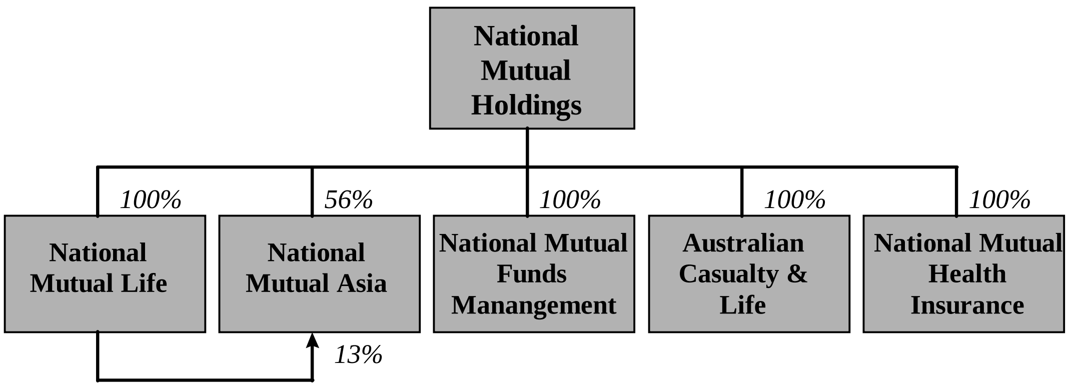
National Mutual is a major player in the financial sector, not just in Australia but in the wider Asia Pacific Region. It has approximately 3 million policyholders and clients in Australia, New Zealand and Hong Kong, more than 800,000 health insurance customers in Australia and New Zealand and employs nearly 5,000 staff and 4,700 agents. National Mutual owns or manages almost A$27 billion of assets on behalf of its policyholders and clients.

National Mutual's principal operating businesses, National Mutual Life, Australian Casualty and Life, National Mutual Health and National Mutual Funds Management are ranked second, first, third and fourth in their respective Australian markets. National Mutual's Hong Kong subsidiary National Mutual Asia is ranked second in that market.

Figure 1.1 shows National Mutual's principal operating businesses and investment.

Figure 1.1

National Mutual's Principal Operating Businesses and Investment



National Mutual Life is one of the largest providers of life insurance in Australia and New Zealand. The company insures over 1 million policyholders in Australia, representing over 5% of the Australian population, and 250,000 policyholders in New Zealand, representing over 7% of the New Zealand population. Its principal products include traditional life, specialist risk, annuities, savings products, financial planning and retail investment products.

National Mutual Asia is the largest listed insurance company and the second largest life insurance company in Hong Kong and Macau. It has in force over 800,000 life insurance policies and employs 480 staff and 2,500 agents. Its main products include traditional life and savings products with health insurance benefits, as well as general insurance.

National Mutual Funds Management manages approximately A$23 billion in assets. It provides asset management services to the National Mutual Group and wholesale funds management to third party clients, including superannuation funds, governments and companies. It also provides a range of listed and unlisted investment vehicles and mortgages to retail clients.

Australian Casualty and Life is a specialist risk insurer providing income protection, term and trauma insurance. It is Australia's leading provider of income protection insurance. Together with National Mutual Life, Australian Casualty and Life is the leading provider of specialist risk insurance in Australia, with a combined market share of 37% in group specialist risk insurance and 29% in individual income protection.

National Mutual Health Insurance provides health insurance and related services to more than 800,000 individuals and 3,000 corporations in Australia and New Zealand. It employs 840 staff. The business trades as HBA in Victoria where is has a 32% market share and Mutual Community in South Australia where it has a 60% market share.

National Mutual is part of the AXA Group, the world's eleventh largest insurance group in terms of 1994 world wide revenues. AXA's operations are diverse, ranging from life insurance, general insurance and reinsurance to related financial services, including asset management, investment banking, securities trading, brokerage and real estate.

AXA and National Mutual believe that to be successful in the emerging global market place for financial services, the Group must be large and global with economic power through access to significant capital and global networks.

In 1995 AXA generated worldwide revenues of US$28.8 billion (A$38.7 billion), insurance and reinsurance premiums of US$22.6 billion (A$30.4 billion) and managed assets of US$275 billion (A$370 billion). Its operations span more than 20 countries in three key regions: North America, Western Europe and Asia Pacific. AXA and its subsidiaries hold significant positions in the US, French, Canadian, Hong Kong, Australian, United Kingdom and New Zealand markets.

National Mutual is the regional base for the combined life insurance businesses of National Mutual and AXA in the Asia Pacific region. It has a major presence in Hong Kong and Macau through National Mutual Asia, and has start-up operations in Indonesia and Taiwan. National Mutual manages AXA's life insurance operations in Japan, South Korea and Singapore. It has also applied for life insurance licences in Thailand and the Peoples' Republic of China, where it has representative offices in Beijing, Shanghai and Guangzhou. AXA/National Mutual is the second most widely represented life insurance Group in the Asia Pacific region.

National Mutual was the first major life insurance company to demutualise in Australia, setting a trend that others are expected to follow. It is also in the process of listing on the Australian and New Zealand stock exchanges, which will make it the largest listed insurance company on these exchanges and one of Australia's largest listed financial institutions. National Mutual therefore looks to the future with new corporate and operational structures, and as part of a truly global group which is setting the pace of change in the emerging global market.

1.3 Conclusion

As a major participant in the Australian financial system and as part of a global financial group, National Mutual has a significant interest in the work of this Inquiry. We would therefore be pleased to discuss with the Inquiry any aspect of our submission and/or provide supplementary material as required. Moreover we would be pleased to conduct further research along lines we have already considered in the context of this submission at the Inquiry's instruction.

SECTION 2

THE AUSTRALIAN FINANCIAL SYSTEM

The Australian Financial System

2.1 Introduction

The terms of reference for the Wallis Inquiry seek recommendations on the nature of regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.[2] The ability to make such recommendations depends on a clear understanding of the scope of the Australian financial system and the current regulatory structure.

[2] COSTELLO, Peter, The Honourable MP, Treasurer. Financial System Inquiry Terms of Reference 30 May 1996. The Inquiry terms of reference are provided in full in Appendix 1.1.

2.2 The Australian financial services industry from the consumers' perspective

The following discussion of the scope of the Australian financial services industry is based on consumer needs and the ways in which these are met by the industry.

Financial services consumers are frequently divided into wholesale and retail consumers. The former comprise large corporate and government bodies, which in general are deemed to be financially sophisticated and in a position of sufficient power to ensure they receive appropriate advice and service in relation to their financial needs. Retail consumers comprise individuals and small to medium businesses. They rely heavily on regulation to ensure the protection of their rights and their money.

2.2.1 Consumer needs

National Mutual's research shows that consumers see only one financial services industry, albeit with differing products to meet different financial needs. They tend to list these needs under five broad headings:

- transactions and cashflow management;
- borrowing;
- savings and investment;
- risk protection, including life, general and health insurance; and
- information and advice on the above.

From the consumer's perspective, all financial products and services fit within these categories, although the boundaries are frequently blurred and many products meet more than one need. The blurring is particularly marked in products and services for wholesale consumers. With such products the range is very large and products are frequently tailored to suit specific organisations. They are also often available directly from another wholesale consumer without any involvement by an intermediary institution.

The inclusion of risk protection in the definition is crucial. Consumers see life, general and health insurance as integral to their financial needs and hence to the financial services industry. The importance of including risk protection in any analysis of the industry is indicated by the fact that financial planners need to assess the risk protection needs of clients before addressing their investment or savings options. This priority has been emphasised in the United States of late, where financial planners are now concerned to avoid possible legal action by clients whom they failed to advise on the need for risk insurance before selling savings and investment products to them.

The individual consumer's viewpoint on risk exposure is most clearly illustrated when the reasons for savings and investment plans are examined. The purpose of such plans is varied - to meet the risk of a 'rainy day', to save for a home or other purchase, to meet the need for an income on retirement, and so on. Whatever the purpose, it is of little value if the opportunity to save is cut short by the death or disablement of the main family income earner, the loss of house or possessions through fire or theft, or exposure to unexpected medical expenses. Consumers are aware of this, and see the need to minimise financial risk as part of their full range of financial needs.

2.2.2 *Consumers' perceptions of the industry*

Interestingly consumers' perception of the financial services industry tends to be linked to function - that is, the nature of the product and the risk - rather than type of institution. This can be demonstrated by breaking down the needs described above into the broad product groups recognised by consumers. This is not a complete listing of financial products and services (particularly wholesale products), but an outline of available products and services grouped as consumers see them.

Transactions and cashflow management

- Transaction facilities and access to the payments system including cheque facilities, electronic transfers, credit and debit cards, etc.
- Demand deposit facilities.
- Broking services which are provided without advice (ie insurance broking etc).

Borrowing

- Personal and mortgage loans.
- Small business borrowing.
- Corporate finance.
- Capital market instruments.

Savings and investment

We have included in this category all savings and investment products and services, other than demand deposits which, from a consumer's perspective, fit more appropriately with transactions and cashflow management. The nature of these products varies significantly and each is viewed in a number of ways by consumers. Examples of the ways in which consumers view savings and investment include:

- by term of investment, eg. short, medium and long term;
- by differentiating retirement from other saving purposes; and
- by type of risk, ie. capital guaranteed or investment linked, or by asset class.

Risk protection

- Life insurance.
- Non-life insurance.
- Health Insurance.

We have included health insurance in a consumer perspective of the financial services industry as we have found that consumers do not strongly differentiate it from other risk protection products. While regulation demands institutional differentiation between life, general and health insurance, there is clearly a high degree of similarity of products at the margin.

Even so, we recognise that the time allocated for this Inquiry is probably not sufficient for it to address regulatory issues relevant to the health insurance industry. Therefore, there are no specific recommendations relating to health insurance in this submission. Should the Inquiry wish to include health insurance in its considerations, we would be pleased to make a supplementary submission.

Information and advice

- Retail, sales and advice.
- Trustee and personal asset management services.
- Wholesale financial advice and services, including complex financial advice and services for corporations.
- Product information and disclosure requirements, etc.

2.2.3 Summary

For the purposes of this Inquiry, we propose that "**financial services"** include any mechanisms by which consumers satisfy their financial needs including: transactions, borrowing, investment and risk management and information and advice thereon. The "**financial services industry"** is consequently all individuals, partnerships and corporates, etc providing financial services.

2.3 Industry participants

Given the scope of the Australian financial system discussed above the following lists include the institutions, intermediaries and regulators which are actively participating in the industry. The institutions include:

2.3.1 Institutions

The groupings in the list below necessarily reflect a historical view of participation in the financial services industry. In particular, a list of this type does not recognise the corporate ownership structure of the industry and the fact that, consistent with the emergence of financial conglomerates, many institutions under a number of the categories listed below now fall under common ownerships. The institutions include:

- banks;
- building societies;
- authorised short-term money market dealers and foreign exchange dealers;
- credit unions;
- 'excluded Corporations' (institutions that can accept deposits through the issue of debentures without a trust deed or prospectus);
- special service providers (which provide financial intermediation services to member credit unions and building societies);
- finance companies;
- money market corporations (merchant banks);
- other non-bank intermediaries including pastoral finance companies, AIDC Ltd, co-operative housing societies, intra-group financiers;
- life insurance companies;
- superannuation funds and approved deposit funds (excluding those run by life insurance companies);
- public unit trust managers;
- listed investment companies;
- trustee companies;
- friendly societies;
- general insurance companies;
- investment managers;
- credit card issuers;
- health insurance funds;
- workers compensation insurance providers; and
- other state regulated bodies (such as funeral funds, etc).

Telecommunications companies, computer network service providers and other new players are seeking to join the industry. Many already provide the communication systems that enable financial services providers and their customers to interact.

Appendix 2.1 provides a brief description of the activities of the major institutional categories listed above and also identifies their key regulators and the primary regulation applicable.

2.3.2 Intermediaries and licensed operators

In addition to the financial services institutions themselves, a range of intermediaries provides sales and advice on financial products and services including:

- life advisers and brokers;
- general insurance agents and brokers;
- securities dealers' and Investment advisers' representatives (financial advisers);
- futures brokers;
- stock brokers; and
- finance brokers.

Other distributors, including those providing 'incidental advice', include:

- mortgage originators;
- loans officers/suppliers of credit;
- asset consultants (normally advise superannuation funds);
- Australia Post;
- portfolio services;
- actuarial and other superannuation consultants;
- salaried consultants/sales persons;
- EFTPOS operators;
- lawyers;
- accountants and taxation advisers;
- real estate agents; and
- health insurance agents.

Appendix 2.1 also lists the principal intermediaries and provides a brief description of their activities, their principal regulators and the primary regulation under which they operate.

2.3.3 Regulators and non-governmental regulatory bodies

The financial services industry is regulated by the following bodies:

- Reserve Bank of Australia;
- Australian Securities Commission;

- Insurance and Superannuation Commission
  - life insurance
  - general insurance
  - superannuation;
- Australian Financial Institutions Commission together with the State Supervisory Authorities;
- Australian Competition and Consumer Commission;
- State Corporate Affairs Commissions;
- Friendly Societies Registration Board;
- Private Health Insurance Administration Council; and
- State Workers Compensation regulators.

Other statutory bodies involved in regulations affecting the industry in areas of interest to this Inquiry include:

- Australian Accounting Standards Board;
- Life Insurance Actuarial Standards Board;
- Australian Taxation Office;
- State Revenue Offices;
- Foreign Investment Review Board; and
- Australian Transaction Report and Analysis Centre.

Finally, other bodies providing services of a regulatory or self-regulatory nature in areas of interest to this Inquiry include:

- Australian Stock Exchange;
- Sydney Futures Exchange;
- Australian Payments System Council;
- Banking Industry Ombudsman;
- State Credit Tribunals;
- Superannuation Complaints Tribunal;
- Life Insurance Complaints Service;
- Financial Planners Association Complaints Resolution Scheme;
- General Insurance Enquires and Complaints Service;
- Private Health Insurance Complaints Commission;
- Professional associations (including financial planning, legal, accounting and actuarial); and
- Real Estate Institutes.

In summary, Australia-wide there are a large number of regulators, quasi-regulatory bodies and complaints handling systems. In addition the Council of Financial Supervisors was established in 1992 to facilitate coordination between the regulatory functions of the key regulatory bodies.

2.4 The purpose of regulation

In the context of the Australian financial system, whether from the perspective of consumers, the industry or Government, regulation is designed to meet two underlying tenets:

- to ensure the stability and soundness of the financial system; and
- to protect consumers, to the extent that they cannot reasonably be expected to protect their own interests.[3]

2.4.1 Consumers' perspective

Consumer advocates have long argued that a robust consumer protection regime is an essential part of a successful deregulated financial services market[4]. Regulation that meets the following objectives is desirable from the consumer's perspective.

Diversity of choice

Price and product competition to maximise choice in a healthy and secure financial services market.

Institutional and financial system security

A system of prudential supervision that minimises the risk of an institution failing to meet its financial promises and that provides stability and security in the overall financial system. The extent to which prudential supervision is required depends on the degree of risk undertaken and the level of security appropriate to the institution. Generally, regulation should be sufficient to prevent or minimise excessive risk taking by financial institutions.[5]

Good advice

Accurate and comprehensive information, presented in a balanced and comprehensible form. In addition to adequate mandatory disclosure rules, consumers desire access to inexpensive (or free) high quality, dispute resolution processes and to information about these processes[6]. They also require a level of comfort in their participation in a market with 'fair market practices'. Appropriate enforcement procedures are needed to minimise the scope for fraud, malpractice or other forms of market abuse on the part of institutions and advisers.

Cost effectiveness

It is the consumer who ultimately funds regulation, either directly (through the pricing of products by financial institutions) or indirectly (through the taxation system). Regulation must therefore be cost effective in that the cost of ensuring diversity of choice, institutional security and good advice must not outweigh the benefits.

2.4.2 Industry perspective

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[3] TAYLOR, Dr Michael - "Twin Peaks; A Regulatory Structure for the New Century" in CSFI, Number Twenty, London 1995 page 2

[4] MOON Gillian - Consumer Consultant. 'Financial Deregulation and Consumers', paper delivered at the Australian Federation of Consumer Organisations' Biannual Conference, Sydney, 10 October 1994 titled 'Competing Interests - Protecting the Public Interest in a Competitive Environment'.

[5] ibid.

[6] ibid.

Industry participants require a regulatory regime that adds value to the industry and promotes the following outcomes.

Equitable markets with ease of access

Lower barriers to entry promote efficiency in the market, as recognised by the Campbell Inquiry[7]. The industry recognises that efficiency is maximised when functionally similar arrangements are regulated in similar ways leading to competitive neutrality in the system.

Efficient and low cost regulatory structure

A cost-efficient regulatory regime that, in conjunction with better informed consumers, enables institutions to launch cheaper, simpler and more attractive products in a competitive environment[8].

Consistency and certainty of regulation

Consistency and certainty of regulation enhance competitiveness by ensuring competitive neutrality. In particular, financial product offerings should be governed by regulation that employs common principles (for example, a common disclosure standard across investment and risk products).

International Compatibility

As companies increasingly operate globally they will desire international compatibility of regulation to achieve synergies in compliance procedures and facilitate cross-border transfer of technologies, marketing and products.

2.4.3 Government perspective

The Government's perspective on the purpose of regulation encapsulates consumer and industry viewpoints but also addresses macro-economic and social objectives.

Competitive financial environment

Government seeks to facilitate a competitive financial environment that attracts both off-shore and domestic investment. A competitive financial environment requires a regulatory structure that is not only high quality but also cost effective.

Policy implementation and economic controls

Implementation of Government policy, such as monetary policy aimed at achieving price stability and high employment, requires a degree of Government intervention and regulation, as recognised by the Campbell Inquiry.[9] In addition to monetary and competition policy, the Government has implemented retirement incomes and national saving policies using regulatory tools that offer both inducements and disincentives (such as concessional tax treatment in the case of superannuation funds). Government has also required the financial services industry to conduct certain administrative functions on its behalf to meet policy objectives. These are dealt with through regulation such as administering the Tax File

[7] CAMPBELL INQUIRY - Australian Financial System. Final report of the Committee of Inquiry, September 1981, AGPS, Canberra, 1981

[8] COLE Tony (then) Executive Director LIFA "The Life Industry Ten Years On" paper delivered at the Australian Federation of Consumer Organisation, Biannual Conference, Sydney, 10 October 1994 titled "Competing Interest - Protecting the Public Interest in a Competitive Environment".

[9] CAMPBELL INQUIRY - Australian Financial System. Final report of the Committee of Inquiry, September 1981, AGPS, Canberra, 1981

Number System, the Financial Transactions Reports Act and State transaction taxes.

2.5 Types of regulation

The key types of regulation in the Australian financial system which are most relevant to this Inquiry can be categorised under four broad headings:

- consumer protection;
- prudential regulation;
- competition policy; and
- capital market integrity.

2.5.1 Consumer protection

Consumer protection regulation deals with standards, guidelines and rules for the provision to customers of comprehensive, accurate information about the terms and conditions attaching to financial products and services, and of objective advice about meeting, often complex financial needs. It takes an interest in procedures for lodging complaints and in arrangements for resolving disputes between financial institutions and their customers. Such regulation can extend as far as prescribing the supply of certain products in particular forms and at certain prices. [10]

2.5.2 Prudential regulation

Prudential regulation has the primary objective of promoting the stability of financial institutions and the broader financial system. Regulation of this type focuses on institutions, with the aim of protecting their solvency or viability by encouraging and promoting prudent behaviour by managers. Prudential regulation therefore involves capital adequacy ratios, liquidity ratios, systems for managing various risks, limits on large credit exposures and so on.[11]

The risk associated with a financial services product can be separated into two groups. The first comprises risk that is passed on by the financial services provider to the consumer (who accepts it as part of the contract). The second comprises the risk borne by the institution, which will only affect the consumer if the institution fails or is otherwise unable to meet the outcomes of risk.

The basic purpose of prudential regulation is to ensure that institutions analyse, manage and provide sufficiently for this second set of retained risks. To put it another way, prudential regulation is concerned with reducing or minimising the possibility of an institution not being able to meet its obligations under the product or contract conditions. Thus the nature of the product risk, and the discrepancies between the product or contract conditions and the assets and systems used by the providing institution to back the product liabilities, are crucial issues in categorising products and services.

Prudential supervision is also importantly concerned with reducing “systemic risk”. Traditionally it has been considered that this is limited to banks and

[10] THOMPSON, Graeme, Deputy Governor Reserve Bank of Australia, talk to Monash University Law School Foundation Melbourne 28 March 1996. “Prudential supervision and the changing financial system”
[11] Ibid

the payments system. However, as we argue later, the range of systemically important institutions is now much broader.

2.5.3 Competition policy

Regulation in this category recognises the need to encourage sufficient competition to ensure that consumers receive the best possible choice and price offering of financial products and services.

2.5.4 Capital Market integrity

Market integrity requires that the confidence of investors in the securities and futures markets is maintained by ensuring adequate protection, the ready availability of public information, consistent interpretation and administration of the law, and the proper functioning of companies, and the securities and futures markets.

These matters are largely dealt with in the Corporations Law, the requirements for which include:

- company regulation, involving the incorporation, and internal and external administration;
- capital market regulation such as capital raisings, securities and futures trading, conduct in relation to securities and futures, and ASX and SFE oversight;
- regulation of capital market participants such as stock brokers, futures brokers, options traders, foreign exchange dealers and money market dealers; and
- the acquisition of securities, including takeovers.

While the four categories of regulation are more or less discrete, their overriding purpose is to ensure that consumers are given appropriate protection in a healthy, competitive financial services market.

[12] CORPORATIONS LAW

2.6 Conclusion

We have defined the financial services industry from the consumers' perspective, applying a comprehensive set of criteria in terms of consumers' needs. This definition encapsulates a wide range of traditional institutions and increasingly a group of new institutions. Indeed, we believe that any other perspective may lead to a short term and ultimately counter-productive regulatory structure.

Furthermore it is relevant in a dynamic financial market-place to adopt a wide definition of the industry to accommodate future developments as well as the existing structure, and to ensure the most flexible regulatory framework results from recommendations made in the context of this Inquiry.

SECTION 3

DEVELOPMENTS SINCE THE CAMPBELL INQUIRY AND FACTORS DRIVING FURTHER CHANGE

Developments Since the Campbell Inquiry and Factors Driving Further Change

3.1 Introduction

There have been significant developments in the Australian and global financial markets since the Campbell Inquiry in 1981. Global trends and competitive responses to these by financial institutions have changed the nature of financial markets and will continue to reshape them in the future. They have major implications for the Australian financial system and consequently for its regulatory structure which must be flexible enough to meet its regulatory objectives in this changing environment.

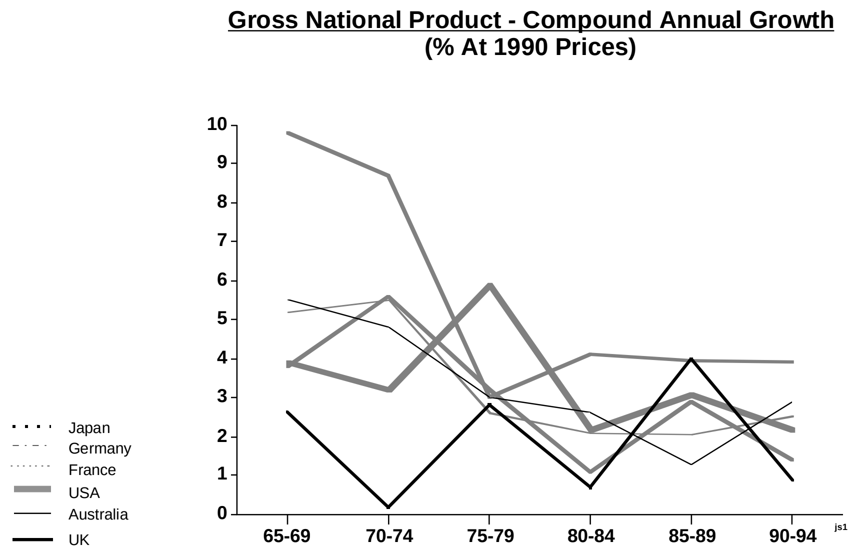
This section looks at the changes since 1981 and the global trends driving them. It also looks at the implications of these changes for the current and potential future regulatory structure.

3.2 Global trends

3.2.1 Macro economic context

From a macro economic perspective, the major financial markets of the world are experiencing slowing growth (Figure 3.1).

Figure 3.1



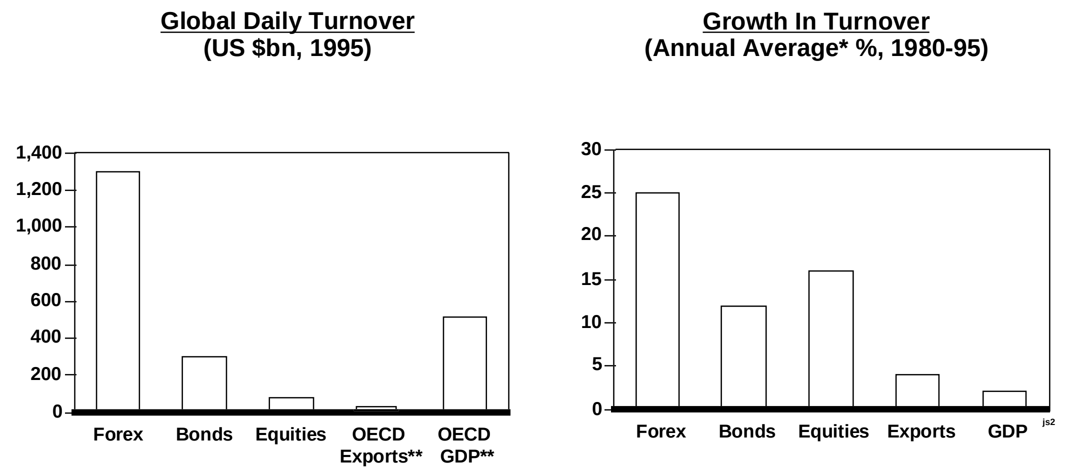
* Real GNP, deflated with CPI

Source: IMF Yearbook 1995

This slower growth has been accompanied by lower inflation and (generally) lower investment returns on equities and bonds. Competition for capital is increasing and there is mounting pressure on costs. Major financial institutions are finding it increasingly difficult to grow organically in their mature domestic markets.

At the same time, the volume of trade in financial markets instruments has increased dramatically across the world and has now reached US$1.75 trillion per day (Figure 3.2), and payments are growing, indicating an increase in the speed and volume of financial flows (Figure 3.3).

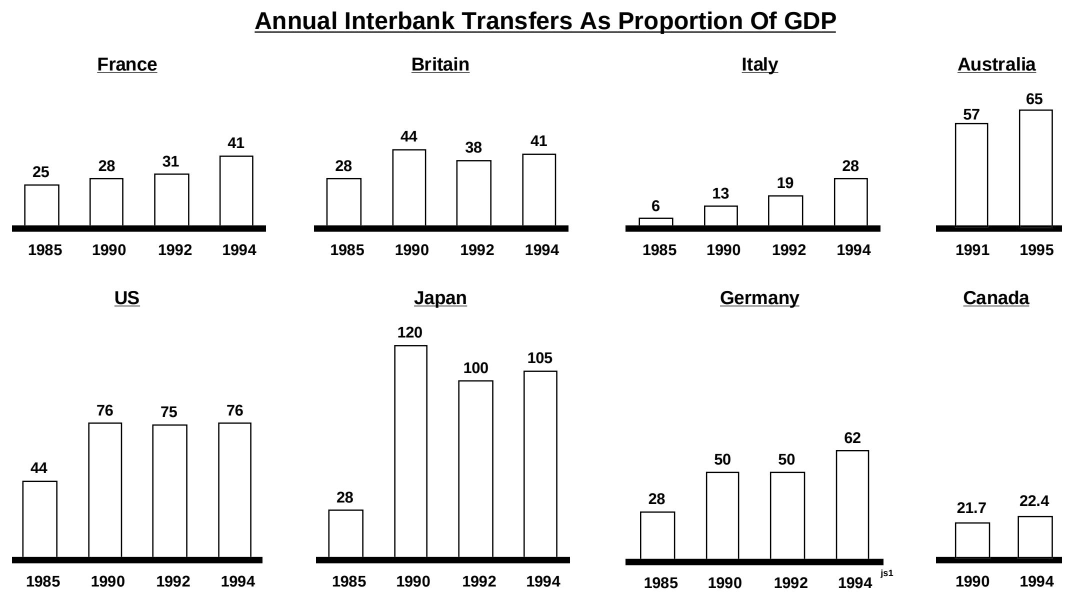
Figure 3.2



* Real growth deflated by CPI
** Daily Equivalent

Source: The Economist Oct 1995; BIS survey Oct 1995; OCED Economic surveys 1996; Reuter Economic News; ASX Research Information 1996

Figure 3.3

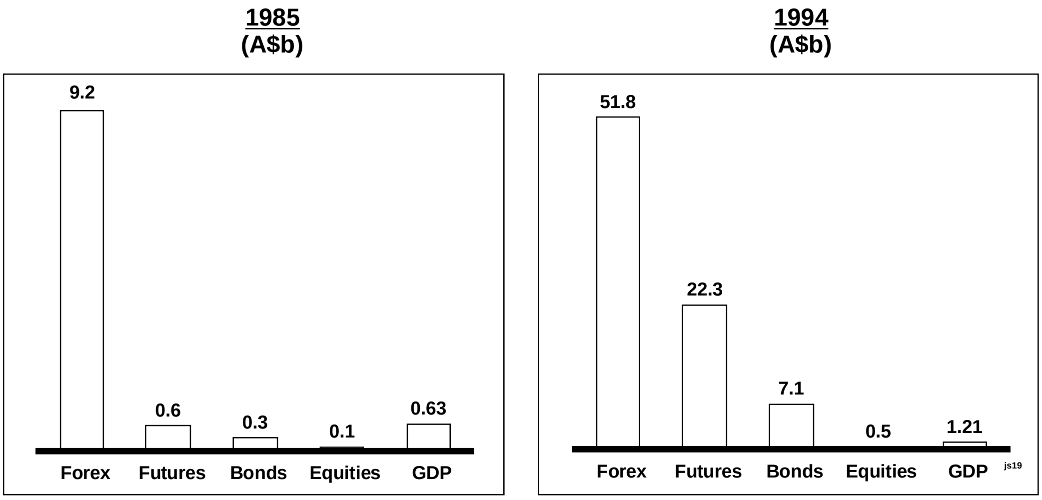


Source: Economist April 27 1996; BIS statistics on payment systems; Annual reports for Australian Payments Systems Council 1985-1995

In Australia, the daily turnover in foreign exchange markets was less than A$1billion immediately prior to the floating of the dollar in 1983[13]. In 1994 it exceeded A$50 billion. Trade in financial futures has been fuelled by significant product innovation and now represents 27% of all daily financial trading.

Figure 3.4

Daily Volume In Australia's Financial Market Instruments



Source: Australian Capital Markets, a report for the Federal Treasurer by the Allan Consulting Group, June 1996; RBA Bulletin Dec 1994; International Financial Statistics Yearbook 1995; 18/5/96 Australian, Forex easily outstrips our other financial markets

3.2.2 Deregulation and liberalisation

In the last 10-15 years, worldwide markets (particularly in the OECD countries) have seen a trend to deregulation and liberalisation. The impact of deregulation on the Australian financial system (particularly in relation to the outcomes of the Campbell Inquiry) is discussed in Section 3.4.

More generally, however, deregulation and liberalisation have led to financial innovation and greater competition, to the ultimate benefit of consumers. As barriers to foreign entry have come down, cross border activities in funds management and other products and services have increased.

Notwithstanding these major benefits the same period has seen some significant financial incidents across the world which have focussed financial regulators' attention. During the last 2 years in particular, there have been some dramatic events including:

- the collapse of the Mexican financial system in early 1995, with world wide repercussions, requiring a rescue package of US$50 billion;
- the fall of the British merchant bank, Barings, at the hands of one trader;
- a similar incident to Barings at Daiwa Bank; and
- problems within the Japanese banking system.

[13] LEWIS M K & WALLIS R H, The Australian Financial System, fourth volume, Longman Chesire.

These events have had major implications for financial system regulators. Mexico highlighted the speed and impact of contagion effects facilitated by technologically supported information flows, and the Barings and Daiwa instances highlighted deficiencies in disclosure and transparency. Nonetheless the worlds financial systems have proved remarkably robust to such major incidents.

With the removal of direct controls through deregulation and in response to incidents such as these, there has been an increased focus on financial regulation, both prudential and consumer protection regulation. This has driven up the capital requirements and administrative costs associated with providing financial products and services.

3.2.3 Technology and marketing advances

Some of the most significant developments, however, have been in technology and marketing. Technology is advancing at a pace that threatens the ability of regulation to keep up, as the reach of global networks and access to data extend markets across previously distant geographical and regulatory boundaries.

Technological advances are facilitating the global marketing of new financial products and services, opening up new markets and enabling truly international competition. Consumers' evolving needs are driving further technological innovation in the marketing and distribution of products and services. These developments are creating marketing possibilities on a scale not previously imagined. There is no more obvious example of this than the Internet and its associated World Wide Web. Even at existing rates of change, emerging technologies and their capabilities will be highly pervasive in 3 to 5 years, and the impact will be felt globally.

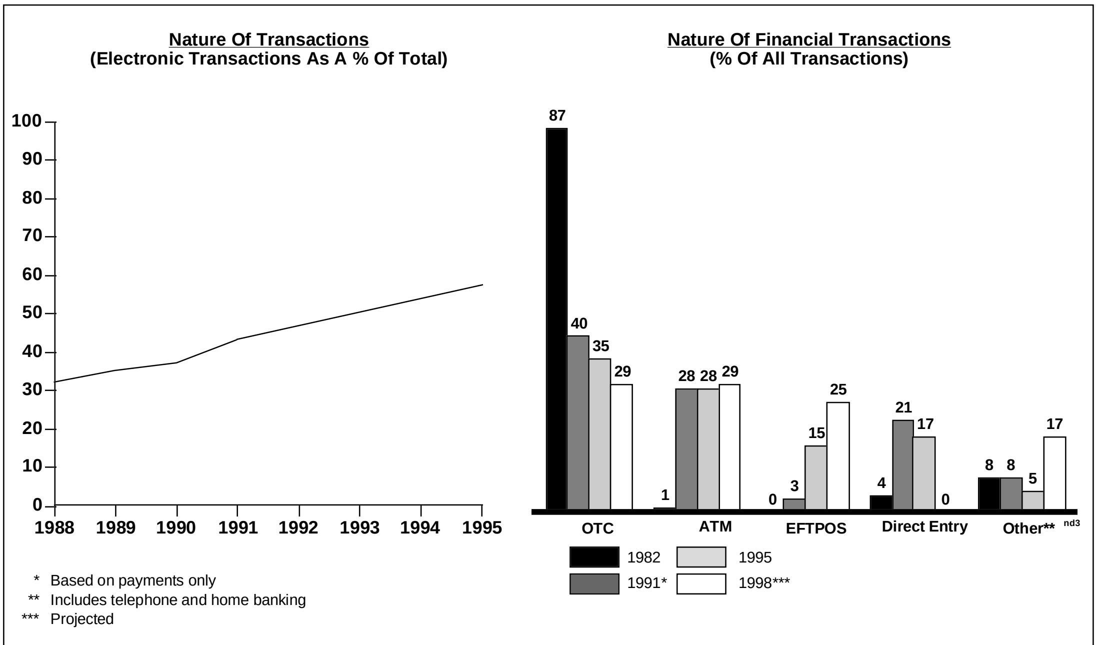
These advances will provide opportunities, open up global competition and bring improved service and efficiencies for consumers as well as challenges, for financial regulators in maintaining financial stability and confidence particularly in relation to the payments system, electronic commerce and the Internet.

The payments system

Consumers in Australia have been quick to adopt Automatic Teller Machines (ATMs) and Electronic Funds Transfer at Point of Sale terminals (EFTPOS), as Figure 3.5 shows.

Figure 3.5

Nature of Australian Financial Transactions



Source: Ernst & Young; Australian Payments Systems Council Annual Report 1994/95; Business Review Weekly, 8 July 1996

The advent of 'smart cards', electronic cash ("e-cash") and Stored Valued Cards (SVCs) will take this a step further. Smart Cards are so named because of their embedded silicon chip technology which provides more sophisticated functions and services than the familiar magnetic-strip credit and debit cards. Stored value cards exemplify this "smartness", storing value such as electronic cash. This is discussed further in section 3.3.4.

Electronic cash, or ''e-cash'', will be needed to exploit the full benefit of payments via technologies such as smart cards, home PCs and Internet access. It is expected that e-cash will provide a secure payments system when encrypted 'banknotes' (actually digital numbers) of various denominations are sent and spent by electronic means, with the transaction as anonymous as cash. Such transmissions will be more efficient and cheaper for consumers than credit cards, as processing costs will make small transactions viable.

The emergence of these technologies within the existing payments system is significant, but the prospect of electronic payment systems outside current controls, particularly in unregulated trading systems, presents a significant challenge for financial regulators. This is particularly the case for commerce on the Internet, where there are concerns about the security of transmission of credit card details and a need for cheap payments systems to complement the Internet's vast potential market for low cost transactions.

Electronic commerce

Rapid developments in computer and telecommunications technologies have enabled many paper-based inter-company transactions to be converted to electronic methods.

The term ''electronic commerce'' is used to describe these methods of transacting business. It includes Electronic Data Interchange (EDI), electronic mail, electronic forms and Electronic Funds Transfers (EFTs). EDI replaces paper-based data transfers by using protocols to transfer prescribed messages between regular trading partners such as banks, financial institutions, suppliers and Government authorities.

The benefits to providers and consumers are reduced costs, increased speed and accuracy, and improved service. In the controlled environment between institutions, the issues are mostly those of standards and formats. A number of institutions and associations are developing the necessary protocols to ensure the successful implementation of electronic commerce at this level.

The Internet

The Internet and similar electronic distribution methods warrant special attention in relation to electronic commerce standards and regulatory issues.

Sometimes referred to as the world's largest network, the Internet is better described as a ''network of networks''. The essential design utilises ''open systems'' standards, enabling maximum connectivity for networks and the computer devices connected to them.

The future of the Internet and the World Wide Web polarises industry analysts, with predictions that ''by the year 2000 more people will be navigating the 'Net' than watching TV''[14]. Others, in contrast, cite the fact that many users 'look but don't buy'.

While it is clear that Internet security for financial transactions will have to be improved before Internet electronic commerce can reach its full potential, the Internet has become a major force in the convergence of information and telecommunications. It is potentially the most formidable world wide communications vehicle of the future.

As a marketing tool, the Internet has tremendous potential. Its interactive online services, electronic mail and bulletin boards are without peer. Many financial services providers now have some presence on the network.

When current security and reliability problems are resolved, a rapid increase in the conduct of electronic commerce on the Internet, without regard to geographical or jurisdictional borders, will be a major issue for regulators.

3.2.4 Consumer needs and demands

Consumer needs and demands have also changed, with a consequent impact on the shape and nature of the Australian and international financial markets. Two key groups are shaping consumerism of the future: the 'Baby Boomers' and the 'X-Generation'.

Baby Boomers, now aged 36 to 50 years, will soon dominate the pre-retirees and retirees market. Their demands on the retirement investment and incomes system is a major issue for governments in most developed markets. The X-Generation, now aged 20 to 35 years, will be the key

[14] DIRECTOR OF MEDIA RESEARCH, Massachusetts University

financial earners over the next 20 years and their expectations of financial products and services will be critical.

At present, Baby Boomers are the largest and most influential group in the population. In comparison to existing retirees, they have significantly different attitudes towards financial institutions. They are more demanding of service, choice and codes of institutional behaviour. This has influenced their relationships with suppliers of financial products and services.

The impact on financial markets of changing consumer needs and demands has been a major shift in the intermediation and direction of household saving, resulting in:

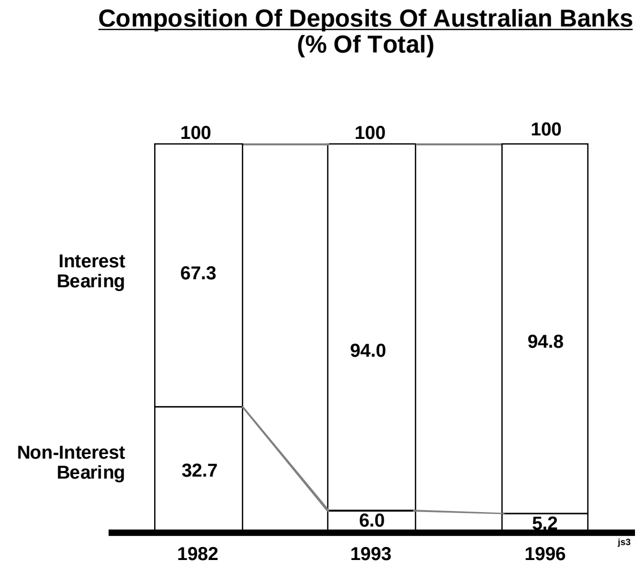
- a reduction in deposits in non interest bearing bank accounts;
- a shift away from traditional life insurance savings products; and
- a massive increase in managed funds and superannuation.

Reduction in deposits in non interest bearing bank accounts

Banks and building societies were once able to raise most of their funds at interest rates below market rates. Since deregulation this advantage has gradually been eroded. In most OECD markets over the last 15 years there has been a shift away from non-interest bearing deposit accounts as customers have become more sophisticated and more interested in their investment options. This reduction in access to low cost funds has been exacerbated in Australia by the adoption in recent years of deeming provisions applying to institutions for the purpose of determining social security requirements The trend has had major financial implications for banks reducing the scope for cross-subsidisation with other products.

In Australia the proportion of non-interest bearing deposits to total bank deposits has fallen from 33% in 1982 to just over 5% (Figure 3.6).

Figure 3.6



Source: RBA Bulletin July 1996

Shift away from traditional life insurance savings products

Since 1990, there has been a marked reduction in the traditional business of life insurance companies. Consumer pressure on prices has led to the disaggregation of traditional bundled insurance business (i.e. risk and savings components combined in a single product). Bundled products are being replaced by pure unbundled investment products, and pure risk products such as term insurance and income protection. This has been particularly marked in Australia (Figure 3.7 and Figure 3.8) but is also a trend in the US, UK and other mature markets.

Figure 3.7

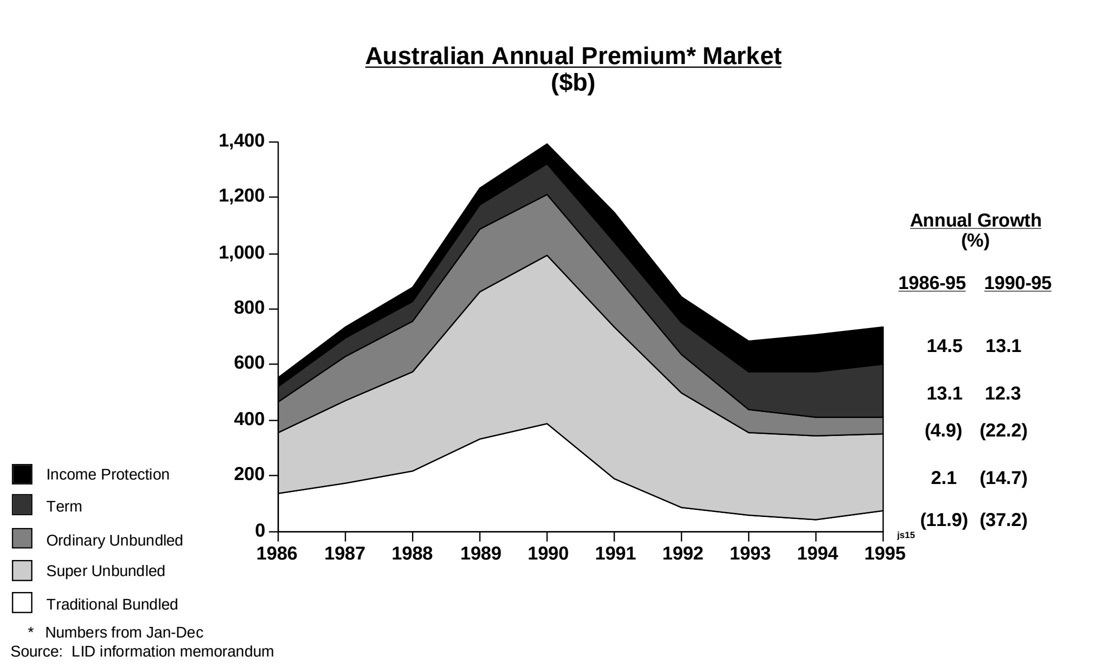
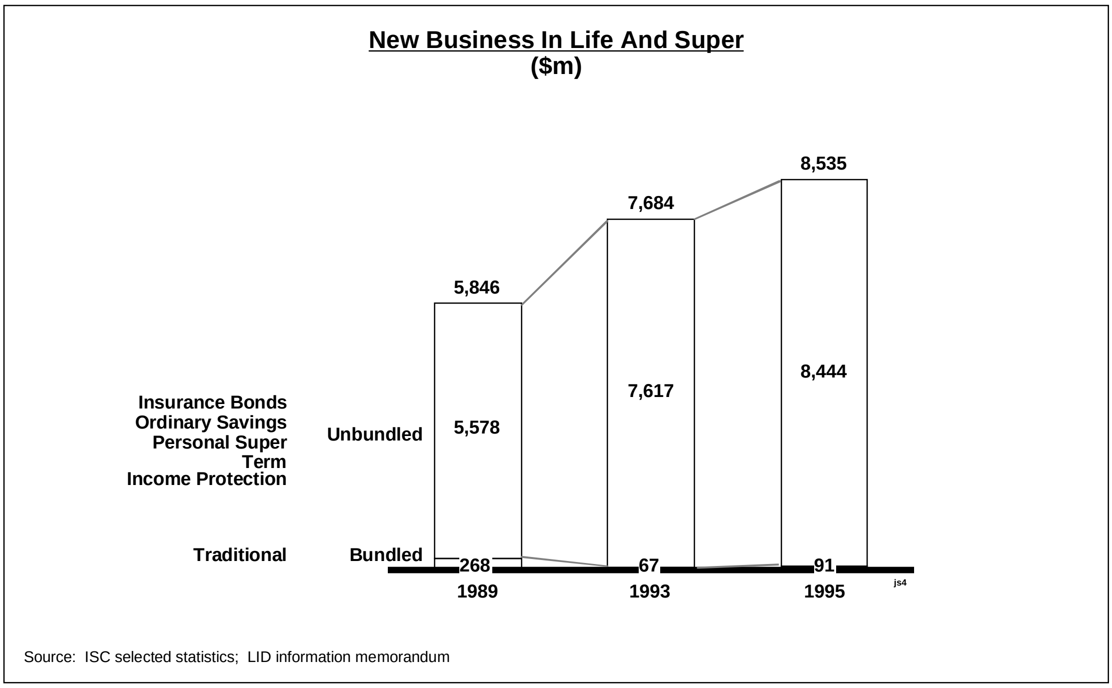
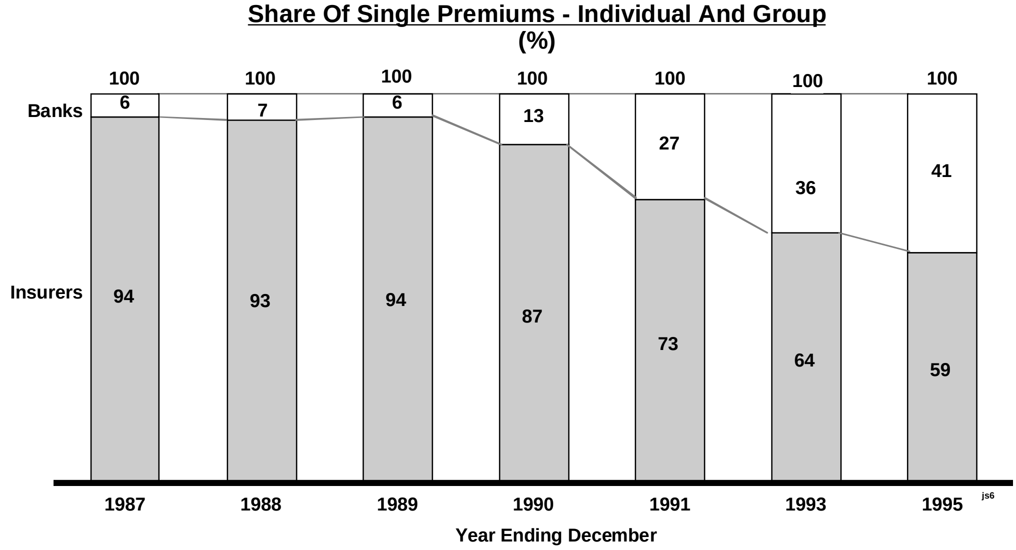


Figure 3.8



In addition to the shift from unbundled products consumers are increasingly opting for single premium investments rather than the traditional regular (annual premium) savings products which have historically been the main product line of life companies. Banks have grasped the opportunity offered by these trends with rapid growth into life insurance savings products (particularly single premium products) (See Figure 3.9).

Figure 3.9

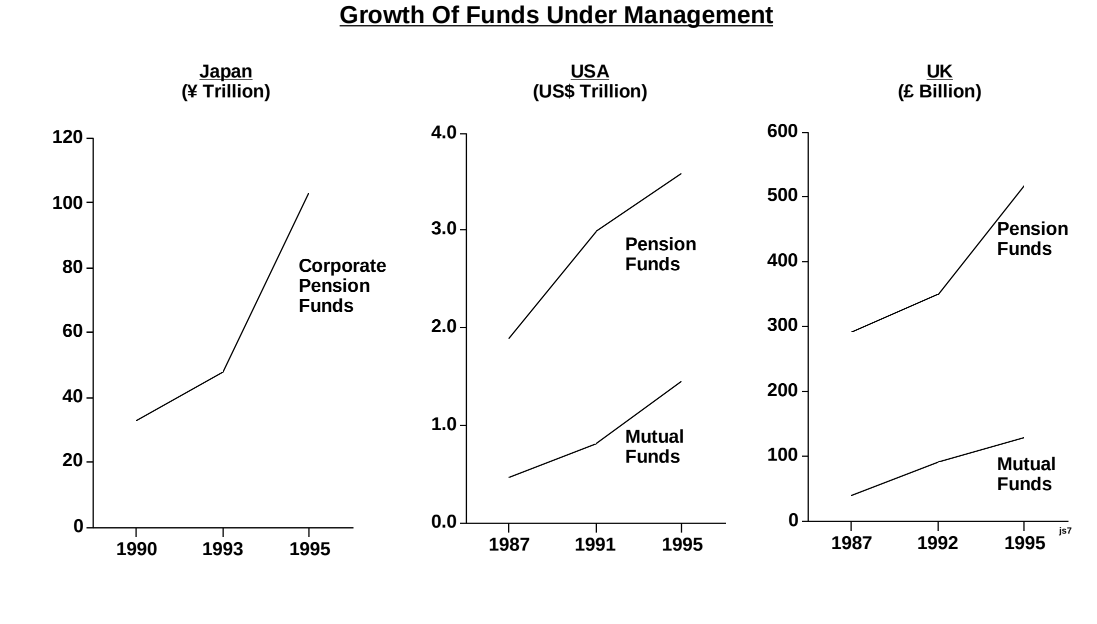


Source: ISC; Rice Kachor Research; Ernst & Young; Dec 1995 and June 1994 Quarterly Australian Life Insurance Tables

Massive increase in managed funds and superannuation

These trends, coupled with the Governments' response to the ageing of the population, leading to consequent growth in superannuation savings, have produced a dramatic increase in managed fund investments in major financial markets (Figure 3.10). Continued growth is expected, particularly in relation to intermediation through banks and life insurance companies.

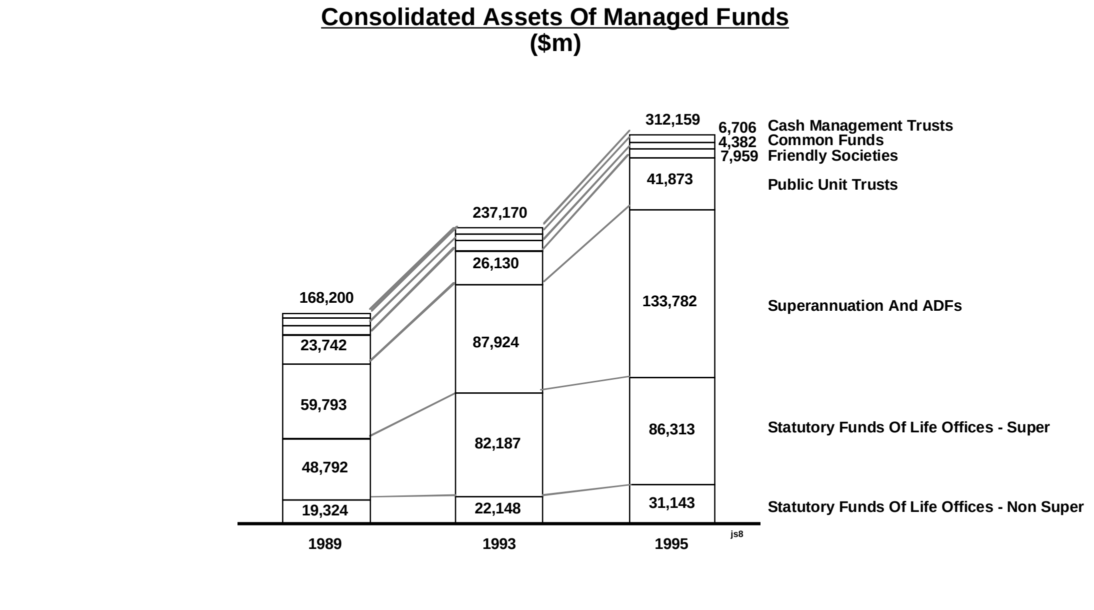
Figure 3.10



Source: Sumitomo Bank; Bernstein; Barclays; USA 1995 statistical abstract

In Australia, the amount of retirement savings has been growing rapidly over the past 5 years. Superannuation products now comprise more than two-thirds of the Australian funds management market (Figure 3.11), and are expected to be approximately A$400 billion by the year 2000.

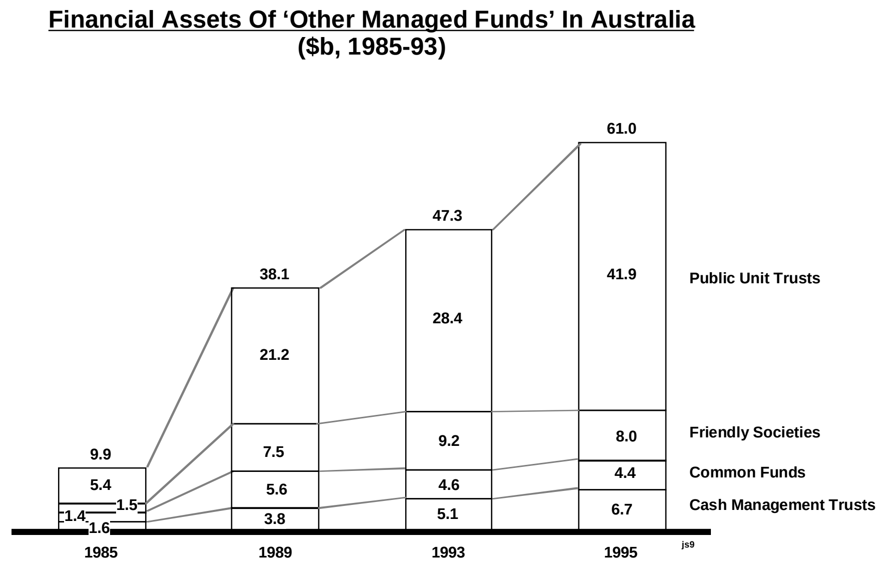
Figure 3.11



Source: ABS Yearbook 1990, 1994, 1996, ABS Cat no 5655.0 March Quarter 1996 'Managed Funds'

Other non super managed funds, particularly unit trusts, have also grown strongly since the mid 1980s, (Figure 3.12). Australian household investment through pooled arrangements is now at roughly the same penetration level as the US mutual funds industry (Figure 3.13).

Figure 3.12



Source: ABS Yearbook 1996, RBA Bulletin July 1996; ABS Cat No 5655.0 March Quarter 1996 'Managed Funds'

Figure 3.13

Household Investments
(1995)

	Australia		US
	($b)	(%)	(%)
Pooled Investments	**61**	**10**	**10**
Superannuation	**220**	**38**	
Other incl. direct	**338**	**52**	
Total Household Financial Assets	**619**	**100.**	

* Includes unit trusts, cash management trusts, friendly society bonds, and common funds

Source: ABS International and Financial Accounts; ABS Yearbook 1996; US Statistical Abstract 1995; RBA Bulletin July 1996, Dec 1995

The consolidated assets of managed funds and superannuation products now account for approximately half of household investment in financial assets (Figure 3.14).

Figure 3.14

Household Financial Assets (1995)

Household Financial Assets		($b)	(%)
619b	Superannuation	220	36
	Pooled	61	10
	Bank Deposits	160	26
	Equities	89	14
	Life Insurance	31	5
	Other Direct	58	9

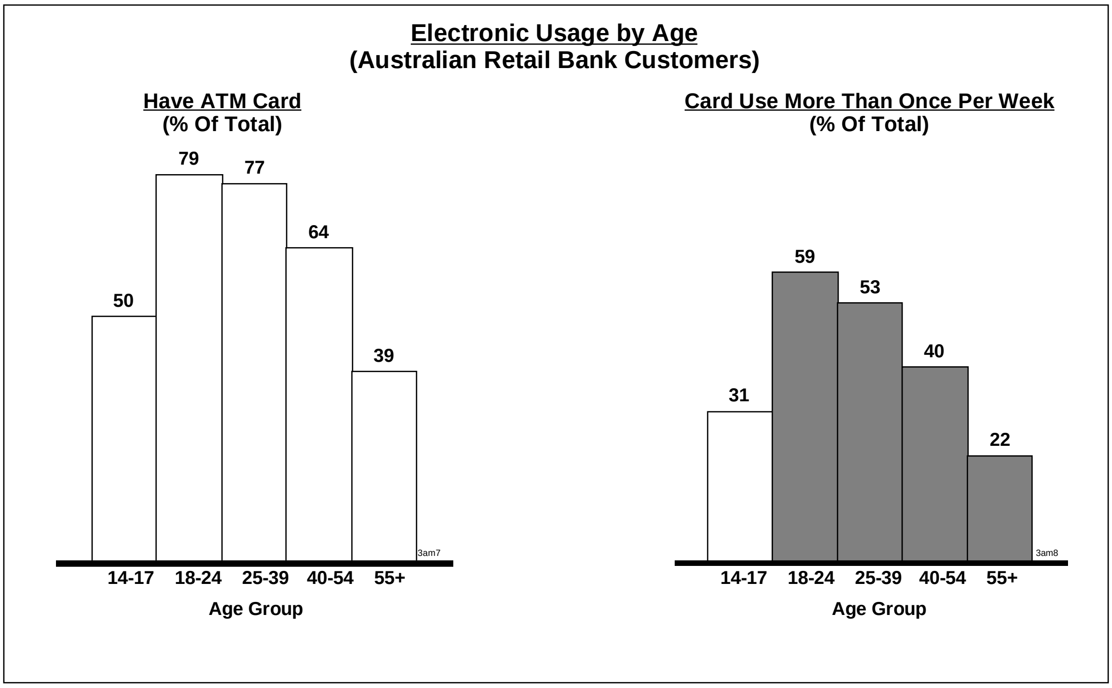
Source: RBA Bulletin July 1996; ABS International Financial and Accounts

Growth of managed funds and superannuation is likely to continue and financial institutions will place more emphasis on their funds management operations as a result.

As well as the impact on the nature of financial markets discussed above, consumers' needs and demands are driving innovations in methods of product delivery, particularly technological developments.

Consumers are seeking greater flexibility and are more actively using electronic technology to access information and services, particularly consumers in the pre 50 ageband (Figure 3.15). Developments include toll free telephone calls to Service Centres, home and personal computer banking and EFTPOS. Access to the Internet will provide them with a global view of products and services, and acquaint them with world's best practice.

Figure 3.15


Electronic Usage by Age
(Australian Retail Bank Customers)
Have ATM Card
(% Of Total)
50
79
77
64
39
3am7
14-17
18-24
25-39
40-54
55+
Age Group
Card Use More Than Once Per Week
(% Of Total)
31
59
53
40
22
3am8
14-17
18-24
25-39
40-54
55+
Age Group

3.3 Competitive developments

In response to these major developments in Australia and globally since the Campbell Inquiry, many traditional players in the finance sector have adopted new strategies, and new players are entering the sector.

3.3.1 Economies of scale and globalisation

The increasing capital requirements required to fund financial operations to meet more stringent regulatory requirements and for investment in new technologies have led many financial organisations to seek economies of scale through growth on a global basis. Because of the difficulties of growing organically in mature markets many financial institutions have turned to acquisitions and mergers and entry into new markets such as Asia in search of scale economies and wider opportunities to leverage resources and skills. At the same time, new technologies are creating opportunities for companies to be selective about the location of back office processing and methods for market access.

Consequently many companies are becoming truly global in their activities. AXA, for example, is now the eleventh largest insurance group in the world, with operations in over 20 countries. By the end of 1996 the AXA group plans to be listed either directly or through its subsidiaries on at least six stock exchanges around the world.

Merger and acquisition activity has led to the emergence of mega players with significant economic power. Examples include the merger of the Bank of Tokyo and Mitsubishi Bank, the Chase Manhattan and Chemical Bank merger, Swiss Bank's acquisition of Warburgs, and Zurich Life's acquisition of Kemper Financial.

Domestically, rationalisation in the banking sector has included the acquisition of Challenge Bank by Westpac and the acquisition of BankSA by Advance Bank. Further rationalisation has occurred in the UK where more than 20 smaller life insurance companies have left the market in the last 2 years.

3.3.2 Customer focus and convergence

Increasing consumer sophistication has led to an increased customer focus by financial institutions facilitated by technological and marketing developments. This reflects a fundamental shift for financial institutions, which were predominantly product/service focused up to the 1980s. In recognising the importance and value of the customer, some companies now provide a wider range of products and services in an attempt to satisfy a broader range of consumer needs. Capital and other resources are being integrated and leveraged more effectively across all sectors of the financial services industry. This convergence has increasingly blurred the historical distinctions between institutions.

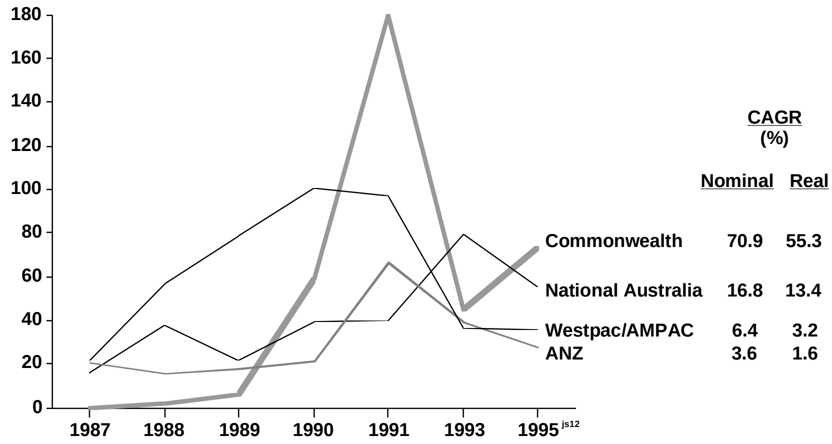
Banks have entered traditional life insurance markets and vice versa. Banks and insurance companies are aggressively entering the funds management market. At the same time, other financial institutions, including building societies, general insurers, health insurers and credit unions, are crossing their traditional boundaries.

In Australia all four major banks have strongly growing life insurance subsidiaries (Figure 3.16). The second tier banks are also pursuing domestic life insurance and superannuation business.

Figure 3.16

New Annualised* Premiums
($m)

Bank	Approach
Common-wealth	Subsidiary: Commonwealth Life Ltd
Westpac	Distribution: joint venture with AMP Underwriting: AMPAC Life (formerly Westpac Life) wholly owned by AMP **
ANZ	Subsidiary: ANZ Life Assurance Co Ltd
National Australia	Subsidiary: National Australia Financial Management Ltd



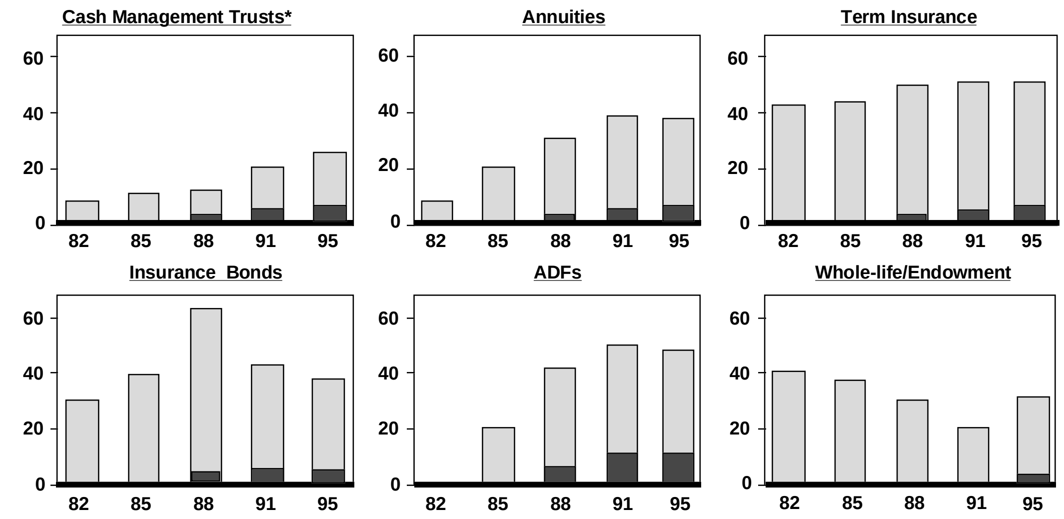
* Annualised = 100% of New Annual premium + 10% of single premiums ** The AMP/WestPac alliance has since been terminated

Source: ISC; Quarterly statistics

Banks have targeted nearly all unbundeled insurance products (Figure 3.17).

Figure 3.17

Number Of Companies By Product Category



Banks or Bank owned companies (Data on numbers of banks is only available for 88 onward)

* Excludes trustee company funds, government trusts and public security trusts

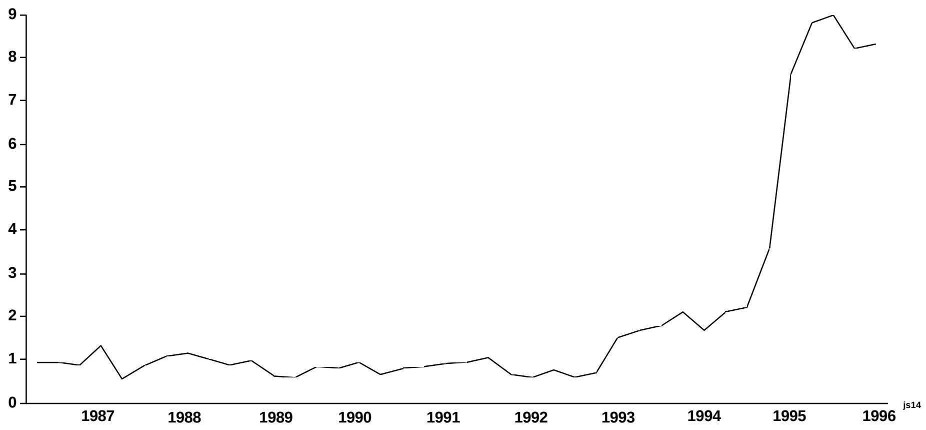
Source: Life Insurance Commissions Report 82,85, 88, 91, Assirt Market Share Report Dec 1995, ISC statistical Bulletin March Quarter 1995, Personal Investment Magazine, Aust Financial Review

In the USA it is now possible to buy from insurance companies what are essentially money market funds, complete with cheque writing facilities.

Insurance companies are playing an increasing role in the Australian mortgage origination market. AMP's Priority One is a direct selling operation that is undercutting the established mortgage providers. The National Mutual superannuation members home loan arrangement enables National Mutual to provide a wider range of options to a specific customer base in addition to its direct home loan service. Indeed, lending by mortgage managers (as distinct from banks) grew to approximately 8% of all new housing loans in the first quarter of 1996, compared to less than 1% in the 1980s (Figure 3.18).

Figure 3.18

Mortgage Managers' Housing Lending
(% Of Total Approvals)



Source: RBA Bulletin June 1996

3.3.3 *New entrants*

Non traditional players are entering or seeking to enter sectors of the finance industry. Technology and access to a client base are key drivers, potentially enabling new players with technological capabilities but no finance sector background to capture significant market share.

In the US, Microsoft and Intuit are working with various banks to deliver electronic banking services. In Australia: GE Capital has recently acquired Coles Myer's credit card business, and is expected to become a major source of personal and even business sector credit and to take a greater role in the broader provision of financial products and services; Telstra recently indicated that it wants to become involved with the content as well as the carriage and delivery of banking services; and Commonwealth Bank of Australia (CBA) has indicated that it may form an alliance with a communications company to ensure that it is well-placed to take advantage of the changes technology will bring.

3.3.4 *Technology take up*

Most importantly, technological developments are driving financial services companies' strategies, and will play an increasingly important role in the way their business is conducted.

Smart card technology is being trialed around the world. In Australia the major banks have formed a joint venture through which they have acquired the franchise for the Mondex SVC 'smart card'. The Mondex card, which is of the 'electronic purse' variety, has been on trial in Swindon, Wiltshire, UK for 2 years. In that system, the stored value of money is downloaded from banks in Swindon into the user's Mondex card through telephones modified to be Mondex compatible. It is then used through readers to purchase goods and services as if it were cash.[15]

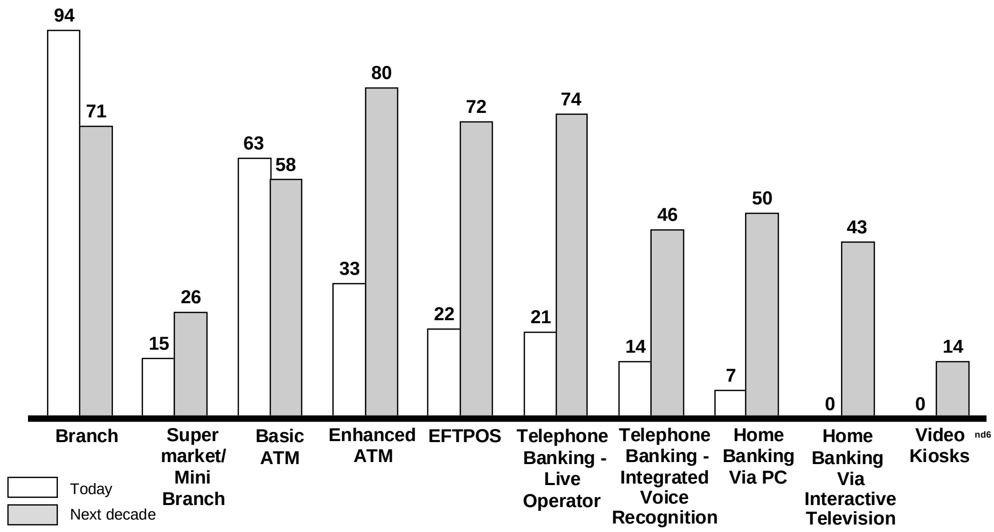
Whilst the Mondex card is still on trial, and only used for small transactions, it has key advantages for the emerging electronic marketplace. It has the ability to hold ''cash'' in five currencies and is safe to use on the Internet, as no credit card details are disclosed. Cards like this will open the way for Australians to shop on the Internet without exchanging currency.

Four trials of other 'smart card'' systems are running in Australia at present, and others have been implemented in the United States. Standards for smart cards are emerging from alliances such as that of Europay International, MasterCard and Visa, with their EMCV Joint Specification for payment systems.

New technologies are being used throughout the financial services industry to reduce costs and improve service, particularly in distribution. Extensive bank branch networks will be replaced by kiosks and supermarket/mall alternatives that rely heavily on telecommunications and multi-media technology to provide services. The nature of transactions is therefore expected to change significantly (Figure 3.19).

Figure 3.19

The Future Of Financial Customer Service
(%)



Source: European FS Organisations Survey 1995

15 THE AUSTRALIAN FINANCIAL REVIEW, June 28, 1996

The Internet

The Internet is revolutionising global information technology communications systems. Global information exchange is both increasing and becoming more commercially-orientated.

The number and variety of international financial services offerings on the Internet make it impossible to catalogue them in this submission. The following selection of current international banking, securities trading and financial information services, indicates the extent of offerings, and the growth that is likely in the short term:

- Bank America, a diversified global financial services provider, has a strong presence on the Internet and is promoting Internet banking after trials with Lawrence Livermore National Library on secure electronic commerce over the Internet. (Appendix 3.1). Bank America also uses the Internet to sell insurance products such as annuities and single premium products, and is poised to increase its activity in this area if legal barriers between banking and insurance are further relaxed;[17]

- European Union Bank bills itself as "the first off-shore bank on the Internet". A member of the American Bankers Association, it provides international banking and financial services including: multi-currency current and time deposit accounts; numbered accounts; international wire transfers online; portfolio management; foreign exchange transactions; letters of credit; and a number of other specialised bank services. Each of these can be accessed on the Internet (Appendix 3.2);

- BanXQuote specialises in "bank rates and news on virtual banking, online trading and electronic commerce". Appendix 3.3 includes some marketing material referring to switching online investments in 401 (k) retirement plans (Fidelity), and electronic payment systems (CheckFree, CyberCash, Redi-Check, DigiCash). BanXQuote also produces documents supporting the strong movement on the Internet for public access to the best encryption technology to secure electronic commerce on the Internet; and

- Lombard Institutional Brokerage Inc. (Appendix 3.4) offers online, cross-border securities trading on the Internet, as does Charles Schwab & Co. (Appendix 3.5). At present, Australian consumers are restricted from trading stocks, bonds and options only by the requirement to have a US-based bank account. As Lombard is willing to open such accounts for foreign investors, this is not a significant barrier to online trading.

Insurance products are also becoming increasingly available on the Internet. There are over 80 insurance sites in the United States and over 40 more around the world. Two companies, AIG Life and the Signature group, have begun direct sales using online credit card payments over the Internet.[18]

Many Australian financial services companies are also establishing a presence on the Internet World Wide Web. Banks are offering home loan simulators and "home page" sites to interact with their customers:

- Advance Bank enables its customers to use the Internet (Appendix 3.6) to transfer funds between accounts and to access account balances and transaction histories. It intends to provide bill payment facilities later this

[16] THE AUSTRALIAN FINANCIAL REVIEW, July 2, 1996.
[17] RESOURCE, May 1996.
[18] RESOURCE, March 1996.

year, and full online banking with smart cards in the future. It is also the first company to receive ASC approval to put a managed fund prospectus on the Internet;[19]

- CBA (Appendix 3.7) concentrates on interactive communications with clients, providing home loan information, share prices and other information services. It is quoted as intending to offer bill payment and funds transfer in the near future;

- St George Bank (Appendix 3.8) has a marketing information site and intends to expand its Internet services;

- the National Mutual site (Appendix 3.9) provides market information on the net asset value of NMFM Asia Investment Limited, updated on a monthly basis. We intend to add further information, including updates to the National Mutual Property Trust's asset values; and

- at the retail level, Lowes' (Appendix 3.10) customers can order menswear, shoes etc, by transmitting credit card details across the Internet, without the protection of encryption.

Developments in the finance sector on the Internet have been rapid and significant. The implementation of secure financial transaction systems transfers will revolutionalise financial markets around the world. It will afford consumers unprecedented choice and diversity in financial products, and force Australian companies to face instant world wide competition. At present, the main factors inhibiting these major changes are:

- security essential to secure transfer of digital cash (e-cash), credit card Personal Identification Numbers (PIN), or any other material that requires protection. Encryption systems that guarantee the identification of the sender and enable authentication of both the sender and message content when received; verification systems, non-repudiation systems that prevent denial of sending, and privacy guarantees. At present, the US government prohibits the strongest encryption systems from commercial use and export. Rival encryption systems are being developed internationally, and Internet users are strongly opposing the US Government's policy;

- the capacity of the Internet is limited by the infrastructure network bandwidth, which governs the speed of transfers. This will improve in urban/suburban Australia as Optus and Telstra roll out fibre optic cable, but very high bandwidth international network connections will be needed to service Australia and the region; and

- the lack of centralised control and commercial accountability which creates difficulties in ensuring quality service levels.

[19] THE AUSTRALIAN FINANCIAL REVIEW, August 16, 1996.

3.4 Impact of the Campbell Inquiry recommendations

It is very difficult to link developments in the Australian financial system directly to the implementation of the Campbell Inquiry recommendations as there have been many other factors which have impacted the system. To a large extent we have therefore relied, in this analysis, on the conclusions drawn from a number of independent analyses and inquiries, including, *inter alia* The Report of the Martin Inquiry on Banking 1991, The Prices Surveillance Authority's Public Inquiry into Fees and Charges Imposed on Retail Transactions 1995 and the Industry Commission report "Availability of Capital in Australia".

The Campbell Inquiry essentially investigated the desirable level and appropriate method of Government intervention to effectively deregulate the Australian financial market. Its recommendations were made with the aim of producing an economically stable financial system with an improved allocation of financial resources and balanced competition over all areas of the market. Its recommendations therefore potentially affected:

- the choice, quality and cost of financial products and services available to consumers;
- the efficiency of the financial system, including its international and domestic competitiveness;
- the evolution of financial institutions and the products offered by them, and the impact of this on the regulatory structure; and
- economic growth, employment and savings.

It should be noted, however, that the recommendations from the Inquiry in relation to financial institutions were largely directed at the banks. Non banking financial institutions have also developed during the period since the Inquiry, but were less directly affected by it.

3.4.1 Choice, quality and cost of financial products and services

Both the Report of the Martin Inquiry on Banking 1991 and the Industry Commission report "Availability of Capital in Australia" considered the impact of the implementation of the Campbell Inquiry recommendations on the choice, quality and cost of financial products and services. Their assessment was

"...much of what was envisaged of deregulation has occurred. The efficiency of banks has increased and they have taken market share from other financial intermediaries that had benefited from regulation. Finance has become more widely available, though customers have had to pay a market price for it, including a component to reflect risk. Product range has increased and banks have increased their responsiveness to customers.

However, deregulation has not delivered some of the benefits envisaged. While competition has been strong (perhaps too strong) in some sectors, particularly in the large-business sector, it has not been strong in the retail market. The failure of the market to deliver better information to consumers and to price better for some products indicates that the retail [market] has still to realise the full benefit of deregulation."[20]

The view of the Price Surveillance Authority was that:

"Competition across the industry is uneven. The evidence suggests, for example, that competition for the supply of Retail Transaction Accounts (RTAs) is less intense than for the supply of mortgage funds. This is because financial institutions (banks) are the only avenue by which consumers can access the payment system. Consumers' demand for RTAs also appears to be relatively insensitive to price, partly as a result of the costs of switching to alternative products. Difficulties in obtaining and comparing information about the cost and characteristics of alternative products contributes to switching costs. Nevertheless, there is evidence that some consumers have switched products or institutions in order to minimise fees." .[21]

Increasing competition in the financial services market, along with technological change, is clearly improving service to customers, although there is a view that the improvements are too slow and to an extent impeded by the financial institutions' need to cut costs.

While there appears to be a general consensus that deregulation has resulted in a benefit to the Australian community, in relation to the choice, quality and cost of financial products and services some economists would argue that there have also been costs, in particular Harper & Leslie in "The Case for Deregulation" noted:

"But to say that deregulation conferred net benefits is not to say that the process was without costs. None of the assessments written by acknowledged economic rationalists has denied that deregulation imposed costs on the community as the adjustment to the new financial environment took place. Indeed, the process is continuing and further costs may yet be incurred. The focus should be on the net result of costs and benefits, and others, apart from the economic rationalists, appear to be convinced that such net benefits exist. Economic rationalists admit that financial deregulation did not usher in paradise, but they reject the claim put forward by the critics that it gave rise to pandemonium."[23]

3.4.2 Efficiency of the financial system, including its international and domestic competitiveness

The most tangible measures adopted by the Campbell Inquiry to promote efficiency and competition in the market were:

- widening the scope for price competition through deregulation of interest rates, fees and commissions, and prohibiting cartel agreements in this field;
- increasing the number of competitors in various sectors of the financial service markets by providing more scope for diversification, and by removing obstacles to the domestic and cross-border expansion of banking networks;
- increasing investor and borrower choice by encouraging the creation of a wide range of new financial asset and debt instruments;

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[20] The Price Surveillance Authority Public Inquiry into fees and charges imposed on retail transactions 1995.
[21] The Price Surveillance Authority Public Inquiry into fees and charges imposed on retail transactions 1995.
[22] ibid.
[23] HARPER & LESLIE, The Case for Deregulation.
[24] HARPER & LESLIE, The Case for Deregulation.

- removing obstacles to free lending and investment decisions of banks and other financial institutions by abolishing or easing direct lending controls and mandatory investment regulations;
- improving the transparency of financial service markets through better information;
- forestalling anti-competitive concentration movements in banking and finance by merger and ownership control; and
- floating the Australian dollar on the foreign exchange market in order to relieve the RBA of its commitment to making up the difference between its nominal (set) and real values. The Australian dollar was floated in December 1983. Capital has since been free to flow into and out of Australia, subject only to certain foreign investment restrictions that may from time to time be imposed in relation to direct Australian investment.

The Martin Inquiry concluded that deregulation had led to a significantly more competitive environment within the banking industry and the overall financial market. A far greater number of institutions now compete for market share and a substantial erosion of traditional lines of demarcation has allowed bank and non-bank financial intermediaries to compete across a broader range of activities.

However, despite an increase in the number of competitors, the level of concentration in the banking industry remains high. The entry of new banks in the wake of deregulation resulted in an initial drop in market share for incumbent nationally operating banks, but a recent series of merged and acquisitions had again concentrated the industry.[25] The Prices Surveillance Authority Report No. 65 reached similar conclusions.

Nevertheless the Martin Committee found that, on the whole:

- banks were more efficient;
- finance was more widely available; and
- banks were more responsive to customers' needs.[26]

3.4.3 The evolution of financial institutions and products offered by them, and the impact on the regulatory structure of the industry

Most if not all financial institutions have to some degree moved away from their historical industry-based products and as mentioned earlier in this submission, many major financial institutions' strategic plans and marketing initiatives are based on the concept of building and promoting themselves as broad-based providers of financial services. Large wholesale financial providers have been developing sophisticated financial products (often referred to as financial derivatives) to meet quickly changing business needs. Whilst it is not correct to say that these developments have occurred solely as a result of the implementation of the Campbell recommendations, the Inquiry has clearly had an input on the shape and nature of the financial market in Australia in which these developments have occurred.

In relation to the impact on the regulatory structure the Campbell Committee recognised that greater prudential supervision was required under a deregulated system. This was understood as deregulation plus simultaneous

[25] The Report of the Martin Inquiry on Banking 1991.
[26] ibid.

re-regulation or 'liberalisation'. The Campbell Committee suggested that capital adequacy requirements should be the principal form of prudential regulation. The Campbell Committee also recommended the development of a 'national framework for the prudential regulation of non-bank institutions which accept deposits primarily from households without issuing prospectuses', along the lines of the co-operative approach adopted by the Federal and State authorities to the regulation of companies and the securities industry.[27] Building societies and credit unions, both of which are supervised by State authorities, would be the main intermediaries affected. Merchant banks that solicit small deposits could also be involved. AFIC has since been established and fulfils this role.

Despite these changes the regulatory structure has predominantly been developed on an institutional basis. Regulators are structured according to the institutions they regulate rather than the nature of the financial products and services those institutions provide. As convergence within the industry has increasingly blurred the boundaries between financial institutions, this framework has become less relevant and has lead to inconsistencies, gaps and overlaps in regulation. Moreover, the national character of Australian markets and the new international trading environment has created jurisdictional, administrative and enforcement problems that only a national approach can resolve.[28]

Globalisation of the financial system is also threatening the effectiveness of the regulatory system and calls for an appropriate policy response. The United States authorities are keenly aware of the problems in this area in recognising:

"The challenges which the Securities Exchange Commission (SEC) faces today both in gathering and enforcing US laws in cases where transactions have an international character are directly linked to the continuing evolution of the international market place. Accordingly, they are just beginning to be engaged. Today orders are routinely entered in one market and executed in another country. However, it may soon be commonplace to execute orders in numerous steps, involving several different and overlapping national jurisdictions. Indeed, the development of this new and complex market system could rapidly overtake market professionals, governmental regulatory bodies and the international legal and financial communities before they can mould a legal framework for it."[29]

3.4.4 Economic effects of deregulation on growth, employment and savings

The economic effects of the implementation of the Campbell Inquiry recommendations particularly the impact on growth, employment and savings are extremely difficult if not impossible to identify given other major factors which have impacted on the Australian financial system over the same period. Indeed, there is conflicting economic opinion on what the results have been and whether the economic trends experienced in Australia would have occurred despite implementation of the Campbell Inquiry recommendations.

[27] CAMPBELL INQUIRY - Australian Financial System. *Final report of the Committee of Inquiry*, September 1981, AGPS, Canberra, 1981

[28] LEVY, Peter, First Asst Secretary, Business Affairs Division, Attorney General's Department.

[29] MANN Michael D., United States Securities and Exchange Commission, 'Current Issues in International Securities Law Enforcement'.

While we offer no opinion on this economic debate, we do suggest that it is disappointing that national saving and in particular household saving for which the financial services industry provides products and services has deteriorated during the period since the Campbell Inquiry. This is despite the significant progress in the deregulation and development of the Australian financial system. This pattern is of concern and clearly impacts growth and employment in the broader economy. (Section 9 discusses national saving in the context of this Inquiry.)

3.4.5 Summary

The direct and specific impacts of the implementation of the Campbell Inquiry recommendations are extremely difficult to assess given other major developments which have affected the Australian financial system. Moreover some of the Inquiry's recommendations are only now being fully implemented whilst others have not been implemented at all.

Nonetheless the deregulated environment which followed implementation of the Campbell Inquiry recommendations has led to positive development in the Australian financial system. In particular, during the same period since Campbell there have been significant developments in the choice, cost and quality of financial products and services, the efficiency of the financial system, including its competitiveness, and the evolution of financial institutions and products. Whilst these developments have generally benefited consumers, it is arguable that they have not gone far enough and have not been without their cost.

3.5 Summary

This section has examined the major developments that have influenced the global and Australian financial market since the Campbell Inquiry including those arising from implementing the Inquiry's recommendations. These developments will also influence the future shape of the industry and by way of summary we have projected how the Australian financial system might evolve in light of them. This projection is predicated on two points:

- first, we have adopted a consumers' perspective, as well as an industry perspective; and
- second, the projection is based on the possible maturity in the early years of the next century of existing technologies, along with reasonable extrapolation of established trends. In that respect, it is conservative rather than 'futuristic'.

The objective of this vision of the future is to identify key emerging issues from the likely future shape of the Australian and global financial market early next century with which financial regulators and more broadly national governments will be faced.

3.5.1 Consumers' perspective

In terms of financial products and services, the consumer of the next century will have the same basic needs as those of mid-90s consumers:

- transactions and cash flow management;
- lending;
- savings and investment;
- financial risk protection; and
- information and advice there on.

However, these needs will be met in ways that reflect technological advances and other progress, and responding industry strategies.

Consumers will have access to so much advice and information from so many sources that the real breakthroughs will be in extracting and packaging relevant information in a personalised form.

At home, the individual consumer will have low-cost access to global information systems (eg. the Internet) integrated with home computing and multi media centres that provide online financial information from Australian and international providers and the consumer's financial adviser. This information will include latest prices, trading volumes, corporate financial reports and prospectus information for corporations and investment vehicles in developed and developing economies and could be presented in real time, on a continuous basis or on demand. The plethora of advice and information will be made manageable by the system's ability to filter according to simple criteria, by the highly summarised content presented by online service providers and by the personalised summary provided by an adviser's computer system. In addition interactive financial advisory services will increasingly enable consumers to manage their own financial needs.

The globalisation and convergence of financial markets will be reflected in real time access to a full range of financial products and services. Loans from a range of domestic and international providers for business, housing purchase, consumption and investment will be advertised online and approved with only minor delay. Life insurance products will be freely available on line although consumers may wish to consult their adviser before purchasing which could be facilitated by video conferencing.

Consumers will also have direct access to their own financial records, be they held on their own system or that of their accountant or adviser, with real time updating of account balances, investment values, trading advice, etc. For corporations this will provide enormous flexibility in treasury management.

Stored value cards or other similar technology will increasingly replace cash for small purchases and electronic cash is likely to be accepted globally, not unlike credit cards today.

Choice, price, service and convenience will be key issues for consumers. Bank branch networks will increasingly be replaced by 'points of representation', including supermarket kiosks, video-conferencing-equipped customer centres, small business outlets. The consumer will not need to maintain funds in low-interest accounts as the many financial services providers will offer customised short to medium term savings and retirement accounts with at-call cash management features.

Two features of savings and investment will be the higher weighting given to foreign offerings in personal investment portfolios as global providers compete vigorously for managed funds, and product flexibility. Highly flexible products will allow on-line switching of funds including cross border transactions in all investments, including retirement savings.

Financial administration matters, will be handled directly and transparently by computer-to-computer systems. Email and electronic commerce, including electronic data interchange will be in widespread use.

Products generally will be highly competitive and range from the highly commoditised and price-sensitive products to more sophisticated tailored products. Many financial products will be manufactured by specialists but marketed, packaged and tailored by third party providers.

3.5.2 Industry perspective

From the industries perspective the financial market is likely to become more polarised into full service entities and niche players, with relatively less 'middle ground'. Companies will increasingly be:

- Large scope, often global, players who can compete on costs, with large, diverse customer bases, multiple distribution channels and an expanded product range; or
- Specialists with a discrete customer base and limited distribution options, specialising in narrow product bands and driving profit through innovation.

This will lead to a market in Australia which is likely to be characterised by:

- a few large universal providers;
- a number of large world wide product specialists; and
- a proliferation of small retailers with specialist products and/or markets.

3.5.3 Implications

The Campbell Committee pointed out that "regulation will do least harm to the efficiency of financial markets if it neither interferes with the commercial and financial decisions of intermediaries nor restricts the range of activities they undertake. Conversely, regulation that inhibits companies' ability to adjust their balance sheets in response to changing market conditions may impair their ability to compete."[30]

As discussed in this section, market conditions have changed significantly since the Campbell Inquiry. Moreover, the projections for the future indicate there will be further major change which we predict will be even more significant than that which has occurred over the last 15 years. In this environment providing flexibility for companies to develop to meet change whilst appropriately regulating the financial system will pose major challenges for regulators. In particular:

- The rapid increase in the volume of trading in financial market instruments poses a major question for national regulators on the extent to which they can continue to regulate huge volumes of increasingly complex financial flows. Similarly, the rapid increase in cross border transactions and the emergence of global institutions will threaten the ability of governments to effectively regulate their domestic financial markets. These factors must lead to greater regulatory cooperation at an international level.
- The increasing level of integration and will increase the potential for regulatory gaps and overlap, as well as for over regulation in an institutionally organised regulatory system. Regulatory systems must therefore adapt to ensure they more closely match the market.
- Contagion risk within conglomerates will become an increasingly important area for regulatory attention, both domestically and at an international level, as companies operate an increasingly wide range of businesses off different balance sheets and across geographic boundaries.
- The impact of technology and marketing developments will have important ramifications for the future regulation of financial systems. There needs to be careful consideration of the potential impact of the Internet and emerging technologies. It is essential that the standards and requisite infrastructure for electronic commerce are developed and implemented quickly, to ensure both local efficiencies and international competitiveness. The control of e-cash and successful implementation of electronic cash systems will be of critical importance in this area. Australians have proved to be early adopters of new technologies, particularly in consumer electronics. Indeed Australia is listed sixth out of 55 countries surveyed in technology acceptance[31]. This positive attitude of Australian consumers, coupled with the experience and expertise developed by Australian firms in the implementation and use of systems such as ATMs, potentially provides Australia with a competitive advantage in the electronic marketplace.
- As the trend towards more direct and less personal marketing continues aided by technological developments, the rights of the consumer warrant greater care. Whilst the obligations of consumers to exercise reasonable care in financial transactions is self-evident, the complexity and range of choice, and the potential for inadequate or misleading information will drive the need to implement consumer education programs.
- As new entrants come into the industry, they will be able to focus on niche segments. Cross subsidisation between customers will become increasingly impractical, and will seriously undermine those institutions that continue to engage in it. The major issue for regulators will be to

[30] CAMPBELL INQUIRY - Australian Financial System. *Final report of the Committee of Inquiry*, September 1981, AGPS, Canberra, 1981

[31] The International Data Corporation [IDC] survey quoted in the *Age*, 18 June 1996

ensure that these new players are not unfairly advantaged by being able to bypass regulations that affect established players

- Australian companies cannot ignore global competitive trends. They must be provided with the flexibility and platform to compete on world wide terms. If this requires a scaling up of operations through mergers and acquisitions, the regulatory framework should provide for this, while ensuring that consumers' interests are not compromised.

As we discuss later in section 6 we believe that there will need to be changes to the current regulatory structure to address these issues and to ensure Australia's financial system is internationally competitive in the emerging global market place.

[32] ibid.

SECTION 4

NATIONAL MUTUAL - A CASE STUDY

National Mutual - a case study

4.1 Introduction

4.2 National Mutual

4.3 AXA

4.4 Summary

4.1 Introduction

The changes in global and domestic financial markets since the Campbell Inquiry will appear minor compared to those expected over the next 15 years. The effects of these changes on one major Australian financial institution - National Mutual - mirror the trends and issues we have discussed.

4.2 National Mutual

At the time of the Campbell Inquiry the financial services industry both in Australia and globally was very different to the industry today. So too was National Mutual different. At that time we were a traditional Life Insurance company with a relatively narrow focus. Our major products were a range of traditional, regular premium policies. Our distribution capability was largely through our tied or sole National Mutual agency force. At that time National was number two in most market segments. We had a similar position in New Zealand. We did not have a separate funds management company and there were quite strict limits on the investments we could undertake for our policy holders. For example the "30/20" rule still applied to fixed interest investment, while we were prohibited from investing in overseas equity markets. We did, however, have a building society.

Internationally, National Mutual had operations in New Zealand - similar in relative size in the New Zealand market to our position in Australia - together with relatively smaller operations in the UK, Ireland and also South Africa. We sold our South African business in 1986. Each of these operations were effectively branches of the parent company, The National Mutual Life Association of Australasia.

It was apparent at that time that the financial services industry both in Australia and overseas was about to enter a period of significant change. Our assessment of the environment was that given our sizeable market presence in a number of our key markets, it was going to be difficult to grow these significantly in the future. As well, we saw that the banks were likely to broaden their product focus entering into markets which we saw as our own. Importantly, we saw that there was likely to be a significant trend towards globalisation of the financial services industry - starting in areas such as funds management - and that successful companies were likely to be those offering a broad range of financial products and services to their clients. This in turn led to a strategy which had two broad themes.

- to broaden the range of services we provided in our core markets in Australia and New Zealand to enhance our growth opportunities; and

- to move to overseas markets to give us a global spread and consequent diversification and to enhance our growth prospects.

In 1983 National Mutual merged with the T&G Society. At the time, this was one of the largest and most complex mergers in Australia, producing a combined life insurance company with a wider range of products and services than that of any other Australian life insurer.

In 1985 we entered into a joint venture banking arrangement with the Royal Bank of Canada and were granted a new banking licence for National Mutual Royal Bank. From our perspective this enabled us to merge our existing building society interests and our investment bank Capel Court into the bank. In the same year we formed National Mutual Portfolio Management which was to be our vehicle to enter the gathering of third party funds in the funds management area.

In 1986 we acquired the life insurance interests of the American Sentry group in both Australia and Hong Kong. These companies are Australian Casualty & Life, based in New South Wales and what has become National Mutual Asia in Hong Kong. That same year, as part of furthering our expansion offshore, we bought the life and unit trust business of Schroders as a means of doubling the size of our existing UK life insurance company. It also gave us access to the important unit trust market. In 1988 we entered the North American insurance market by the acquisition of Integrity Life, a specialist life insurer of the Equitable group.

Our global aspirations were expanded to include funds management in 1989 with the establishment of what became known as National Mutual Funds Management Global. By combining our existing funds management operations in Australia, New Zealand, the United Kingdom and Hong Kong with an acquisition in North America and a start-up operation in Japan we were able to create a full global funds management business.

The new decade started with the proposed merger of National Mutual with the ANZ Banking group. This would have led to Australia's largest bancassurance operation, but was prevented by the then Australian Government, leading to the establishment of the "Six Pillars" principle. Prevention of the merger forced National Mutual to exit from the banking sector in Australia, with the sale of its interests in National Mutual Royal Bank (Australia) and National Mutual Bank (New Zealand) to ANZ.

In 1991 National Mutual Health Insurance Pty Ltd was established, acquiring Mutual Community Ltd, which operated the HBA and Mutual Community health fund businesses. National Mutual Health is now Australia's third largest private health insurance provider.

The early 1990s were a period for reassessment of our previous strategy. In simple terms the results of our international expansion were mixed. While we enjoyed and continue to enjoy outstanding success and rapid growth in Hong Kong, our expanded life insurance operation in the UK and our newly acquired US business both found it difficult to compete in their mature markets with large local players who were in the process of consolidating their operations. Our review led to the sale of our non-Asian life insurance businesses in the United Kingdom, Ireland and the United States in 1993. Our focus in the future was to be in our own timezone in Asia Pacific.

Similarly, on the funds management side, we found it extremely difficult to make a success of our fledgling and small operations in the US and the UK and the sale of our US and UK life operations seriously eroded the profitability of those two businesses. With the alliance with AXA both of these operations have been closed with investment management services subcontracted to Alliance Capital (an AXA subsidiary) in the United States and AXA Asset Management in Europe. In addition, we have arrangements for marketing of our products and services to American and European clients.

Within our core domestic market we reviewed our market position with a view to broadening our distribution options and reducing our costs. This resulted in the closure of most of our direct branch network and the centralisation of back office processing. In 1994 the first NM-ACTU home loans were launched offering members of affiliated industry funds access to lower cost home loans through a direct marketing approach. This was quickly followed by the offering of home loans more broadly. In December 1995 National Mutual entered into an arrangement with Advance Bank under which we distribute risk products to Advance clients either directly or through the Banks branch network.

In some of our key markets we will continue to move towards the provision of a full range of service to our clients. However in contrast to our earlier strategy, we will not necessarily look to provide all these services ourselves but rather enter into arrangements with other providers.

Notwithstanding the failure of the proposed ANZ merger, we continued to pursue options for moving to a stock company listed on the stock market. Our views about the continuing likely trend towards globalisation were unchanged as was our conviction about the need to be able to provide to consumers a broad range of financial services. This stance combined with the need to meet proposed more stringent capital requirements in the new Life Insurance Act, led us down a path of investigating the options of linking with a large global financial services group and the resulting demutualisation. This culminated in the alliance with AXA and demutualisation in August 1995.

We see significant benefits from demutualisation and listing. We will move to a more modern corporate structure as a stock company. In addition to giving us access to capital markets it will also impose new disciplines and a higher degree of accountability on management. These changes will be, we believe, beneficial to both our policy holders and our new share holders and will be essential for us if we are to compete effectively in Australia, New Zealand and the Asia Pacific region as competition in these markets intensifies.

Our relationship with AXA has enabled our goal of becoming a global financial services group to be realised far more effectively than we were able to achieve on our own. Given our strengths in the Asia Pacific region we fit well with the AXA group which is strong in both Europe and North America.

We gain significant advantages as part of a large global group being able to share technology, product, marketing and management expertise while at the same time gaining access to huge financial resources. In total the AXA group has funds under management of around US$275billion (A$370billion). National Mutual is now the "third pillar" of the AXA group, with responsibility for development and management of National Mutual's and AXA's combined life insurance businesses in Asia Pacific.

4.3 AXA

While National Mutual's experiences over the last 15 years to some extent illustrate the trends that have affected the Australian financial system, its partnership with AXA is an important barometer of international developments. Over the past several years, the AXA Group's strategy has been to expand outside of France to gain worldwide stature and rank amongst the small number of global competitors active in all major international insurance markets (notably Western Europe, North America, and Asia Pacific).

AXA believes that sustainable success in global financial services markets will depend on the following:

- companies must be **large** (i.e. financially powerful) both to compete effectively with other global players and to insure the increasingly large risks their customers wish to cover; and
- they must be **international**, to be able to hedge their risks worldwide, to avoid dependence on a single economy and to be able to support clients in their international growth.

The Group has taken significant steps towards achieving these objectives and today ranks amongst the top insurance groups worldwide. This has been achieved through significant international expansion initially in Europe through the merger of five French mutual companies including their European subsidiaries and over the last five years in the US and Asia Pacific through the acquisition of a controlling interest in the Equitable Companies Inc (a US life and financial services group) and the alliance with National Mutual.

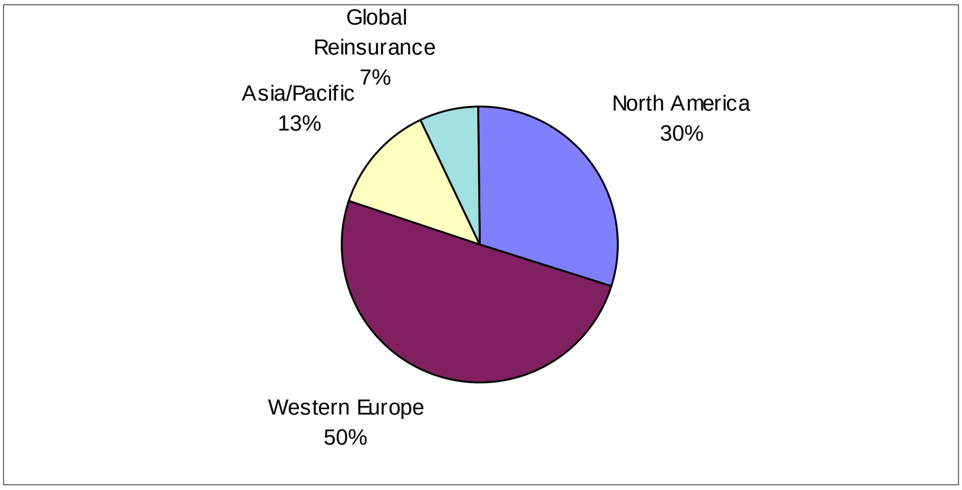
AXA now operates in over 20 countries and intends to continue its international expansion, giving top priority to three economic areas: North America, Western Europe and Asia Pacific. Figure 4.1 shows 1995 premium income derived from these three regions as well as from global reinsurance.

Figure 4.1

AXA Group

Geographic Distribution of Premium Income 1995

(Proforma - including full years premium for National Mutual)



Source: AXA Annual report 1995

At present the Asia Pacific region makes the smallest contribution to AXA's premiums excluding reinsurance, but its rate of growth is the highest. AXA expects this region to become the largest contributor to Group's revenues over the long term.

Whilst the AXA Group is firmly pursuing a strategy of globalisation it is focussing on its core businesses of insurance and related financial services in particular, Asset

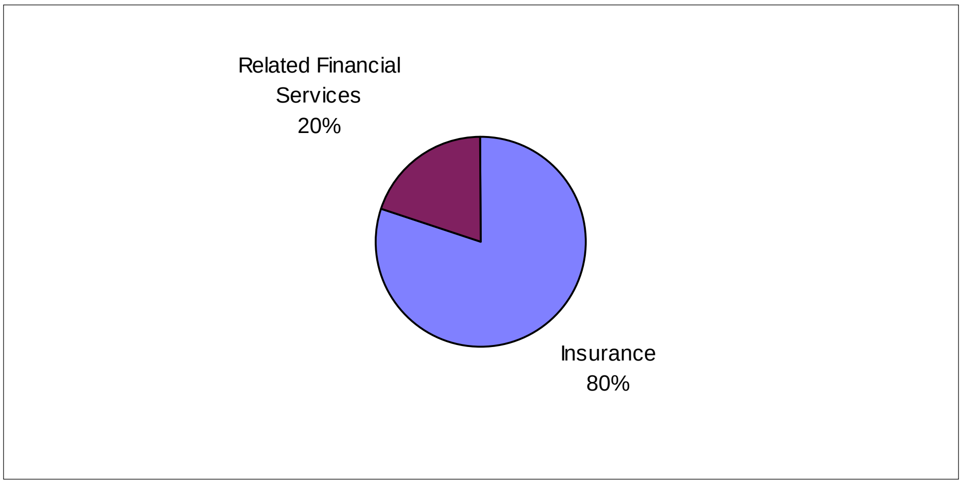
Management. Insurance includes life insurance, non life insurance and health insurance. In 1995 the split of revenues between these major business lines was as follows:

Figure 4.2

AXA Group

Functional Split of Total Revenues 1995

(Proforma - including full years revenues for National Mutual)



Source: AXA Annual report 1995

As with National Mutual, technological and marketing advances and the increasing sophistication of AXA's customers have led to significant developments in the intermediation and distribution of AXA's products and services. This now involves tied agents, multi agents, part time agents, salaried sales forces, brokers and brokerage houses, financial advisers, banks, financial institutions, major retailers, direct and telemarketing, and other channels.

4.4 The Future

The last 15 years since the Campbell Inquiry have seen monumental changes in the Australian and global financial markets which have been reflected in the developments of National Mutual and AXA. Moreover, AXA's future plans and operational focus indicate that the trends identified will increasingly alter the required approach to be competitive in the global market, in particular;

- Key strategic developments in technology and marketing focus the group's international approach in these areas regardless of national boundaries;
- AXA runs a series of synergy groups across its worldwide network the sole purpose of which is to facilitate the transfer of technologies and expertise across the group; and
- AXA is increasingly looking to adopt global marketing strategies which involve the cross marketing of 'local' products across geographic boundaries. Local implementation is driven by market and cultural differences as well as regulatory constraints. However, as these regulatory constraints come down (such as in the European community with the harmonisation process) and as technological developments become more important (such as the Internet), national boundaries will become increasingly irrelevant to truly gbbal players such as AXA.

For National Mutual we believe even more firmly than before in the continuation of the trends towards globalisation of our industry and the need for major players to be able to provide a broad range of products and services to their clients. Importantly, our relationship with AXA means that our global aspirations will be satisfied as part of the Group so that National Mutual can focus its efforts geographically on the Asia Pacific region. We expect that the scope of our operations within the region will continue to expand and cover more than 10 countries early in the new decade.

SECTION 5

AN ASSESSMENT OF THE CURRENT REGULATORY STRUCTURE

An Assessment of the Current Regulatory Structure

5.1 Introduction

While Australia has maintained a very high standard of regulation, massive change over the last 15 years and the institutional and reactionary evolution of the regulatory framework, has led to some inconsistency, overlap and uncertainty, especially in relation to similar products that fall under different regulatory regimes.

The level of complexity which has emerged in the regulatory structure is apparent when one matches the broad product service groupings from a consumers' view of the financial market with the regulators most actively involved.

Transactions and cashflow management	
Transaction facilities and access to the payments system	RBA, AFIC/SSAs, APSC
Demand deposit taking	RBA, AFIC/SSAs
Broking services	ASC, ACCC, ASX, SFE, SSAs
Borrowing	
Personal and Mortgage loans	RBA, AFIC/SSAs, ACCC
Small business borrowing	RBA, AFIC/SSAs, ACCC
Corporate finance	RBA, ASC
Savings and investment	
Savings and investment	RBA, AFIC/SSAs, ASC, ISC, ACCC, other State supervisors and Professional Associations
Risk protection	
Life risk insurance	ISC
Non-life risk insurance	ISC
Health Insurance	PHIAC
Information and advice	
Retail sales and advice	RBA, APSC, ASC, ISC, ACCC, ASX, SSAs, APSC, Professional Associations, and others.
Trustee and personal asset management services	SSAs
Wholesale financial advice	RBA, ASC, ISC, SSAs, Professional Associations.
Product information and disclosure requirements	RBA, ASC, ISC, ACCC, ASX, SFE

In addition to this complexity, the regulation of the Australian financial services industry does not reflect the industry's national structure. Many state regulated institutions are increasingly trading across state borders. An additional level of State regulation must be questioned as it not only increases regulatory complexity and cost of regulation but is also out of keeping with the direction of the international financial services market. Furthermore making changes to the existing structure is cumbersome and time consuming as the development of the Credit Code clearly demonstrates.

Given continuing market changes, the major question, therefore, is whether the Australian financial system can be regulated more simply and efficiently. A more detailed assessment of the current regulatory structure, particularly in relation to the areas of most concern, consumer protection and prudential regulation, is provided below and suggests that it can.

5.2 Consumer protection regulation

Consumers desire a number of outcomes from regulation of the financial system. While details vary, there are appear to be two broad requirements against which existing regulatory structures must be measured. They are:

- the provision of accurate and comprehensive information and advice about products and services, and
- the existence of simple, effective and accessible dispute resolution mechanisms.

In the area of disclosure and the provision of advice the current regulatory structure has not produced an optimal outcome.

The ASC regime of disclosure and regulation of advisory and sales intermediaries has been quite successful. The fairly broad disclosure obligations are quite well understood and allow for individual companies to determine the required level of disclosure. In addition, as the Corporations Law allows for the imposition of penalties on advisers and intermediaries who engage in inappropriate activities, both principals and agents have an incentive to comply.

The ISC disclosure regime has been in existence for almost a decade, but has gone in the opposite direction from the ASC regime. Rather than broad-based disclosure requirements, an increasingly prescriptive regime has governed both life insurance and superannuation. This has partly been the result of lack of legislative backing on the life side and the complex superannuation system in Australia, but also reflects a different philosophical outlook. In respect of agents and brokers the ISC has only very recently assumed responsibility for regulation. It would be fair to say that prior to that the regulation of agents and brokers was largely ineffective. This was partly the fault of the industry, but more importantly it resulted from the fact that the agents and brokers have very little direct liability for misleading and deceptive sales practices. Unlike the ASC regime, where both principal and adviser are liable, in the life regime the insurer is held solely responsible.

In terms of banking and related activities, disclosure in respect of deposit-type products has been more limited. The credit laws address this to some degree in relation to consumer loans; as does the Code of Banking Practices in relation to investments with the bank. The fact however, that the credit code was originally recommended by the Campbell Inquiry and yet is only now being fully implemented is an indication of the problems and delays presented by the current highly fragmented regulatory structure.

On the general insurance side, there has been little regulation of disclosure and sales practices. The recent Code of Conduct addresses this to an extent.

5.2.1 Disclosure and Advice

Disclosure in this context is used to describe the provision of information before, during and subsequent to entering into an agreement for the provision of financial products and services (however simple). From the consumers' perspective, such information must be comprehensible, accurate, complete and sufficient to enable informed decision making.

A wide range of legal requirements dictate disclosure of information in the Australian financial system. They include:

- Common Law requirements;
- Corporations Law;
- Superannuation Industry (Supervision) Act;
- Trade Practices Act;
- State Fair Trading Laws;

- Life and General Insurance Circulars;
- Insurance Contracts Act;
- Credit Acts; and
- Code of Banking Practice.

To further complicate matters, there is a different regulator for almost every set of regulations. They include:

- ASC;
- ISC;
- ACCC;
- RBA;
- various State Regulatory Bodies;
- State Credit Tribunals; and
- the Courts

Despite the proliferation of regulators and regulations since the introduction of the Trade Practices Act in 1974, we believe there are still significant shortcomings in the areas of disclosure.

From this large volume of regulation, three fairly distinct disclosure regimes can be distilled: the ASC prospectus regime, the ISC prescriptive disclosure regime, and the ACCC catch-all disclosure regime.

The bank, building society and credit union regimes require limited disclosure. This has always been argued as sufficient because of the nature of bank products. Indeed, no-one seriously challenged the lack of bank product disclosure until the Code of Banking Practice introduced some limited prescriptive requirements.

While the non-prescriptive ASC due diligence/prospectus regime has been successful, it requires fine tuning as it arguably requires the production of too much of disclosure material, which sometimes serves to confuse consumers.

The ISC disclosure regime is heavily prescriptive. It requires the production of detailed and jargonistic disclosure documents the contents of which many would argue will tend to confuse rather than enlighten consumers. Further, because of the current institutional basis of regulation, the regime does not apply to similar products that are covered by other aspects of the regulatory structure. The banking disclosure regime is also prescriptive, but less so.

Finally, the Trade Practices Act imposes another set of disclosure requirements that overrides both regimes and often conflicts with them.

A further example of unsatisfactory overlap relates to the fundamental requirement for a consumer-oriented financial services industry to provide information that is neither misleading nor deceptive, whether by act or omission. So widely accepted is this proposition that no less than three sets of federal laws deal with the issue, together with at least one set of rules from each of the States.

It is not necessarily inefficient for different sets of regulations to prohibit the same conduct. However if those laws are administered by different regulators, at best they create confusion and, at worst, they can deliver an entirely different outcome, depending upon which regulator chooses to become involved.

For example, each of the ASC, ACCC and ISC is entitled to require a product provider to adhere to its rules relating to misleading and deceptive disclosure obligations in circumstances where an ASC-regulated product is sold together with, or as part of, a life insurance/superannuation product.

The need to comply with the most stringent requirements often occurs as a result of different views being taken by different regulators as to what is misleading or deceptive with respect to a particular product or, indeed, what is omitted from the raft of disclosure that could by reason of its omission tend to mislead or deceive. In order to ensure compliance with all the different regulators' requirements, providers will often give consumers large quantities of information, some of which may not be relevant to the particular product or is, at best, marginally helpful to a consumer in forming an opinion on whether or not to purchase.

Investment advisers face particular difficulties because they are often required to advise on products that are generically similar but fall under different regulatory regimes. These include the Corporations Law requirements for financial planners, the Code of Practice for life agents and the Code of Conduct for general insurance. Conversely there are no specific requirements for non-life superannuation advisers and bank employees.

Regulators have recognised this problem and have entered into processes (including the ASC/ISC ''Harmonisation'' project and the Council of Financial Supervisors "Financial Supervision Boundaries and Approvals" project) designed to eliminate gaps, overlap and inconsistencies in the regimes regulating sales and advisory practices for functionally similar retail savings and risk products.[33] These are clearly worthwhile exercises, but the issue must also be addressed by this Inquiry, particularly as advice on other matters (such as general insurance and property gearing schemes) are not covered.

5.2.2 Dispute resolution mechanisms

Historically, adequate dispute resolution systems did not exist and, notwithstanding the contribution of some State bodies and other consumer bureaux, consumers were largely required to resort to the courts to achieve acceptable outcomes. The fact that many could not afford this recourse led to a strong consumer push for an alternative system.

As a consequence, over the last five years or so a multiplicity of procedures and systems for consumer complaints resolution have been established. The number of alternative processes has reached a point where it is now potentially confusing to consumers, as well as adding a layer of unnecessary costs to the system.

There are now numerous complaints resolution schemes (including the ISC and ACCC informal arrangements). Often it is open to consumers to choose more than one scheme in relation to a specific complaint. Many of these schemes are also available to consumers who have exhausted the remedies available under one of the alternatives. While a consumer who has already tried (and failed) in another scheme may be less likely to succeed, the fact that the option is available at no (or minimal) cost, provides the temptation to use it.

While we believe that the existing complaints schemes deliver their intended outcomes, they do so in a highly inefficient way.

By way of example, there are at least three informal and two formal avenues of redress available to a person who has entered into a personal superannuation arrangement through a life insurance policy.

[33] Council of Financial Supervisors Annual Report 1995.

Informally, the policyholder is entitled to (and often does) complain to the trustee of the fund, the ISC and the ACCC. Depending upon the nature of the complaint, any or all of those three may choose to become involved in the complaint resolution process.

In addition to the informal processes, an aggrieved person may choose to utilise the services of the Superannuation Complaints Tribunal (SCT) scheme or the (separate) Life Insurance Complaints Services (LICS) scheme. They are quite different.

The SCT is a statutory based scheme with a right of review, whereas LICS is an informal industry scheme with no right of review for the company, although complainants are not bound by decisions of the Life Insurance Complaints Panel.

A complainant may choose any or all of these processes, going on to another if one does not provide a satisfactory outcome.

A schematic (Figure 5.1) of just one of these schemes, the SCT illustrates the complexity and hence potential cost involved.

Further, if the customer has also invested in a unit trust, a bank product, or taken out general insurance or health insurance, all of which may be sold or advised upon by the same intermediary, he or she may also complain to the ASC, the ISC, the RBA, and PHIAC, as well as the Financial Planning Association Complaints Resolution Scheme, the General Insurance Enquires and Complaints Service (GIECS), the Private Health Insurance Complaints Commission, or the Banking Industry Ombudsman.

In addition to the concerns of consumer confusion about the multiplicity of schemes, some overlap and the resulting cost issues, some scheme enable consumers to exhaust their remedies by using a number of complaints mechanisms for the same issue and, having failed, then have recourse to the courts. Another concern relates to the consideration of medical evidence by schemes that may have no medical expertise. The industry is often bound by the outcomes of these schemes, and has no right of review or appeal in the event of adverse findings.

It is inevitable in the development of satisfactory consumer-oriented complaints systems that the rules and processes applicable under common law will be compromised. However it is recognised that this is a necessary part of ensuring the speedy and cost-effective resolution of complaints provided complaint resolution systems demonstrate the following advantages:

- demonstrable cost-savings for both consumers and the industry;
- accessibility to consumers;
- speed of resolution; and
- an overall impression in the mind of consumers that industry is prepared to be part of a system that treats them fairly.

Clearly, the current arrangements do not demonstrate these advantages.

Figure 5.1

5.2.3 Summary

In summary, the major shortcomings of the current consumer protection regulatory system are:

- uncertainty in the mind of the consumer about
  - who is responsible for the regulation of financial products and services, particularly where products have similar features,
  - why extensive disclosure is necessary for one product but not for another with substantially the same features, and
  - which of a variety of complaints resolution processes they should utilise;
- the additional cost (inevitably built into product price) associated with the processes; and
- industry dissatisfaction about the duplication and inconsistencies in regulation.

5.3 Prudential regulation

To provide the best environment for the development of the financial services industry, prudential regulation must be effective, competitively neutral, flexible and efficient.

5.3.1 Effectiveness

The recent history of the Australian financial services industry shows that the existing prudential regulators have been effective in maintaining the integrity of the financial system. Despite some financial failures, the system has maintained its integrity and public confidence (although consumers are doubtless now more aware of the risks involved in investment).

However, there is an increasing discrepancy between the financial regulatory structure and the structure of the market, making it necessary to re-assess regulatory boundaries. Convergence is eroding traditional distinctions between institutions, necessitating a broader view on the regulation of the industry.

Financial conglomerates are emerging because institutions see the need to provide a range of products outside their existing borders. Any regulator charged with responsibility for the integrity of the financial system must now monitor the position of a wide range of institutions. The RBA in particular needs to monitor institutions outside the Banking Act in order to prudentially supervise banks with non banking finance subsidiaries. This process is hindered by restrictions on the sharing of information concerning financial institutions which exist in various legislation.

In recent times non-banks have developed equivalents or near equivalents to most bank products. For example; certain capital guaranteed life insurance products and cash management trusts mirror some bank demand deposits; a broader range of financial institutions are providing lending products; and there is increasing demand for non-bank access to the payments system.

This blurring of institutional categories is an accelerating trend, ensuring that any arbitrary division of the financial services industry will become increasingly inappropriate. A regulatory regime that does not take an overall view of the industry will continually be forced to readjust as the industry changes, thereby creating inefficiencies and unnecessary impediments to industry development.

5.3.2 Competitive neutrality

Competitive neutrality is essential for a competitive market place and to ensure consumers receive the best choice and price for financial products and services. Competitive neutrality depends on:

- a consistent regulatory approach across all financial services providers and products; and
- minimum barriers to entry and ownership, subject to prudential requirements.

Competitive neutrality is important to Government, the industry and consumers. From the Government's perspective it is difficult to see why different regulation should apply to effectively the same products, determined only by the historical origins of the provider. From the industry perspective such a situation is inefficient in terms of both time and resources by requiring the development of two or more sets of compliance skills and procedures. It also inhibits competition. From the consumers' perspective multiple regulators create confusion about the prudential regulatory policy and conditions applying to a particular product, and the level of security or implicit guarantees they can expect.

The proliferation of savings and investment products is an example of an area which lacks competitive neutrality in the current system. As institutions battle for consumers' investment dollars, some are finding that the differing taxation, capital and other regulatory requirements make it very difficult to compete. Virtually identical products in the life insurance, funds management and unit trust areas have significantly different prudential regulatory requirements and involve several different taxation and regulatory regimes. Retirement Savings Accounts for example will be subject to different prudential regulatory provisions depending on whether they are sold by life insurance companies, banks, building societies or credit unions.

In an intensely competitive marketplace, a price differential caused for example by differing capital requirements can put some institutions at a significant disadvantage and is a barrier to free competition. Consequently financial institutions "regulation shop" for the most favourable regulatory regime.

Because prudential regulation is still based on the historical origins of the institution rather than the product provided, regulatory differences have made the financial services market more fragmented than it naturally would be. Breaking down these barriers and inconsistencies will free competitive forces and allow financial services to evolve into a more broadly based market.

Australia's regulatory structure must allow the necessary transformation of the financial system as competition and technology permit and require. Most importantly, it must allow the industry to keep up with (if not ahead of) international developments. Regulation should not unnecessarily stifle innovation nor inhibit competition.

5.3.3 Flexibility and Efficiency

A flexible and efficient regulatory structure has the following characteristics:

- the minimum regulatory restrictions on institutional and product structure;
- less prescriptive regulation, providing flexibility to meet different needs over time, without the need for continually updating regulations;
- cost effectiveness;
- certainty and stability; and
- the ability to lead and deal rapidly with future developments, particularly in product innovation and technology.

A rigid division of regulatory boundaries makes it difficult for companies to provide more comprehensive products (i.e. combining a number of consumer needs in one product) and can therefore stifle innovation. While some balance sheet separation is required for significantly different risks, differing regulatory regimes does not maximise the use of resources in the industry. This is particularly true in financial conglomerates where in effect the same senior staff may deal with compliance and regulatory issues covering several institutions.

5.3.4 Summary

The recent history of the Australian financial services industry shows that the existing prudential regulators have been effective in maintaining the integrity of the financial system. Any proposals for change should therefore acknowledge this success and build on it.

However, measured against the yardsticks of effectiveness, competitive neutrality, flexibility and efficiency the regulatory structure is fragmented and inconsistent with the market. This situation will worsen as the market evolves and the regulatory structure will come under increasing strain as the industry change in response to global competition and technological developments.

5.4 Cost of regulation

Given the shortcomings which we have identified in the current regulatory structure in particular, in relation to consumer protection regulation and prudential regulation, we have conducted some preliminary analysis of the cost of regulation in Australia and drawn some comparisons internationally. There is often considerable speculation as to the cost of regulation not just in Australia but in financial markets around the world. Unfortunately there is very little analysis available to support discussion.

Such analysis is by its nature extremely difficult because data in this area is not easily available and the assessment of costs is usually highly subjective relying on a number of assumptions. Nonetheless National Mutual believes that greater effort should be applied to analysis in this area. This will, we submit, provide a more robust framework for decision making on regulatory issues in the future.

The calculation of the **benefits** of regulation is even more difficult as it tends to involve a higher degree of subjectivity. Unfortunately in the time available for this submission we have not been able to conduct any analysis in this area.

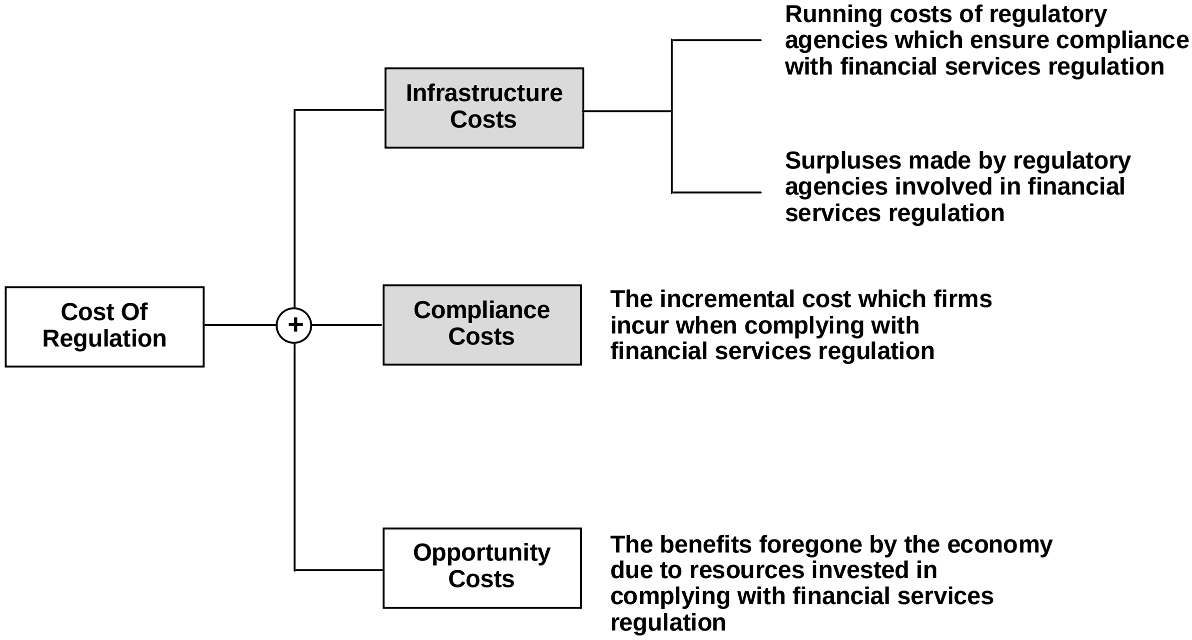
Whilst we would like to warn that conclusions drawn from this analysis of the cost of regulation should be treated very carefully because of its subjective nature, there are indications, we believe, that the cost of regulation in Australia is relatively high when compared internationally. As the opportunity for cross border selling increases it will become increasingly important for financial products and services offered by Australian providers to be internationally competitive. The extent to which the cost of regulation is not competitive internationally will compromise the attractiveness of Australian products and services in the global market place.

Components of cost

Conceptually, the total cost of regulation can be broken into infrastructure costs, compliance costs and opportunity costs as illustrated in Figure 5.2. We have conducted analysis in the areas of infrastructure costs and compliance costs.

Figure 5.2

Schematic: Components Of Financial Services Regulation Cost



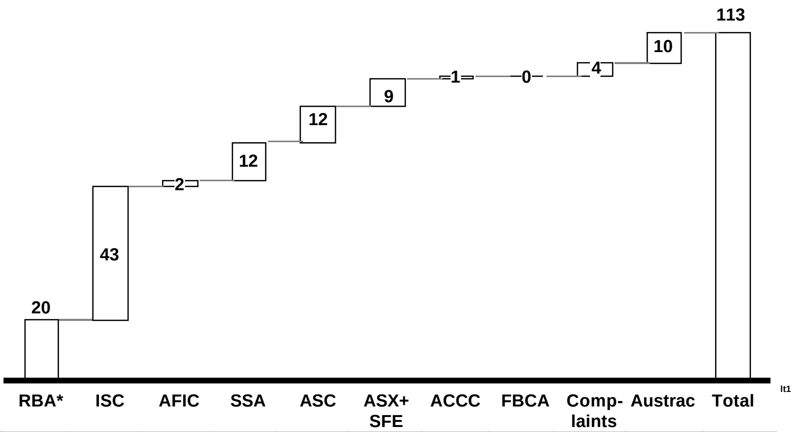
5.4.1 Infrastructure costs

Infrastructure costs include both the running costs of the regulatory agencies plus any surpluses made by them through their changing structures to industry. These infrastructure costs are recovered by the regulators from industry through a variety of methods. In general the costs are fully recovered with only a marginal surplus or deficit arising indicating that industry is essentially fully funding the infrastructure costs of regulation. However, the RBA adopts a different approach and does not separately recover the costs associated with its consumer protection and prudential regulation activities but derives significant income from profits made on holding banks' non callable deposits.

Given this net position and to enable international comparability this analysis of regulatory infrastructure costs includes only the running costs of the regulatory agencies. On this basis we estimate the infrastructure costs of regulation in Australia to be approximately A$107 million per annum. As measured against financial assets this is equivalent to just over 1 basis point.

Figure 5.3

Operating Expenses Of Financial Services Regulators
(1/100th Of A bp, 1994/95)



Cost ($m)	18.6	40.6	1.8	11.2	11.2	8.1	1.3	0.3	4.1	9.3	106.5

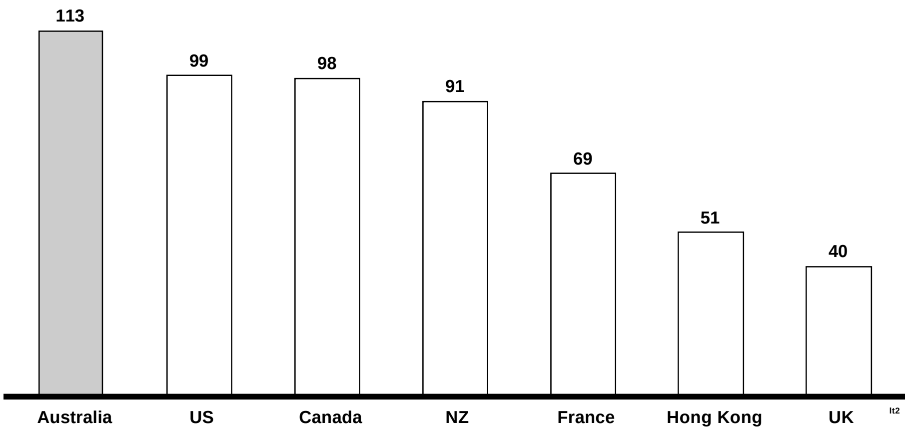
Source: Annual reports of regulatory agencies

International comparison

Our analysis indicates that as measured against financial assets the infrastructure cost of legislation in Australia might be high when compared to other countries (Figure 5.4)

Figure 5.4

Cost Of Regulatory Infrastructure
(1/100th Of A bp, 1994/95)



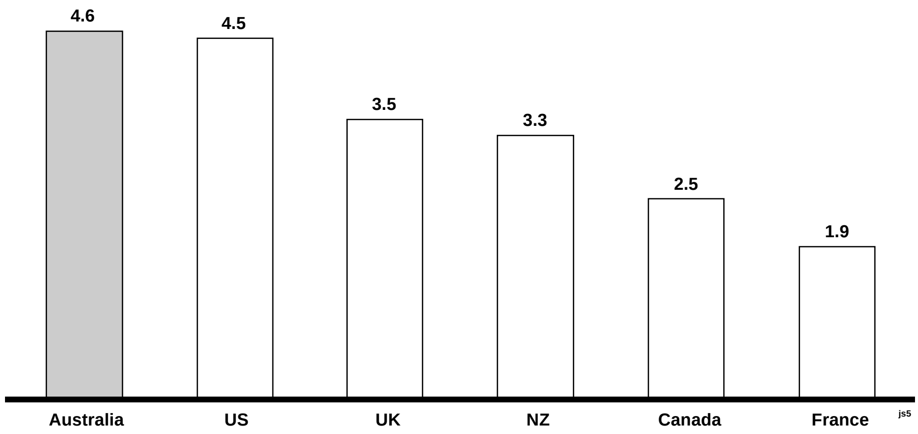
Regulator Cost (US$m)	78.8	1,134.3	66.2	10.0	109.6	113	202.7

Source: Annual reports of regulatory agencies, The Cost and Effectiveness of the UK Financial Regulatory System

Recognising that different markets may have disproportionate levels of assets the regulatory costs have also been compared internationally on a per capita basis with similar results (Figure 5.5).

Figure 5.5

Cost Of Regulatory Infrastructure Per Capita
($US Per Capita)



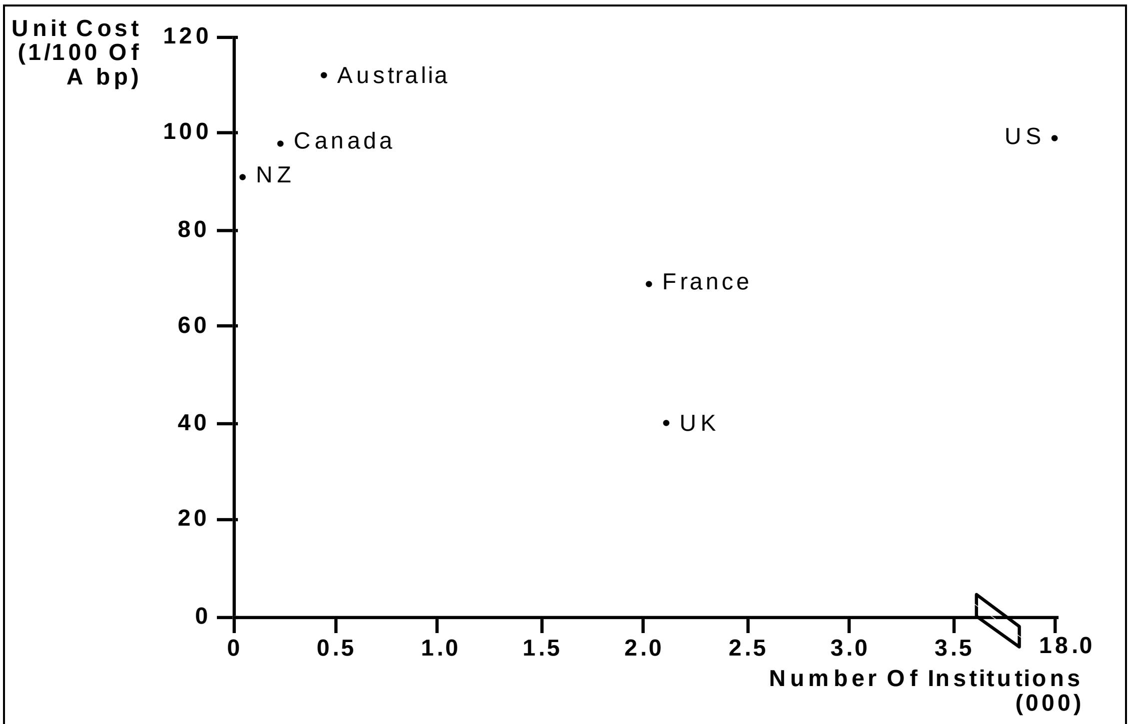
Regulator Cost (US$m)	78.8	1,134.3	202.7	10.0	66.2	109.6

Source: Annual reports of regulatory agencies, The Cost and Effectiveness of the UK Financial Regulatory System

This difference in regulatory infrastructure costs appears only partly to relate to economies of scale. An additional comparison based on a number of institutions regulated (Figure 5.6) also suggests that regulatory infrastructure costs in Australia might be higher than the other markets measured on a relative basis.

Figure 5.6

Unit Cost Versus Number of Institutions



It is not clear why the US appears to be an 'outlier' on the above graph. However, we suspect it may be associated with the complexity of the US financial system as indicated by the number of institutions regulated and its Federal / State structure.

Whilst based on the above analysis the regulatory infrastructure costs in Australia appear high when compared internationally, it is clearly important to understand the factors which might drive this. In addition to our concerns as to the regulatory structure discussed earlier in this section, these could also include, the following:

- the high standard of regulation in Australia which may come with associated cost;
- the mandatory approach to superannuation in Australia which has led to a relatively complex regulatory environment for superannuation designed to support confidence in a compulsory system of investment;
- different regulatory approaches adopted by each country. For example, in Canada the authorities have attempted to consolidate the regulation of different types of financial institutions;
- the extent of regulatory intervention including the veracity with which prudential regulation is implemented; and
- the sharing of the burden of the cost of regulation between the regulators and industry schemes, although as we show later preliminary analysis indicates that the cost of compliance in Australia might also be high when compared internationally.

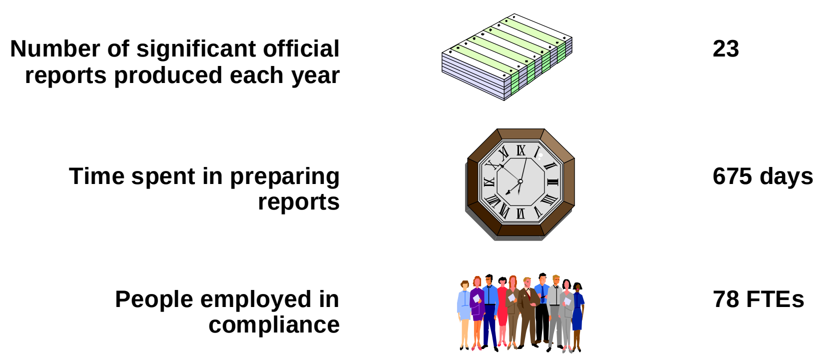
The analysis in itself does therefore not prove that the infrastructure cost of regulation in Australia is too high, as clearly the quality of the regulatory system and benefits to the consumer need to be considered. However, if Australia is to compete internationally in the future when global regulatory shopping will be feasible, it is important to understand more about these differences.

5.4.2 Compliance costs

Compliance costs include those expenses incurred by industry to comply with financial services regulation. We have looked at compliance costs by conducting internal analysis at National Mutual. Compliance activities at National Mutual Group generate substantial outputs and consume significant resources (Figure 5.7).

Figure 5.7

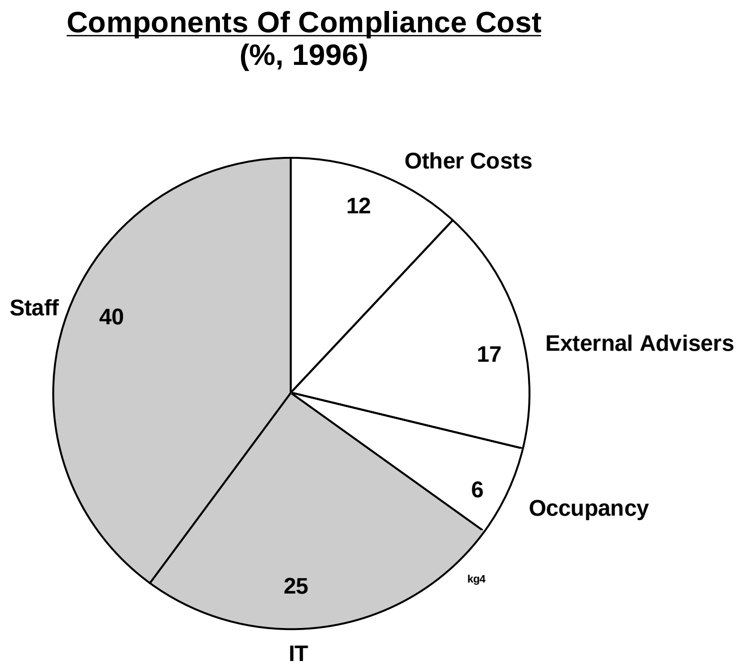
Example Of Compliance Activities



Source: National Mutual

The bulk of compliance costs incurred at National Mutual are related to systems and staff (Figure 5.8).

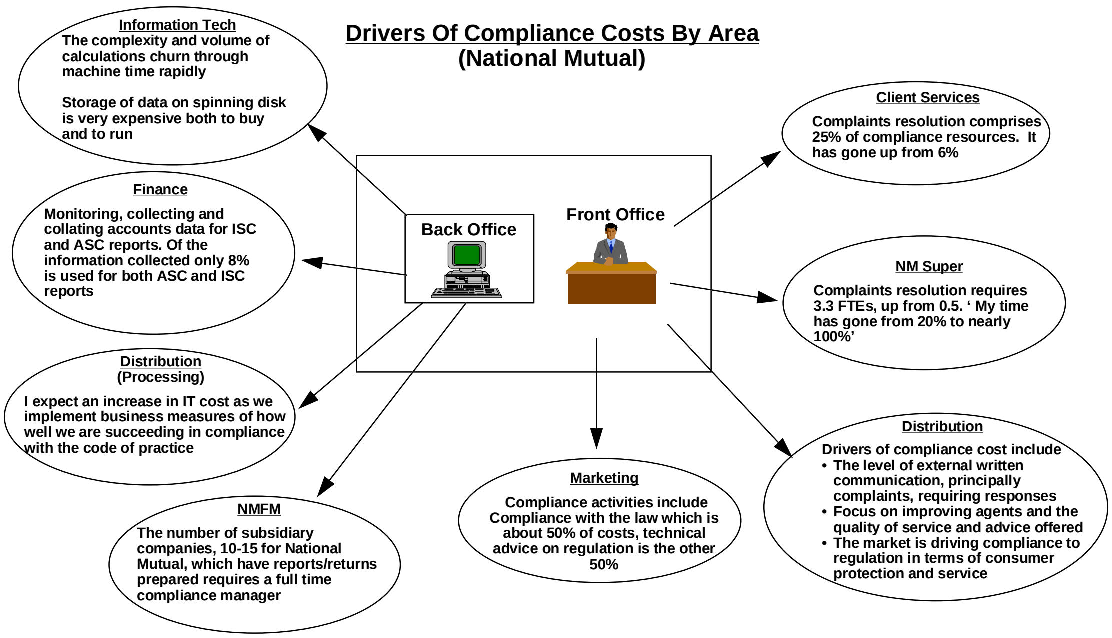
Figure 5.8



Source: National Mutual

Compliance activities are spread throughout National Mutual including the operating businesses as well as most head office functions. Consequently the drivers of compliance cost arise from many areas. (Figure 5.9).

Figure 5.9

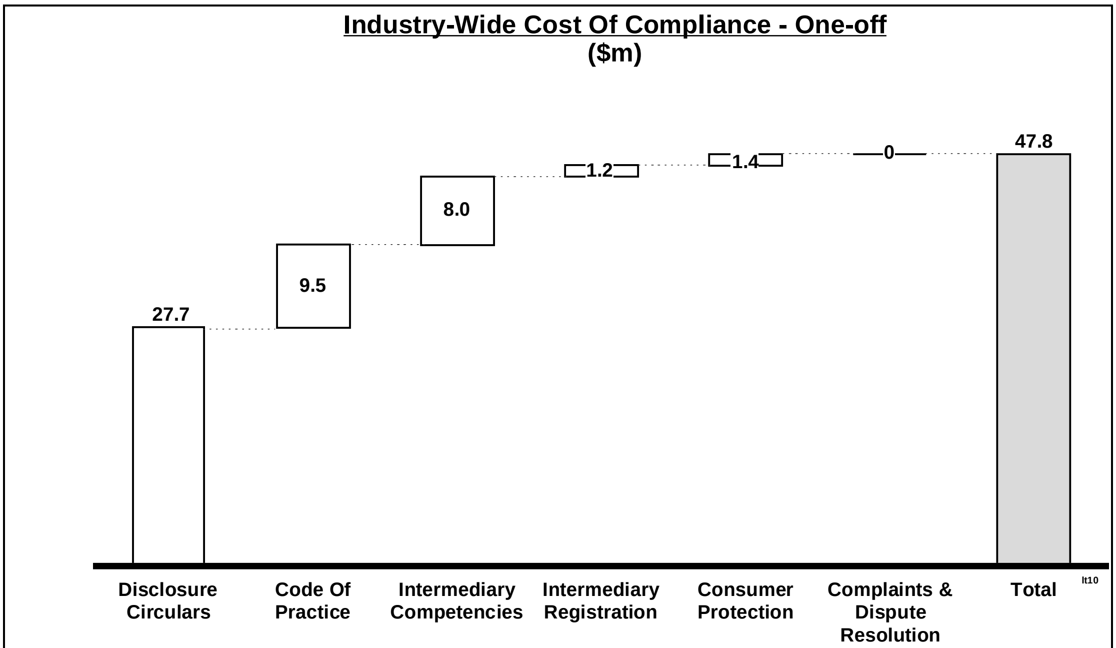


Source: National Mutual

Whilst compliance obligations are clearly significant, there is no doubt that a proportion of work which is conducted to meet regulatory requirements would be incurred anyway as good management practice. We estimate that the incremental costs associated with meeting the regulatory requirements which would not otherwise be incurred represent approximately 45% of all compliance costs incurred at National Mutual. We are not suggesting that compliance work should necessarily be reduced, however as an industry it is important to continually review our regulatory approach with a view to improving efficiency.

Compliance activities give rise to both recurring expenses and one off expenses. The later usually arise from new procedures which are introduced as a consequence of regulatory changes. For example a number of recent developments within the regulatory framework affecting the life and superannuation industry have, using analysis from a survey conducted by the Life Investment and Superannuation Association (LISA), given rise to one off costs across the industry of A$48 million (Figure 5.10) and recurring costs of A$88m per annum (Figure 5.11).

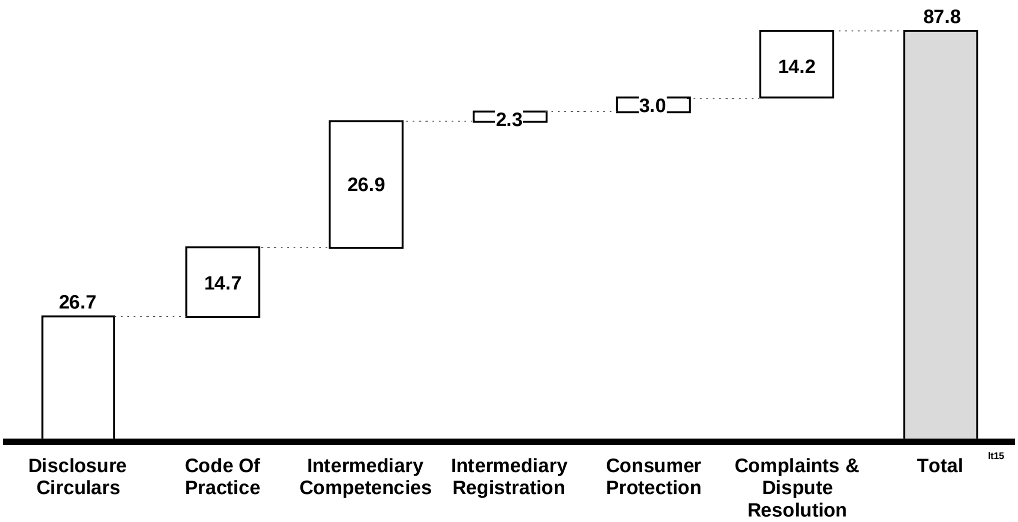
Figure 5.10



Source: Life Investment and Superannuation Association survey; Interdata Financial Handbook 1996; Assirt Market Share Report 1996; RBA Bulletin

Figure 5.11

Industry-Wide Cost Of Compliance - Recurring costs
($m pa)



Source: Life Investment and Superannuation Association survey; Interdata Financial Handbook 1996; Assirt Market Share Report 1996; RBA Bulletin

International comparison of the cost of compliance is even more difficult than comparison of infrastructure costs of regulation due to the lack of analysis and availability of data, the degree of subjectivity involved and the different approaches which have been used internationally within the limited analysis which has been done.

Nonetheless we have attempted to conduct some comparative work based on the limited information which is available. First however we have estimated the total compliance cost of the industry in Australia.

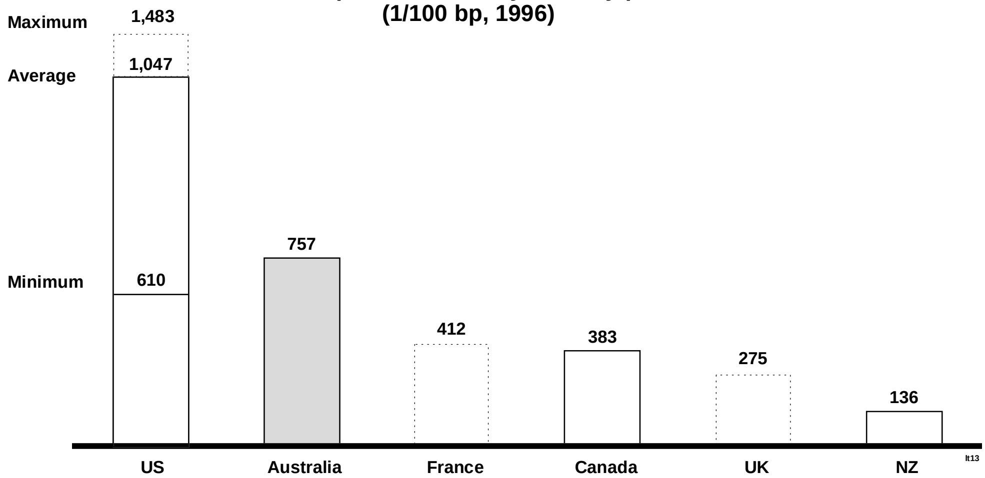
- we have estimated the cost of compliance for the life and superannuation industry and funds management industry based on our own internal analysis and that of LISA to be A$220-A$330M per annum.
- from an independent survey by Ernst and Young we estimate the cost of compliance for the general insurance industry to be A$40-A$60M per annum; and
- based on anecdotal evidence from various sources we estimate the cost of compliance for the banking industry to be A$300-A$500M per annum.

This analysis indicates a total cost of compliance for the Australian financial services industry of A$560-A$890M per annum, the mid point being A$725M.

Compared internationally as a percentage of financial assets, this cost seems high (Figure 5.12).

Figure 5.12

Compliance Costs By Country pa
(1/100 bp, 1996)



Compliance Costs (US$m)	**12,000***	**533**	**649**	**258**	**1,425**	**15**

Source: The Cost and Effectiveness of the UK Financial Regualtory System; American Bankers Association; BAI and McKinsey; Lomax "London Markets after the Financial Services Act"; Graham Bannonck and Associates; The Conference Board of Canada Journal; New Zealand Bankers Association; National Mutual

5.4.3 Conclusion

The cost of regulation is exceptionally difficult to measure. There is very little data available and any analysis is by its nature highly subjective. Subject to this caveat, preliminary analysis does suggest the cost of regulation in Australia might be high by international standards and this cannot be explained by economies of scale alone.

The high cost of regulation may relate to the relatively complex regulatory environment which exists in Australia and the duplication which arises as a consequence. However, whatever the conclusion, it is clear that further analysis must be conducted in this area to provide a framework for decision-making on regulatory issues in the future and to monitor our international competitiveness in this area. Future regulation of the financial system must recognise the need to be cost competitive, effective and of high standard on an international basis.

5.5 Competition policy

Competition policy has been regulated in Australia by the ACCC since November 1995 and before then by the Trade Practices Commission. The ACCC operates under the provisions of the Trade Practices Act. It is responsible for the administration and enforcement of the competitive conduct rules of the Trade Practices Act.

National Mutual believes that the existing structure of a single national commission to administer competition policy is sound and has served the Australian consumer well. The ACCC has fostered discussion of merger and acquisition guidelines and generally makes public its evaluation process. The Commission has also recognised the importance of educating the community and business about the provisions of the Trade Practices Act to permit a clearer understanding of what needs to be achieved across a spectrum of competition policy and between trade practices and prices policy.

5.5.1 Approach to competition policy

The ACCC in considering an acquisition is required to:

- define the market;
- consider whether that market is substantial; and
- determine whether the acquisition would be likely to substantially reduce competition within that market.

In evaluating whether or not a proposed acquisition is likely to have the effect of substantially lessening competition, there are statutory 'merger factors':

- the actual and potential level of import competition in the market;
- the height of barriers to entry in the market;
- the level of concentration in the market;
- the degree of countervailing power in the market;
- the likelihood that the acquisition would result in the acquirer being able to significantly and substantially increase prices or profit margins;
- the extent to which substitutes are available in the market or are likely to be available in the market;
- the dynamic characteristics of the market, including growth, innovation and product differentiation;
- the likelihood the merger would result in the removal from the market of a vigorous and effective competitor; and
- the nature and extent of vertical integration in the market.

As part of the evaluation process, the ACCC will look at such factors as:

- what constitutes the market;
- concentration thresholds which filter out mergers that are not likely to result in a substantial lessening of competition; and
- barriers to entry.

There is currently a divergence of views as to how competition policy is applied in Australia, particularly in relation to banks.

5.5.2 What is the market?

Consumers of financial services in Australia historically relied upon competition between participants in well defined and separate segments of the financial industry. Consumers looked to banks for traditional banking services, life insurance companies for traditional insurance products and more recently to a broader range of participants in the savings products industry offering collective investments. Consumers therefore traditionally relied upon competition between the participants in the segment of the market in which they were dealing. Market and technological forces have resulted in a convergence of these market segments and a blurring in the distinction of products available to consumers.

This trend raises issues as to how the market is defined for competition policy purposes. In particular, is the market restricted to banking or banking products with another market for non-banking savings products, another market for non-banking credit and yet another market for insurance related products? Do we consider deposit share; or loan share; or a combination of both?

As has happened in the US, the ACCC adopted the "cluster approach" of retail banking services to define this market. The ACCC believes the factors which lead to a competitive advantage in supplying a full range of services are:

- the continuing importance of branch networks for a range of retail banking services, of which transaction banking forms a part, and is seen as the basis of a relationship that generates other retail banking business. At the present time the ACCC's view is that the transaction relationship appears to be capable of permitting "cross-selling" of service products and "price rises" (increases in loan interest rates and decreases in deposit rates) without significant movement of customers. Customers are reluctant to change banks or go to a variety of suppliers of financial services, for a number of reasons including,

  - information and search costs,

  - procedural requirements under the *Financial Transaction Reports Act*,

  - the possibility of having to go to a more distant branch,

  - perception of financial security of banks, and

  - break costs such as interest penalties and stamp duties;

- financial products are now combined through the linking of transaction accounts with credit cards, the linking of personal loans with home loans and the linking of access to electronic transfer system with other products;

- the possibility that the integration of products through electronic banking will significantly increase customer information and transaction costs in sourcing particular products from disparate suppliers; and

- customer surveys which indicate that the overwhelming majority is unlikely to change their main financial institution.[34]

It is submitted, however, that the advantages being enjoyed by the banking sector are being quickly eroded. Non-bank institutions have acquired significant shares of the credit card market and the importance of branch networks is rapidly diminishing. (Indeed, some banks are considering whether they should write-off the carrying value of their branch network). Transaction relationships now can be forged by a life insurance company with its traditional customer base and superannuation funds to promote

[34] FELS Profeesor A paper for AIC Conferences on 28 February 1996

home or personal loans, the approval for which can be provided over the telephone (ie no branch network is required).

5.5.3 The merger concentration thresholds

Having defined the market ACCC establishes concentration thresholds to filter out mergers which are not likely to result in substantially lower levels of competition. If these thresholds are not exceeded, the ACCC is unlikely to examine the merger further.

Under the current guidelines the merger thresholds are:

- if the merger results in the four largest firms having a market share of 75% or more and the merged firm having a market share of over 15%; or
- if the four largest have less than 75%, and the merger will result in the merged firm having 40% or more.

If the proposed merger does not fall within the ‘safe haven’ established by the concentration criteria, the onus lies with the parties to the merger to convince the ACCC that the merger will not result in a serious lessening of competition and hence that there is no need for intervention.

Where the parties to the merger consider that there may be significant public benefits arising from the merger, and where there may be a case for allowing it to proceed despite the likelihood of a substantial lessening of competition, the ACCC will encourage them to apply for authorisation.

The ACCC recognises that mergers can also yield significant benefits in the form of economies of scale or scope for vertical integration, and the acquisition may be authorised if it results in a benefit to the public.

In some cases a merger which breaches the concentration thresholds may create a more vigorous competitor in the market place.

In order to consider the weight of consideration that the ACCC will place on market share concentration, it will also be necessary to consider the structural changes that are currently taking place within the industry, and the implication on market competitiveness. If the wider market definition is adopted, which encompasses the whole financial services sector, merger thresholds of 40% and 75% might need to be adjusted to reflect the participation of ‘other’ market players.[35]

5.5.4 Barriers to market entry

The ACCC has indicated that significant barriers to entry and barriers to non-bank competition in the retail banking market are:

- the need to establish extensive branch and agency networks;
- the need to establish electronic banking facilities;
- customer inertia, the effects of “relationship banking” (where customers tend to use one institution for all requirements), and information and transaction costs;
- the economies of scale and scope for key costs such as data processing;
- “banking premium” (that is, the premium which banking derives from its prudential security and perception of government guarantee);
- advertising expenditure and brand awareness;

[35] BZW, Bank Sector Report, July 1995

- significant sunk costs;
- historical factors, eg access to the payments system and to deposits; and
- special skills in credit assessment in small scale lending are not easy to acquire quickly.[36]

Barriers to entry are however reducing with the introduction of new technology which has enabled non bank financial institutions to introduce alternatives to traditional banking products such retail deposit accounts and mortgage origination, while the changing nature of bank distribution channels has facilitated an easy transition for customers. Even more importantly, technology has provided non-banks with access to the payment systems via the development of electronic funds transfer and the direct debit system

5.5.5 The consequences of technological and structural changes

National Mutual believes that there is a convergence of the segments of the Australian financial industry which is causing existing markets to merge. The result in the creation of a much broader financial services market. We do not foresee any need to change the regulatory structure in relation to competition policy to respond to these changes. There is, however, a need to monitor and adapt the definition of the "market" for competition policy purposes in light of them.

[36] FELS Profeesor A paper for AIC Conferences on 28 February 1996

5.6 Summary

Whilst the current regulatory structure has established a good track record from the perspective of consumers, industry and government there are clearly some concerns.

From the consumers' perspective

- The current regulatory structure does not reflect the way in which consumers see the industry.
- The cost of the regulatory complexity could affect the price of financial products and services for consumers.
- The number of regulators and quasi-regulators adds unnecessary complexity and confusion.

From the industry's perspective

- Market inequities arising out of different regulatory approaches places some institutions at a disadvantage relative to competitors.
- Explicit and implicit regulatory barriers restrict the extent to which free competition can thrive.
- Inconsistency, uncertainty and a degree of overlap, particularly in relation to savings, investment and advice compromise operational effectiveness.
- Potentially high costs of regulation can make Australian financial services companies uncompetitive as an international basis

From Government's perspective

- The current regulatory framework does not guarantee free competition and is sub optimal in maximising Australia's international competitiveness.

Most of the areas of concern within the current regulatory structure have been recognised by the regulators, and much work is already underway to address them. In particular:

- the Council of the Financial Supervisors (CFS) was established in 1992 with a view to adopting a coordinating role among the ASC, ISC, RBA and AFIC;
- the CFS has commenced a "Financial Supervision Boundaries and Approaches" project to identify proposals to "remove or remedy unintended gaps, overlaps and inconsistencies in the regimes regulating sales and advice practices for functionally similar retail savings and risk products"; [37]
- the ASC and ISC is also conducting a harmonisation project designed to eliminate overlap and conflict between unit trust and life insurance/ superannuation products and advisory practices; and
- the RBA, ISC and ASC are all active in working on solutions for emerging regulatory issues such as contagion risks from financial conglomerates with their respective international counterparts through the Basle Committee, IOSCO and IAIS.

[37] Council of Financial Supervisors Annual Report 1995.

Whilst we welcome this work we believe that the cultural and philosophical differences between the regulators will make harmonisation within the existing structure a slow process. Further, our view of future market trends (including technological developments, globalisation of financial markets and increasing convergence within the industry) indicate that the current regulatory structure will become less effective in the future and this problem cannot be solved by the harmonisation projects alone and that the current market definition in adopted for competition policy purposes will need to change.

SECTION 6

A NEW REGULATORY STRUCTURE

Recommendations for a New Regulatory Structure

6.1 Introduction

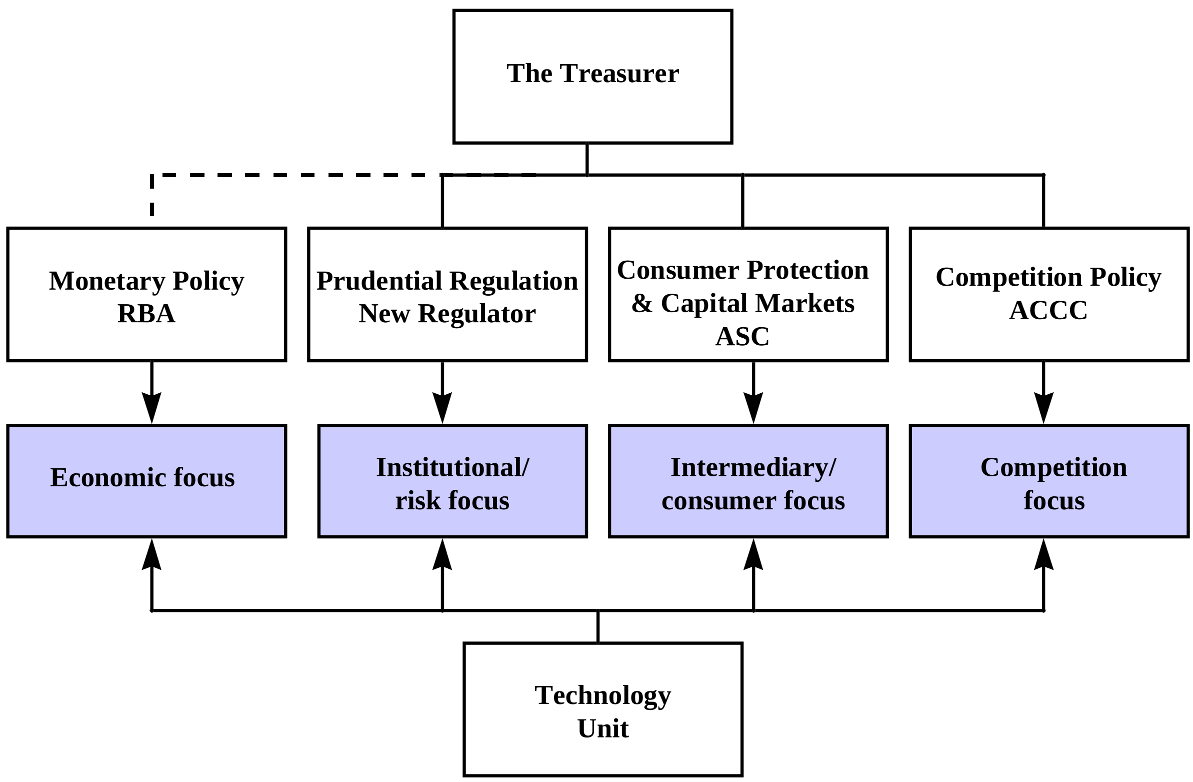
In light of the emerging inefficiencies in the current regulatory structure and more importantly the trends driving further change, National Mutual recommends a new regulatory structure for the Australian financial system. The proposed regulatory changes are both revolutionary and evolutionary:

- **revolutionary** because they recommend a new regulatory structure which more closely meets the emerging nature of the financial system and which is sufficiently flexible to adapt to future change; and
- **evolutionary** because they build upon the significant value in the existing structure and recognise the importance of maintaining financial system stability by moving quickly but carefully to the new model.

The structure is illustrated Figure 6.1:

Figure 6.1

Recommended Regulatory Structure for the Australian Financial System



The key features of the new structure are:

- a single regulator for consumer protection supported by a due diligence regime for all financial products and services, thus placing more regulatory responsibility on providers. The single consumer protection regulator should be the ASC, consolidating the current consumer protection roles of the other regulators under the ASC regime;
- a new single regulator for prudential regulation of the industry initially through the existing structures of the RBA, ISC AFIC/SSAs and the minor prudential

functions of the ASC in relation to securities dealers. The new prudential regulator will, in addition to managing a move to a single regulatory regime, be responsible for monitoring conglomerate risk;

- an approach to financial regulation based on the nature of products and risks undertaken rather than the institution providing them, thus removing existing regulatory inconsistencies in relation to products of a similar nature;
- in addition to absorbing consumer protection responsibilities for the industry, the ASC retains its capital market integrity responsibilities;
- the ACCC's responsibilities in relation to consumer protection and competition policy across the whole economy will remain unchanged, although the Trade Practices Act (TPA) needs to be amended to exclude disclosure requirements on financial product providers to ensure the Australian financial system is not subject to two consumer protection regulators implementing different disclosure regimes. This point is of such importance that if the appropriate changes to the TPA were not effected, it would be necessary for the ACCC to be directly and exclusively responsible for consumer protection of the financial services industry to ensure one regulator and one regime for the Australian financial system;
- in accordance with the terms of reference we make no recommendation in relation to the implementation of monetary policy which will remain the responsibility of the RBA; and
- the establishment of a technology unit skilled in technologies such as electronic commerce, electronic payments systems and telecommunications, and charged with addressing regulatory issues arising from emerging technological developments in the financial system. The unit would address issues of relevance across the financial regulatory structure and would work closely with all regulatory bodies.

The new regulatory structure should work towards developing consistent policy, methodology and standards across the industry, taking account of global trends in regulation and the increasing need for greater harmonisation internationally. In the area of consumer protection this should include moving to a consistent regime for disclosure and advice under the regulation of the Corporations Law and the establishment of a single Financial Industry Complaints Scheme in place of the existing multiplicity of schemes in the industry. In the area of prudential regulation special focus should be applied to: developing world-leading risk-based capital measures addressing all major areas of risk; removing existing inconsistencies in capital requirements; thoroughly reviewing the extent and nature of systemic risk and the difficulties in assessing conglomerate risk, with recommendations for appropriate regulatory reforms; and the need for and nature of any implicit "Government guarantees" on financial products, with clarification for consumers of the level of protection to be provided.

In the proposed new regulatory structure each of the regulators will report to the Treasurer. This will facilitate the essential coordination at a policy level and consultation between the regulators in relation to approach and cross industry issues while enabling each body to develop the skills and resources necessary for its specific task in financial regulation. In particular, there would be a special relationship between the prudential regulator and the Reserve Bank in relation to the sharing of information, advice and response to market developments relevant to their respective roles of promoting financial system stability and monetary policy.

6.2 A single consumer protection regime

6.2.1 A single consumer protection regulator's charter

There is no rational basis for the existence of multiple and overlapping consumer protection agencies. A single, properly resourced national regulator could provide consumer protection by overseeing the distribution process, including disclosure in all its forms, as well as complaints resolution.

Such a regulator should primarily concern itself with the retail end of the market, as the professional or wholesale market is well placed to obtain appropriate information, and assess the suitability of products and services, and has the resources to utilise ordinary legal remedies.

To be effective, the model we propose should take over from all other consumer protection regulators their consumer protection responsibilities in so far as they relate to financial products and services. This would require the co-operation of the States and while the States should be attracted by such a proposition on economic grounds, some work may be required to deal with issues of State's rights.

The regulator should be responsible for setting policy on consumer protection and, through a participative mechanism with the industry, would provide non-prescriptive guidelines for the operation of effective compliance structures through its sub-structure discussed below.

6.2.2 The sub structure

The model suggested above relates to the macro aspects of consumer protection. The operational work and responsibility would be conducted through a compliance structure consisting essentially of two components:

- a consistent disclosure methodology supported by a due diligence regime for all products and consistent advising and selling practices; and
- a single industry-sponsored complaints resolution mechanism.

These components, would be subject to the overriding supervision of the single consumer protection regulator and would deliver cost-effective consumer protection across the industry.

Such a due diligence regime is based on the idea that institutions and intermediaries must themselves take more responsibility for adherence to regulatory obligations, without the comfort of government approval, and with penalties being imposed for failure to comply.

The regulator would adopt more of a monitoring role encouraging and assisting compliance, and punishing persistent or material non-compliance. The current Corporations Law regime for disclosure on the part of securities dealers and financial planners is a good example of a successful due diligence regime.

While the proposed regime has a degree of self-regulation, it is different to the so-called self-regulatory system introduced in the UK following the 1986 Financial Services Act In our view, the UK system was never ''self-regulatory' but consists of a series of bureaucratic structures that act essentially as agencies of Government, their only element of self-regulation being that they are funded by the industry.

The UK regime also requires ''best advice'' in advising and selling practices, the execution of which is almost impossible to establish unless intermediaries broke the entire market. It is quite possible to breach the best advice rule while nevertheless providing ''appropriate advice" which is the standard applicable in Australia and which we maintain adequately serves consumer interests. Such a standard of advice should in our view form the backbone of an effective advisory and selling due diligence regime.

The due diligence regime requires regulatory oversight to ensure institutions and intermediaries maintain their enthusiasm for compliance.

6.2.3 The ASC

The consumer protection regulator needs to:

- have a good understanding of the financial services industry, its products and advisory and selling practices;
- be able to take action against both institutions and intermediaries; and
- be responsive to market developments.

In our view, the ASC fits the role of consumer protection regulator. The ASC already has the philosophy and structure, and can be provided with the resources to assume the role of consumer protection regulator for the broad financial services industry from the other regulators. It is already experienced in setting policy and has established a reputation for strong consumer protection. It has also demonstrated through its surveillance programs that it understands very well the financial services industry, its products, and its advising and selling techniques. Moreover, the Corporations Law provisions for disclosure which the ASC administers have been developed with the objective of harmonising standards internationally. This is discussed further in 6.2.4 but will become increasingly important, with the expected increase in cross border business, ensuring Australia maximises its international competitiveness in this respect.

The financial services consumer protection laws the ASC would administer are already contained in the Securities chapter of the Corporations Law and would be able to be extended fairly easily to cover, life insurance, superannuation and banking products by the removal of some existing exemptions. General insurance and other products would need to be specifically included. Some modification to dealers licence requirements would be necessary, to allow existing prudentially supervised institutions to automatically qualify for that status.

Some State issues will need to be dealt with in order to ensure that all aspects of consumer protection are effectively covered on a national basis.

6.2.4 Implementation

Disclosure and advice

The Corporations Law regime for disclosure is the preferred model. In developing the Corporations Law, the previous prescriptive disclosure regime under the Companies Code was dispensed with. The prescriptive regime was found to be overly bureaucratic, tending to focus issuers' attention on the checklist requirements rather than ensuring that the overall document was clear and of benefit to investors.

In formulating the disclosure requirements and the due diligence defence in the Corporations Law, the Federal Government had regard to similar standards operating in the UK under the Financial Services Act and in the US under the Securities Act. Similar requirements to sections 1021 & 1022 of the Corporations Law dealing with disclosure also operate in Hong Kong, the European Community under the Undertakings for Collective Investments in Transferable Securities (UCITS) Directive, and other countries, supplemented by varying degrees of prescriptive requirements. Consequently, the drafters of the Corporations Law moved to a broad-based disclosure requirement with international consistency with the onus on the issuer to ensure that reasonable care and due diligence were exercised in the preparation of prospectuses. These requirements were supported by both criminal and civil sanctions for failure to ensure appropriate disclosure.

The severity of some of the requirements may have led to a tendency on the part of many issuers to ''over-disclose''. This has been exacerbated by additional TPA requirements that prohibit issuers from engaging in any misleading and deceptive conduct, or omissions that may mislead or deceive without a supporting reasonable care and due diligence test. Consequently, any clause in a prospectus that misleads or deceives any investor, despite the fact that no other investor is in the same way misled or deceived, can breach the requirements of the TPA.

It is important that Australia adhere to standards which will be recognised globally, so that our products can compete in foreign jurisdictions where there is mutual recognition of disclosure standards. Disclosure standards must be subject to a reasonability requirement which is why there should be a due diligence defence, so as not to make the costs of raising capital unduly onerous as ultimately the capital raising costs are passed on to the investor.

For these reasons we recommend that the broad-based disclosure requirements in the Corporations Law be extended to all financial products as these provide for the level of disclosure appropriate to the nature of the product being offered. We also suggest that the regulator be given certain limited powers to allow for more restricted forms of disclosure where these are appropriate. For example, a prospectus of no more than a few pages might be required for a transaction account. This would be supplemented by a more detailed set of accounts relating to the institution that would be made available to the customer if he or she chose. This is the approach adopted in New Zealand, and we consider that the recent developments in ASC policy would support such a move. It would also have the added advantage of providing the opportunity, in the case of demand deposits, of clarifying the extent to which the Government does or does not "implicitly guarantee" these products and therefore the extent to which the consumer must exercise vigilance.

Finally we consider that the role of the ACCC in respect of disclosure should be carved out for all financial products as an effective disclosure regime is more achievable if there is a single set of requirements and a single regulator. This would require the exclusion of s.52 and the associated provisions of the TPA, so that conduct in relation to fund raising and other dealings in financial products would be dealt with solely under the provisions of the Corporations Law. This is consistent with recommendations made in respect of fund raising, takeovers and securities by the Corporations Law Simplification Taskforce.[38] Other reasons for supporting this regime were also given the Taskforce Report.

Furthermore, we note that Senator The Honourable Brian Gibson MP, Parliamentary Secretary to the Treasurer in a public address recently confirmed that the coalition supports the Corporations Law Simplification Program. He also stated that:

"Removing unnecessary regulations and legal uncertainties is an essential part of the process of encouraging risk-taking and through that achieving a more efficient national economy. ...Improving the rules on fund raising is crucial if we are going to increase the level of investment in this country and facilitate growth. ...Concerns have been expressed about the operation of s.52 of the Trade Practice Act where prospectuses have been issued. I have considerable sympathy for the views of business that they should not be subject to overlapping and inconsistent regimes in this area".[39]

We support these conclusions as we consider that a single disclosure regime is essential across the financial services industry. Consequently, we would seek the ASC's role being extended to cover enforcement of disclosure and advice/selling practices in the financial services industry, and the role of the ACCC being carved out in respect of disclosure obligations in the financial services industry.

The second feature of such an expanded due diligence regime relates to the monitoring and supervision of the advisory and selling processes. Under the existing ASC regime there is a strong focus on internal compliance by the industry, subject to the supervision of the ASC, which has the power to take action against both institutions and intermediaries.

It is unlikely that any significant member of the financial services industry would lack internal compliance programs, including processes to monitor and supervise their distribution network. However, to avoid risks of non-compliance with a due diligence regime for advisory and selling practices, we recommend that the audit/monitoring regime currently in place under the Corporations Law should be adopted for the whole industry.

Complaints resolution

We recommend the establishment of a new single Financial Industry Complaints Service to replace the existing multiplicity of schemes in the industry. As mentioned in section 5.2.2 such a scheme must be easily accessible, cost effective, quick and must have the confidence of the consumers and industry. Preferably the scheme would be free to consumers subject to on appropriate maximum dollar value.

In National Mutual's opinion the existing industry-sponsored Life Insurance Complaints System (LICS), is well supported by the industry and has been

[38] Report to the Attorney General from the Corporations Law Simplification Taskforce, on the Application of s.52 of the Trade Practice Act to Fund Raising and other Dealings in Securities, November 1992.
[39] GIBSON, Brian, Parliamentary Secretary to the Treasurer, "The Government's View on the Corporations Law". Address at the Marriott Hotel, Sydney, 14 May 1996.

favourably commented on by regulators. This may therefore provide a good model for a single comprehensive, industry-funded system dealing with all financial services consumers' complaints.

6.3 A single prudential regulator

6.3.1 The prudential regulator's charter

To ensure the appropriate level of consistency, competitive neutrality, flexibility and efficiency in regulation a new single prudential regulator should be established.

The regulator would oversee all aspects of the prudential supervision of financial services markets that are now the responsibility of the RBA, ISC, AFIC/SSAs and the ASC.

The key regulatory objectives would be to:

- promote the stability, soundness and integrity of the financial system and financial services institutions;
- promote consumer understanding of and confidence in the financial system, together with the ASC;
- encourage prudent management and sound risk control practices of world best standards by financial institutions;
- establish a prudential regime that is consistent and equitable across all financial services providers and is sufficiently flexible to cope with changes in the structure of the industry and its products;
- regulate in an efficient manner, balancing the cost of regulatory imposts to Government, the industry and consumers against the benefits; and
- develop standards that are as consistent or feasible with overseas practice

Financial services institutions and conglomerates are developing a greater commonality of asset, liability and management control issues. There is a need to pool regulatory knowledge and expertise to develop a common and consistent regulatory framework. This need will become even more important in the coming decade, as the pace of convergence increases and financial conglomerates proliferate. A single regulator should be more effective as it will be able to more easily take account of any changes in each institution it monitors. Importantly, the likelihood of "gaps" in regulatory oversight that must exist in a structure of many regulators would be removed. This will provide better protection for the system, institutions and consumers. Without a single prudential regulatory body, efforts at consistency will always be slow and only partially successful. Partial consistency will compromise the long term competitiveness of the Australian financial services industry.

The new single regulatory body with a single philosophy and approach to regulation, will be a more effective and more appropriate regulator than the current multiple regulators. It will be more flexible, and hence able to respond more quickly to the changing market conditions. In areas of common concern it will be able to apply consistent rules to ensure equitable treatment of all institutions.

The regulator would be responsible for setting consistent prudential standards regardless of the institutional nature of the provider. In particular, it would establish flexible and consistent regulation across all institutions, particularly in capital adequacy, where the development of more detailed risk-based capital measures will provide greater sophistication and consistency in the prudential regime. It should also aim to develop flexible regulation, particularly in relation to products and services, to avoid such regulation reducing competitive and product flexibility or requiring frequent revision.

The regulator would be responsible for the institutions currently regulated at the state level including credit unions, building societies, friendly societies, trustee companies, funeral funds, industrial provident funds, and the like as well as those regulated nationally. While this will require extensive negotiations with the States, it will remove anomalies and complexity in the financial regulatory markets and enhance the ability of these institutions to compete in an environment of rapid change.

We recognise that the establishment of a single prudential regulator will require a transitional approach in the interests of market stability and confidence and in recognition of the significant bank of expertise which exists within the existing regulators. We therefore recommend that the regulator be established immediately, with responsibility for prudential regulation exercised initially through the existing prudential structures of the RBA, ISC, AFIC/SSAs, and the ASC. An important initial priority will be the establishment of a task force to recommend on the process of moving towards a true single prudential regulator with a common policy and regulatory approach to prudential supervision.

6.3.2 The separation of monetary policy and prudential regulation

In Australia monetary policy and banking supervision have traditionally been combined in one body, the RBA. However, this is not the only practical regulatory structure. Although these functions are closely related, with both requiring the collection of similar data, in many developed countries the responsibilities are separated. These include Austria, Belgium, Canada, Finland, Germany, Japan, Norway, Switzerland and to, some extent, the US.[40]

The advantages to the RBA of keeping both functions together were summarised by Mr Graeme Thompson, a Deputy Governor of the Reserve Bank of Australia, in a recent speech:

- it gives the RBA a direct hand in the stability of the financial system, for which it has ultimate responsibility;
- as supervisor, the RBA can better assess the need for lender-of-last-resort assistance to a bank which needs liquidity;
- supervision of banks gives the RBA information about financial conditions which can be used for the conduct of monetary policy;
- a knowledge of macroeconomic conditions, gained through monetary policy formulation, can be used to foresee threats to bank stability; and
- banking supervision is inter-related to the RBA's role in overseeing the payments system.[42]

We submit that each of these issues can be addressed satisfactorily under an appropriately designed separation of functions. In particular:

[40] HILTON, Andrew. (1995), 'UK Financial Supervision: a blueprint for change' (published by The Centre for the Study of Financial Innovation)
[41] THOMPSON, Graeme. 'Regulatory Policy Issues In Australia', Reserve Bank of Australia Conference, 8-9 July 1996
[42] ibid.

- we do not believe it is necessary to give the RBA ultimate responsibility for the stability of the financial system (i.e. the institutions and mechanisms comprising the system). This responsibility can, as in other countries be given to the prudential regulator, with the central bank being assigned responsibility for macroeconomic stability. Indeed there are advantages in providing the Reserve Bank with a single clear mission enabling it to unambiguously focus on its macroeconomic monetary responsibilities. This would provide a better, sharper basis for central bank performance and accountability, and the prospect of greater independence than is possible for a body also responsible to Treasury for prudential regulatory issues. There are sometimes situations when conflict of objectives between control of the overall money supply and the augmentation of troubled but sound institutions' liquidity might conflict. A separation of responsibilities can give a clearer perspective on such occasions;

- the second argument has some force but it is not compelling. The RBA could liaise with the prudential regulator as to whether a bank in trouble is fundamentally insolvent or just temporarily illiquid. The same kind of coordination between people with different responsibilities has to occur on the issue of the provision of liquidity within the RBA. There are nonetheless strong connections between the needs of the central bank and prudential regulation in relation to systemic risk. Although as we argued earlier these needs now cover a broader range of institutions than banks potentially giving rise to systemic risk. It is crucial that these needs in this broader sense are addressed in any revised structure;

- the experience of the early 1980s is often used to support the ‘synergy of policies’ argument. It is true that falls in property prices (a macroeconomic phenomenon triggered by the high interest rate policies of the late 1980s) contributed to the losses made by the banks. It is also true that the banks' losses had macroeconomic effects that contributed to both the length and depth of the recession. (There were similar experiences in Sweden and some regions of the United States.) But the banks’ losses could have been predicted by examination of their balance sheets, while the macro effects of these losses could have been factored into any monetary policy considerations (if any), without the information necessarily coming from within the supervisory arm of the central bank;

- the information requirements could adequately be dealt with through the relationships between the financial regulators. A special relationship would exist between the RBA and the single prudential regulator concerning regular meetings and access to information. Co-ordination of information flows and advice would be structured such that the RBA receives the information it requires for the conduct of monetary policy; and

- finally, one of the purposes of bank supervision has historically been the protection of the integrity of the payments system. Settlement of netted payments between banks is executed in ‘central bank money’, with debits and credits to exchange settlement accounts held by the banks at the RBA. However, as with liquidity support, there is no reason why the RBA cannot liaise with a separate supervisor on payments system issues, as is the case in many other developed countries. Moreover, the move to gross real-time payments settlement from 1997 will reduce the central bank’s role in providing settlement facilities and the opening up of the payment system as we recommend will lead to the entry of a number of non bank participants not currently regulated by the RBA.

Should the RBA be the Prudential Regulator for the Industry?

The next question, then, is whether the RBA should be the single prudential regulator. We believe not.

Given sufficient co-ordination and co-operation between the prudential regulation and the RBA, there is no compelling reason for them to be combined. In fact, the skills and policy approach required for the tasks are quite distinct, and making the RBA a super regulator would only result in a body divided into separate monetary policy and prudential supervision arms. To give the tasks the focus they require, and to avoid conflicts between the differing tasks, we believe separation is the better option.

The moral hazard argument is frequently cited against the supervision by the RBA of non-banks' institutions. This is the contention that if there is only one supervisor for all financial institutions then the public will believe that all institutions are 'as safe as a bank' and that all are backed by the banking 'implicit guarantee' of depositor protection.

Many consumers believe that the government guarantees the financial viability of all licensed banks. This ranges from a belief that the government is obliged to bail out a failing bank to the Government guarantees all deposits with a licensed bank . As we discuss later in 7.3.3 the Government should assess the appropriateness and extent of guarantees, implicit or explicit, on financial products in light of market changes with clarification of the resulting arrangements for consumers. We believe it would then be easier to ensure the correct public perception of the existence or otherwise of any government protection if the RBA (which holds the government's money) were distinct from the prudential regulator.

Summary

In summary we believe that a new single prudential regulator in Australia will be more efficient and effective than the current separate, institutionally focussed regulators. We believe that the benefits which arise from such a model outweigh the benefits of keeping prudential regulation of one group of financial institutions, ie. the banks with the RBA, especially given the convergence which is occurring in the market and the existence of other systemically important, non bank institutions.

We do not however, believe that prudential supervision of all financial institutions is the industry should be consolidated with the RBA. A separate single prudential regulator will give a clearer focus to the prudential regulation of institutions and mechanisms making up the financial system on the one hand and macroeconomic stability and monetary policy on the other.

6.3.3 The structure of the prudential regulator

A major feature of the single prudential regulator would be consistency of regulatory approach across the industry. This will require a high level division responsible for establishing consistent policy, methodology and philosophy across all financial service institutions and product categories.

A prudential regulation division would be responsible for all levels of risk assessment (systemic, conglomerate and institutional). By having responsibility across all institutions in the financial system it would have the information and expertise to assess conglomerate and systemic risk to a greater degree, more transparently and more reliably than under the current structure.

Initially, the prudential regulatory division would be based on the existing regulatory structures, with the appropriate sections of the RBA, ISC, AFIC/SSAs, and the ASC reporting directly to the new regulator. This would reduce any initial confusion at the establishment of the single regulator, and would ensure existing controls are not compromised. A more integrated, streamlined and flexible structure would then be progressively implemented.

6.3.4 *Functional vs Institutional*

There has been considerable debate on the merits of a functional versus an institutional approach to prudential regulation. We believe that in practice an institutional focus is inevitable, as in the final analysis it is only institutions that fail. However, this is not incompatible with a functional approach to the development and administration of regulation where the nature of the products and services is the primary consideration rather than the type or classification of the institution. This is a practical and realistic approach even if the final assessment of adequacy must necessarily be focused on the institution.

In the discussion of a functional approach, it is worth bearing in mind that the current institutional approach is simply the original functional approach which has become out of date. When the current regulatory structure was adopted, institutions were more closely aligned with functions, and hence the rigid categories of financial institutions was more appropriate. However, with the rapid and continuing changes in the financial services industry institutional categories no longer align with functions, and the regulatory structure needs to change to meet the market structure.

6.3.5 *Key initial priorities*

In the process of moving to a single prudential regulation regime the following key initial priorities should be addressed:

- establishing consistent and risk-based prudential regulation across the industry; and
- analysis of systemic and conglomerate risk and action that might be taken to control this.

Establishing consistent prudential regulation across the industry

A major priority in the single prudential regulation regime should be developing world leading risk based capital measures addressing all major areas of risk and removing inconsistencies in capital requirements for similar products. This work will include plans to better utilise specialist expertise and share ideas and information across previously sectional boundaries. There is much expertise, for example, in the ISC Life Insurance section that would be applicable to banking and vice versa.

Capital requirements for all financial institutions should be reviewed in the light of recent theoretical work undertaken in Australia and overseas (particularly in the life insurance and banking industries) on the amount of capital required to meet many types of risks. Financial institutions need to show that they hold sufficient capital to meet the full range of risks (including asset, liability, market, credit, large exposure, counterparty, product, pricing system and operational risks and their interactions) as well as to fund anticipated new business flows. Without adequate capital standards companies may be (perhaps unknowingly) inadequately capitalised.

Furthermore, minimum capital requirements for various institutional groups are highly inconsistent, despite the ability to write equivalent products or services. (This is particularly true for life insurance offices and trustee and unit trust companies). Lack of capital requirements for some corporations in the industry, such as equity issue underwriters, is causing concern to the existing regulators and should be addressed.

In addition there is currently international discussion on the introduction of more sophisticated risk-based capital requirements for banks. This is an area where Australia could look at early adoption of such measures, whilst extending risk-based capital requirements across the industry.

A review should also be conducted to look at the range of guarantees and risk profiles of savings and investment products, the graduations between them and the appropriate capital requirements for all savings and investments products, regardless of the providing institution. The ISC in particular has done and is continuing to do significant theoretical and practical work on the capital required to back the various forms of guarantees, pricing structures, etc. This should be reviewed and, where appropriate, applied across the industry.

As part of this work, a review should be conducted of the capital adequacy requirements that differ for equivalent assets and liabilities for banks, unit trusts and life insurance companies. There are few apparent reasons for these differences, other than the historical divisions between institutional groupings. Example of areas of difference include:

- loan assets;
- unit linked or unit based products, where the value of the investment is directly based on and proportional to the market value of a pool of assets;
- cash and capital guaranteed products; and
- term deposits and life office fixed term annuities.
- These areas should be examined and recommendations made on removing inconsistencies.

Several other issues of inconsistency deserve particular attention. Some are acknowledged by the existing regulators and are being addressed. An example of the items that should be reviewed is the discrepancy between institutions in the requirement for minimum early termination values. Life insurance savings products, unlike equivalent products from other providers, are subject to minimum surrender value regulations.

Analysis of systemic and conglomerate risk control

The rise of the derivatives market and the increasing role of non-banks in traditional banking business require us to extend our concept of systemically important corporations to a much wider range of institutions. It is arguable that the failure of one of the larger non-bank financial institutions would have a much larger impact on the integrity of the Australian financial system than the failure of one of the smaller banks.

The problem of systemic risk should be extensively investigated, which will require the involvement of the RBA and industry. There is considerable debate around the world on the extent of systemic risk, and the organisations that contribute to or are affected by it. We recommend continued participation in this debate and research to determine the reality of and possible regulatory responses to this area of concern.

The assessment and control of conglomerate risk is also being discussed in many forums in Australia and around the world. Particularly relevant papers on this topic have been produced by the Tripartite Group of Bank, Securities and Insurance Regulators[43] and by the Council of Financial Supervisors[44]. The issue of multiple regulators is addressed by our recommended single regulator, whilst the other issues of assessing conglomerate risk, contagion risk, ‘conglomerates of equals’, etc can only be properly addressed by a single regulation. We recommend that the single regulator develop mechanisms to ensure that appropriate prudential regulation of financial conglomerates is in place.

[43] ‘The Supervision of Financial Conglomerates’, A report by the Tripartite Group of Bank, Securities and Insurance Regulators. (July 1995)
[44] Council of Financial Supervisors (1995), Annual Report Chapter 4 and Appendix E.

6.4 Competition Policy

National Mutual believes that there is no basis to suggest a change in the structure of the regulation of competition policy in Australia by the ACCC.

We believe that the guidelines already in place should be adequate to deal with the changing scope of definition of market within the financial industry. Provided that the ACCC continues to encourage and be receptive to public debate on changes to the system which might result in a need to review the guidelines, no change to the structure is warranted.

6.5 Capital market integrity

We recommend that the ASC retain responsibility for company regulation and capital market integrity, including oversight of the ASX and the SFE. As previously stated in section 2.5.4, we consider that market integrity requires that the confidence of investors is maintained in the securities and futures markets through adequate protection, the ready availability of information, and the consistent administration of the law. We contend that these requirements extend beyond the securities and futures markets to consumer issues in the financial services industry as a whole. Under our recommendations, the ASC would thus have responsibility for both capital markets regulation and consumer protection in the broad financial services industry.

Furthermore the regulation of these function as they pertain to securities and futures is already contained in the Corporations Law, which was agreed to by all the States after a High Court challenge and protracted negotiations. To seek to dilute this Law would be a challenging political task. Strengthening and expanding the operation of the Law would, we consider, be far more achievable.

6.6 Technology

Technology is driving and facilitating much of the change in today's global financial markets. This is giving rise to new issues and challenges for financial regulators and in earlier sections we identified some immediate concerns including:

- consumers receiving advice on the Internet and other online offerings;
- prudential regulatory concerns associated with electronic payment systems; and
- the need for Australia to develop and support world's best practice in information systems and infrastructure.

Currently the issues of most immediate concern are those of a consumer protection nature. These relate to product offerings currently available electronically and their compliance with regulations especially where those product offerings originate from outside of the jurisdiction of Australian regulators.

There is no doubt however, that the issues which arise from technological developments will also rapidly include those of a prudential nature as electronic commerce develops. Further out issues will broaden to include, *inter alia*, monetary policy, taxation, money laundering etc.

Technological developments therefore have implications across regulatory boundaries even within the new structure proposed in this submission. Moreover the impact of technological developments is not a temporary phenomenon and will continue to raise issues which it is impossible to predict well into the future.

National Mutual therefore recommends the establishment of a Technology Unit which is skilled in technologies such as electronic commerce, electronic payments systems, smart cards and telecommunications, etc. The unit will ensure that the necessary expertise is available to assist the regulators with immediate problems such as coordinated consumer advice and protection and, most importantly, to advise on future technology impacts so that regulators can address them proactively.

The unit would investigate and advise on such issues as:

- electronic commerce standards;
- technical issues relating to prudential control of electronic cash, smart cards, electronic payment systems, etc;
- technical aspects of local and international regulation of electronic cross-border trading;
- information and telecommunications infrastructure development;
- future technology developments and impacts on the financial system; and
- electronic delivery of advice, information and sales.

In particular, however, we have identified the following key priorities:

- the early development of a plan to educate and protect consumers in relation to financial products and services becoming available via electronic means;
- a proactive lead in international regulator cooperation in relation to technology supported cross border offerings; and

- the encouragement of innovation in electronic commerce and support for the development of essential information technology and telecommunications infrastructure.

6.6.1 Develop an action plan to educate and protect consumers in relation to products and services becoming available via electronic means

The ASC has already initiated warnings to consumers on the dangers of investing in online securities on the basis of advice circulating on the Internet, particularly from unlicensed sources. The ASC will take action under the Corporations Law against offenders within its jurisdiction, but cannot act as ‘a gatekeeper to the World Wide Web’. It is also clear that resolution at an international level cannot be expected in the near term.

The ASC is also consulting with Australian financial services industry associations on electronic commerce, on the basis that globalisation and information technology will force structural change in Australia’s capital markets. One of their concerns is to ensure that market integrity is preserved as electronic commerce is implemented (i.e. investors retain confidence in the market and investment products).

With regard to supervision and enforcement, the ASC is involved in the IOSCO Working Parties on Secondary Markets and on Enforcement. An immediate issue is that of electronic prospectuses, and the extent to which the ASC can grant relief from the law, which is based on paper prospectuses. The ASC has just granted its first approval for an Internet based prospectus to Advance Bank.[45]

A more cautious but proactive approach is being taken with regard to electronic commerce on the Internet. The ASC noted its importance in its Consultative Documents on Electronic Commerce and Corporations Law, and has issued a Draft Policy Statement on Electronic Prospectuses, which deals with distribution ‘via Internet (including the World Wide Web) or other computer networks, CD-ROM, floppy disc or other electronic means.

Whilst the securities offerings on the Internet have attracted the most attention, examples of all types of financial offerings are now emerging. There is not as yet any advice for consumers in this respect.

The need to coordinate education and advice to consumers on all financial products and services offered by online service providers is increasing. We recommend that further action be taken through this unit to educate consumers so that they can recognise approved offerings and understand the limitations of those that fall outside recognised agreements.

6.6.2 Take a proactive lead in international regulator cooperation in relation to technology supported cross border offerings

Australian financial regulators do not currently have a single point of reference to focus on cross-border offerings. We recommend that through the technology task force Australia takes a lead role in coordinating international regulatory cooperation on Internet cross-border offerings and other technology related developments. We would expect this to be

[45] THE AUSTRALIAN FINANCIAL REVIEW, 16 August 1996

facilitated through the existing international organisations including the Basle Committee, IOSCO and IAIS. Australia could well become a leader in this area, and could certainly assist other countries in the region to join the global electronic marketplace.

6.6.3 Encourage innovation in electronic commerce and support the development of essential information technology and telecommunications infrastructure

The successful development of electronic commerce and the underlying information technology and telecommunications infrastructure is critical to Australia's competitive position in the global information marketplace. The financial services industry's needs are vital to that competitiveness and must be addressed in industry development plans.

Australia is potentially well-positioned due to its high level of technology expertise and technology taken up by consumers, it should capitalise on its advantages to achieve world's best practice in technology implementation and maximise investment in IT infrastructure. Current concerns include the certainty of telecommunications competition and therefore investment, the widest access for all consumers, and competitive prices.

There is a clear role for Government in leading (without over-regulating) the development of Australia's information infrastructure.

"Where, moreover, do the roles of Government and the private sector meet and diverge in the construction of the infrastructure and development of new applications? It is generally agreed that it is the role of the private sector to construct and operate the infrastructure. And it is the role of governments to work together to create the conditions which encourage innovation, investment and the creation of new jobs. Governments could, where appropriate, promote experiments and pilot applications. They could also help investigate how to harness the power of information infrastructures to improve the quality of life, especially in health, education and other public services - a development which, in addition to enhancing efficiency, would probably help reduce government spending."[47]

The essential topics that pertain to the competence and responsibilities of governments are the design and implementation of the appropriate legal frameworks for the protection of intellectual property rights, the security of information systems and the protection of personal data and privacy . These policy areas urgently require further discussion. They have been referred to as 'show-stopper' issues since they could obstruct the development of new applications and potentially enormous markets.

Although Australia is further advanced in the liberalisation of telecommunications than some other OECD countries, and plans an open telecommunications market post 1997, it has a long history of strong regulation and needs to find the balance between sufficient self-regulation and appropriate supervision of technical standards.

The vision outlined in 'Better Communications' released by the Coalition prior to the last general election and a statement by the Minister for Communications and the Arts in May 1996 advocated development of a world class infrastructure, a multitude of service providers with equal and

[46] PAYE, Jean-Claude. Secretary-General of the OECD, OECD Observer, No. 196 October/November 1996.
[47] ibid.

non-discriminatory access to carrier facilities and contestable market strategies that drive prices down and the quality of service up. These objectives must be achieved if Australia is to be internationally competitive.

The finance industry needs low cost, high availability, secure communications if electronic commerce in all its forms is to be successful. As security and privacy are of crucial importance in the electronic marketplace, there is the potential for a financial services industry carrier specialist or services provider to provide these. Whether this can be achieved will depend on the flexibility of telecommunications provisions in the post-1997 environment.

In the context of Australia and this submission we recommend that these needs be facilitated through the Technology Unit including:

- promotion of electronic commerce pilots and joint work with industry on standards, an example of which is the ATO work with LISA and ASFA on electronic commerce standards;
- government encouragement (e.g. Partners in Development) to ensure the Australian technology industry remains competitive through research and development;
- provision of public consumer access to key Government and financial services industry information via public multi-media kiosks; and
- financial services sector involvement in policy discussions on information technology and telecommunications.

6.7 The relationship between the financial regulators

It is apparent from the above discussion that, whilst the different types of financial regulation essentially require different skills and approaches and hence should reside in separate regulatory bodies, there is clearly a need for a high degree of communication and cooperation between them and a common philosophical approach. For example:

- the RBA and the prudential regulator will need to consult on a number of matters involving financial stability;
- the prudential regulator and the ASC will need to coordinate approaches to disclosure which recognise the level of prudential regulation applying to providers of different financial products and services; and
- the impact of technology crosses boundaries of each of the RBA, the prudential regulator, the ASC and the ACCC and will therefore require close communication.

Under the proposed regulatory structure each of the regulatory bodies reports directly to the Treasurer. We believe that this is important to facilitate the essential coordination which is required at the policy level and provide for ultimate arbitration in the event of an irreconcilable dispute.

Consultation between the regulators in relation to approach and cross industry issues mentioned above must also be facilitated. This might be achieved by cross board memberships amongst the regulators; the establishment of joint committees on issues of common interest; the secondment of staff; and regular contact and liaison. Furthermore we recommend that consultation be encouraged with appropriate external bodies such as consumer representatives, professional bodies and international organisations.

6.8 Funding the regulators

The funding of the new regulators is an important issue. What we propose is not a more expensive regulatory regime, but rather a more efficient one. We recommend that the funding of the financial regulators rely as little as possible on consolidated revenue, being achieved primarily through supervisory levies, lodgment and transaction fees.

6.8.1 Funding from consolidated revenue

Funding from consolidated revenue is easy to administer, allocate, and account for. However the allocation of funding may be adversely affected by fiscal restraint and reductions in tax scales. Further, proper funding of regulators may require an increase in the direct tax burden which would be unattractive from a savings perspective.

The question, then, is whether financial regulation is of benefit to the whole of society and should therefore be paid by direct taxes. The answer requires a determination of whether the net social benefits are more properly served by funding from the budget or whether the costs should be recovered from a particular group.

The Department of Finance (1993) has identified conditions under which cost recovery by Government is most likely to be appropriate. These are where:

- there are no public interest or equity reasons why charges should not be attached to the goods or services being produced;
- the principal beneficiaries of the goods and services can be identified;
- charging for the goods and services is technically feasible; and
- users are able to influence their consumption.[48]

Clearly in relation to financial services these conditions do not exists and therefore we believe funding from consolidated revenue is a less desirable approach.

6.8.2 Funding by way of a supervisory levy

The Department of Finance framework can also be used to assess the case for charging for the regulatory activities of some agencies by way of a supervisory levy. Funding by way of a supervisory levy is already in place for life insurance and general insurance companies, superannuation funds and certain other financial institutions. In this method of funding, administration costs are low and there are no inequities and no impact on direct taxes.

Properly structured, levies provide a reasonably fair user pays system and are easy to adjust if costs increase. Also, a carefully designed cost recovery regime, which does not compromise the independence of the regulator, can complement the regulatory goals of an agency by instilling cost consciousness in the agency itself and in the users of the services.

[48] 1994-95 the Industry Commission Report on '*Regulation and its Review*'

Levies are, however, an additional tax on companies that will be passed through to consumers in the price of products and services. Furthermore, they create distortion if Government does not pass moneys back through to the relevant regulators. Even so, we believe that levies are superior to funding from consolidated revenue.

6.8.3 Lodgment and transaction fees

Lodgement and transaction fees are another reliable source of income for regulators. They are justifiable on the user pays principle if they are set at a level that allows regulators to recover their processing and other direct costs. However, such processing and transaction work is of indirect benefit to those who are forced to subscribe to the system. For example, many public registers contain a variety of information that is necessary for a reasonably transparent and fully informed market.

If these fees are set too high, however, they may inhibit the development of innovative products and services, new business structures and other entrepreneurial activity. They may also lead to distortions in the market. (FID and BAD taxes are notable examples of this.) If Australia is to be a friendly environment for international businesses, these sorts of fees should be abolished.

6.8.4 Conclusion

In conclusion we recommend that the funding of regulators be achieved primarily through supervisory levies, lodgement and transaction fees and rely as little as possible on consolidated revenue. The benefits of this approach are that:

- it would result in no increase in the direct tax burden;
- it clearly accords with user pays principles;
- it accords with principles stated by the Department of Finance;
- it means that regulators would be more independent of Government; and
- the regulators would be freer to set their own levels of remuneration, an important factor if they are to retain the talented and experienced staff necessary to perform their complex regulatory functions.

SECTION 7

INTERNATIONAL COMPETITIVENESS OF AUSTRALIA

The International Competitiveness of Australia

7.1 Introduction

In the context of this Inquiry it is of fundamental importance that the recommendations are drawn with the objective of improving the international competitiveness of Australia. As financial markets continue to globalise and cross border business increases, the competitiveness of financial products and services provided by Australian regulated financial institutions will become increasingly important. The changes to the regulatory framework which we recommend will enhance the international competitiveness of Australia by making it a more efficient and effective system to use. It will also be more attractive within which to invest and will promotes globally competitive products and services.

In addition to the changes to the regulatory structure and regulatory approach, we recommend that international regulatory cooperation should assume greater importance. In this respect Australia has already been involved in actively promoting cooperation with overseas regulators. Greater international cooperation will mean significant cost savings and additional choice for consumers.

National Mutual submits that the present regulatory structure of competition policy as it applies to the finance industry is sound and requires little, if any, change. We believe that the present structure and the principles upon which competition policy have been administered have resulted in strong competition within the financial industry. Within the non-banking sector, there is strong competition for a broad range of financial services. In the banking industry, there is strong competition for the wholesale consumer and increasing competition for the retail consumer.

There are however structural impediments to competition in Australia which when removed will further enhance our competitiveness.

It is our view that the removal of structural impediments to competition, the greater level of international regulatory cooperation and the technological advances impacting the market result in a broadening of the "market" for competition policy.

7.2 International regulatory cooperation

Most Australian financial regulators have been actively involved in promoting cooperation with overseas regulators. Under the new regulatory framework recommended by National Mutual, international cooperation will assume an even more important role. We submit that there will be significant cost savings available to consumers of financial services if international cooperation can be advanced to a level that includes entering into treaties recognising that offering documents which comply with the laws of a treaty partner are exempt from the prospectus type laws of the other parties. Australia has a very good track record in providing these benefits to consumers through its recognition of offering memoranda from countries with comparable regulatory frameworks such as New Zealand, the United Kingdom and the United States. Regrettably, only New Zealand reciprocates Australia's recognition.

Historically, most countries' prudential regulators have been reticent to recognise the adequacy of foreign prudential regulation, even in jurisdictions with comparable or more stringent regulatory requirements. By way of Australian example, one of the large UK based banks could not carry on a banking business in Australia unless various consents were obtained and the UK bank's Australian operation complied with the Australian prudential regulations. The same generally would apply to non-bank financial institutions, including life insurance companies subject to local prudential regulation. Other countries have also been slow to recognise the adequacy of Australian prudential regulation by permitting Australian financial institutions to trade in the foreign country without complying with their own licensing and prudential regulation. It is submitted, however, that access to foreign competitors is becoming easier as a result of technological advances. Australian consumers will soon be able to conduct significant business with non resident financial institutions by telephone, over the Internet and/or by other means.

On a multi-lateral level there are fundamental requirements which must be satisfied before the level of international regulatory co-operation can advance to a system of mutual recognition. The Chairman of the Technical Committee of IOSCO reported that the objective of their first working party was to be able to recommend to the Technical Committee approvals of a comprehensive body of international accounting standards that could be used to facilitate multinational offerings and listings. National Mutual believes settling multinational disclosure and accounting standards is a very high priority and should be given further support by the Government although it will clearly be a protracted and difficult process.

The Technical Committee of IOSCO has also recognised the need for countries to promote high standards of regulation and co-operation, and to obtain information from other jurisdictions. The Government is encouraged to continue to work towards the mutual recognition of member countries' regulatory mechanisms, including, measures available at the judicial or administrative level to freeze and repatriate assets and to enforce foreign orders in all the jurisdictions represented on the Technical Committee.

The promotion of mutual recognition treaties would deliver international competition to Australian consumers. The regulatory framework, if developed on a mutual recognition basis, would cater for the breaking down of international borders as a result of technological advances. Progress of mutual recognition on a multilateral basis will clearly be slow but should nonetheless be supported. We submit there is also potential to simultaneously make progress in this area on a bilateral basis and that Australia should actively pursue these opportunities in particular, taking a lead role in the Asia Pacific region.

7.3 Structural Impediments to Competition

A number of structural impediments to competition act as barriers to entry into the Australian financial industry by potential competitors, both Australian and foreign. They include:

- limitations on shareholdings in Australian banks and insurance companies;
- restrictions on access to the payments system;
- consumers perceptions of Government guarantees of some financial institutions;
- foreign investment restrictions; and
- State/Territory tax costs on financial transactions.

7.3.1 Limitations on shareholdings in Australian banks and insurance companies

Under the Bank (Shareholdings) Act, shareholding in an Australian Bank is limited to 10% of the bank's voting shares or, if the Treasurer is satisfied that it would not compromise the national interest, it can be increased to 15%. Restrictions also exist under the Insurance (Acquisitions and Takeovers) Act.

While the Campbell Committee suggested that ownership restrictions may be necessary to avoid undue concentration of ownership within the financial sector, this becomes a more important issue where there are significant barriers to entry, as presently exist in Australia. In a more highly competitive, deregulated environment, market forces are likely (even allowing for significant economies of scale in some activities) to ensure that a small number of intermediaries does not gain a disproportionate influence over the financial system. As these barriers to entry break down in the near future, the issue of concentration and its effects on competition will be most efficiently dealt with by a consistent application of Australia's competition policies, not arbitrary statutory restrictions. More appropriate alternative instruments (e.g. the competition provisions of the Trade Practices Act (TPA)) are available to ensure that monopolies do not develop.

A TPA argument put forward in favour of maintaining the restrictions is that management is more likely to be "unduly influenced" by a small number of shareholders than by a widely diversified group, that is, ownership restrictions are necessary to ensure reasonable independence and continuity of management, and thus confidence in the institutions concerned.

It has also been suggested that ownership restrictions are necessary to ensure that investors' funds are not used primarily for the benefit of particular shareholders, and to prevent the transfer of ownership to new owners who may not themselves be of sufficient stature to obtain a licence. These concerns are valid and are taken up later.

As the Campbell Committee noted, however, in relation to banks a dispersion of shareholdings might give unwarranted security of tenure to management, which could inhibit efficiency and innovation. Further, if appropriate prudential requirements were in place (including, for example, disciplines in respect of loans to single customers, shareholders and directors), a change in management arising from a shift in patterns of ownership would be unlikely to damage depositor confidence. Indeed, it might have the opposite effect if the quality of management has been a cause for concern.

We agree that greater accountability of management to shareholders is unlikely, of itself, to increase the concentration of financial power. Ending the shareholding restrictions would simply mean a different distribution of effective power between managers and owners.

Ownership restrictions have also been advocated as a means of ensuring that, if substantial increases in capital were required, these could be met without imposing excessive demands on any one shareholder.

The Campbell Committee again in relation to banks also disagreed with this view. It believed that a few substantial shareholders are, in many instances, more likely to provide increases in capital than a much more diversified shareholding. As well, the backing of large prestigious shareholders tends to promote confidence.

The Campbell Committee did not believe, on balance, that it is necessary on prudential grounds to restrict the ownership of banks. Accordingly, it recommended that the Banks (Shareholdings) Act should be repealed.

The Martin Committee, on the other hand, stopped short of recommending the end of the limitations. It appears that Committee felt that the balance of argument still favoured the restrictions, but acknowledged the reasons for ending the restrictions were gaining more momentum. With the benefit of hindsight the Campbell Committee seems to have correctly articulated compelling reasons for lifting the restrictions on shareholdings in Australian banks, but to have had too aggressive a timetable to implement the change.

As it so happened, the Australian (and international) financial industry needed time to adjust to deregulation and other changes introduced after the Campbell Committee. Consumers also needed time and information to be able to differentiate between products offered in the deregulated environment. Technological advances have surpassed even the most ambitious reformer to the point where the advances are fast coming to the point where the shareholding restrictions will have little practical significance. Looking forward, consumers will be best served by the creation of a regulatory structure which is sufficiently flexible to promote and deliver prudential controls which will be recognised internationally.

National Mutual recommends the lifting of the shareholding restrictions contained in the Bank (Shareholdings) Act and the Insurance (Acquisitions and Takeovers) Act. The changes should only take place after the prudential regulatory framework recommended in this submission is operating effectively.

7.3.2 Restrictions on access to the payments system

The Australian payments system effectively provides for a monopoly by the banks. This restriction has been noted as a barrier to entry in the financial industry and therefore anti-competitive in the Campbell Committee and Martin inquiry reports and by the ACCC.

The Martin Inquiry recognised that the question of access cannot be considered in isolation from the broader issues of confidence in and stability of the payments system. The existing restrictions, which limit direct participation to banks and authorised money market dealers, are based on the principle that only those institutions which satisfy the most stringent prudential requirements should be allowed direct access. Given the importance of the payments system to the overall stability of the financial system, the Martin Inquiry considered that this principle must be upheld.

Nevertheless, the competitive disadvantages suffered by non-bank financial intermediaries due to their inability to gain direct access were acknowledged. While reforms to the payments system since deregulation have improved the situation, by enabling increased access through agency arrangements at a more competitive price, non-bank financial intermediaries clearly believe the reform process has not gone far enough.

Many of the Martin Committee's recommendations are aimed at ensuring a strong competitive environment within the banking industry. Access to the payments system, on terms which are fair and equitable, is vital to this aim. In this context, the Committee was of the view that further consideration needs to be given to the question of access for non-bank financial intermediaries.

National Mutual submits that participation should be widened to include financial institutions that can satisfy the Australian Payments System Council that they either have sufficient financial reserves or are regulated in a country with comparable prudential regulation supervision. We believe it would be more manageable to grant such access to the payments system rather than permit alternatives to develop beyond the control of the regulators. Although immediate access to an alternative to the payment system is limited, technological advances are occurring at such a rate that the regulatory framework must now be put in place now to deal with them. Moreover our recommendations to consolidate prudential regulation of financial institutions will allow for consistent prudential regulation of institutions wishing to participate in the payment system.

7.3.3 Consumers' perception of Government guarantee of some financial institutions

As we noted previously, many consumers believe that the Government guarantees the financial viability of all licensed banks. This ranges from a belief that the government is obliged to bail out any failing bank, to the government guaranteeing all deposits with a licensed bank. Although this is only a perception, it remains a significant barrier to entry into the Australian financial industry, as the ACCC has recognised.

It is appropriate in light of the changes to the financial system and future trends to reconsider the appropriateness of Government guarantees. In particular:-

- with the internationalisation of markets consumers will increasingly have access to non domestic banks which may or may not have similar protection thus creating a disparity in the system;
- securitisation of lending products is making these assets more liquid and therefore the potential for a run on a bank to give rise to the need for liquidity support and depositor protection should reduce in the future;
- in a system which mandates superannuation it seems anomalous that a level of protection is given to certain types of financial products but not those which are mandated;
- product innovation is leading to the development of an increasing number of equivalent/near equivalent deposit products; and
- increasing focus on prudential regulation following deregulation and enhanced disclosure and selling/advisory regulation is providing increased protection to consumers in financial investment.

Based on the level of protection to be provided given these changes and in line with our earlier recommendation to consolidate prudential regulation with a single regulator and our discussions on moral hazard, we recommend that the Government correct the perception of "guarantees". Perceptions of the financial strength of financial institutions should rest on sound management, prudential regulation and safeguards. Consumers will need assistance (mostly in the form of education) in learning to rely on independent assessments of financial strength, such as the rating agencies.

7.3.4 *Foreign investment restrictions*

Commonwealth legislation imposes restrictions on foreign ownership of participants (or businesses) in the Australian financial system, eg. the Foreign Acquisitions and Takeovers Act. These restrictions preserve the right of the Australian Government to determine whether the national interest is better served by domestic or foreign ownership of participants in the Australian financial industry. If foreign ownership is permitted, the legislation enables the Government to refuse ownership by persons who, or in circumstances which, threaten the national interest. Control of the Australian financial industry has long been considered of vital national interest because it is fundamental to a sound economy and plays a central role in the enforcement and collection of taxes.

While the reasons for the foreign investment limitations will still exist, forces outside the control of any national government will render the limitations less effective and make the limitations more difficult to enforce. For the reasons discussed in relation to shareholding restrictions, foreigners will be able to compete for a share of the financial services market in Australia without necessarily owning an Australian business. Technological changes alone will permit Australian consumers to access foreign competitors with credit standings the equal of Australian financial institutions. Government foreign investment policy should therefore change over time to reflect the globailisation of the financial services industry.

Current Government policy not only restricts foreign ownership in the financial sector but also restricts the business activities of domestic financial institutions which are majority foreign owned and active in the funds management market. Legislation restricts these businesses' ability to compete fully with other businesses which are majority Australian owned, by requiring them to seek FIRB or other approvals before investing in companies subject to foreign investment limits. This occurs regardless of whether the funds to be invested are Australian sourced or not. This issue is particularly relevant in view of the growing importance of domestic saving vehicles for mobilising superannuation savings. Recognising that the removal on foreign investment limits will only occur over time we recommend that as a matter of priority the Government amend legislation to allow Australian sourced funds to be invested without restriction.

7.3.5 *State/Territory taxes on financial transactions*

The following financial transaction taxes are impediments to competition:

- mortgage (loan) security duty ;
- loan security duty on all corporate debentures other than wholesale fundraising ;
- rental business duty on financial leases;
- transfer of marketable security duty on equities for listed companies;
- financial institutions duty; and
- bank account debits tax.

The mortgage security head of duty applies to refinancing and thus is a cost impediment to free movement from one lender to another. New South Wales has already recognised that this head of duty prohibits consumers from taking advantage of the competitive interest rates now on offer and is removing the duty. Victoria has removed the duty for refinancing of business loans, but not extended the exemption to consumers of other forms of finance, notably housing loans.

Loan security duty, rental business duty and transfer of marketable security duty do not exist in most countries. As they are directly or indirectly passed on to the consumer, these taxes make the cost of these Australian financial services internationally uncompetitive.

Financial institutions duty and debits tax are direct taxes on financial institutions. Technological advances, especially electronic banking, are already threatening the revenue base of these taxes. Rather than developing convoluted methods of protecting the taxation of financial transactions, (as most States are doing), National Mutual recommends their abolition as soon as possible.

Although we recognise the significant implications of the above recommendations on Federal/State financial relationships, the existence of taxes on financial transaction makes the cost of our financial services uncompetitive on an international basis and acts as a disincentive for international financial institutions to use Australia as a base for their Asia Pacific operations.

7.4 Competition policy implications

The implementation of National Mutual's recommendations in relation to the regulatory structure, increasing international regulatory cooperation and the removal of structural impediments to competition will make the Australian financial service industry more internationally competitive and provide benefits to consumers. These changes will result in a broadening of the "market" when implementing competition policy rules.

7.5 Summary and recommendations

The proposed regulatory framework outlined in section 6 will facilitate a clear focus for the Australian financial system in light of the major changes affecting it. We believe that Australia can take advantage of these changes to become a much more competitive provider of financial services and a more competitive place in which increasingly globalised financial institutions can conduct their business for the ultimate benefit of consumers.

In addition we recommend that to ensure the Australian financial system is internationally competitive in the future, the following action be taken subject to the safeguards and transitions discussed.

Pro-Active Role in International Regulatory Co-operation:

- reinforce present Australian practice of recognising offering documents registered under laws of certain countries;
- expand the number of countries which are already recognised by promoting bilateral agreements which embody a system of mutual recognition of registration approvals;
- recognise adequacy of foreign prudential supervisory rules in jurisdictions with which Australia can promote a mutual recognition treaty; and
- support international multi lateral moves to increase regulatory cooperation in particular in the Asian Pacific region.

Remove structural impediments to competition and relax barriers to entry for foreign competitors including:

- lifting the restriction in the Banks Shareholding Act, Insurance (Takeovers and Acquisitions) Act;
- remove restrictions on access to the payment system;
- assess the appropriateness of Government guarantees either implicit or explicit and correct the consumers perceptions accordingly;
- remove foreign investment limitations;
- remove the following State/Territory taxes on financial transactions,
    - Mortgage (Loan) Security Duty ,
    - Loan Security Duty on all corporate debentures not merely wholesale fund raising ,
    - Rental Business Duty on Financial Leases,
    - Financial Institutions Duty,
    - Bank Account Debits Tax, and
    - Transfer of Marketable Securities (equities)

Acknowledge that the scope of “market” will broaden for purpose of applying the test of “substantially lesser competition” (section 50 of TPA). The “market definition” will then need to be redrawn to embrace the further competition from international competitors, removal of significant barriers to entry and removal of impediments to competition.

SECTION 8

NATIONAL SAVING

National Saving

8.1 Introduction

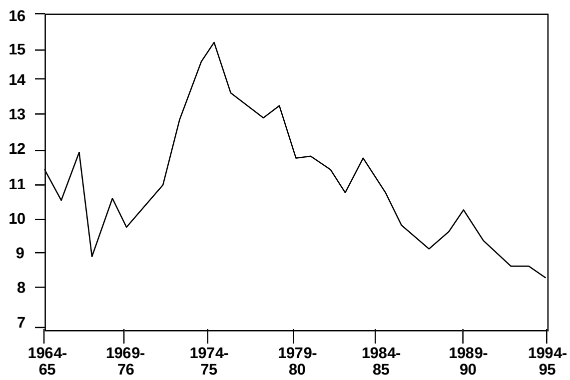
We commented in section 3 that notwithstanding significant developments in the Australian financial system over the last 15 years since the Campbell Inquiry, national saving has deteriorated. Whilst we accept that the issue of national saving is not central to this Inquiry, especially given the limitations placed upon it from making recommendations on retirement incomes policies and policies for taxation of financial products, services and institutions, it is nonetheless an issue of importance which should not be ignored.

8.2 Household saving

Whilst the decline in national saving is of concern, the underlying decline in household saving, for which the industry provides financial products for investment, is perhaps of more specific concern in the context of this Inquiry. Household saving has declined during the period including the last few years when the economy has moved out of a recessionary phase.

Figure 8.1

Household Saving % of GDP



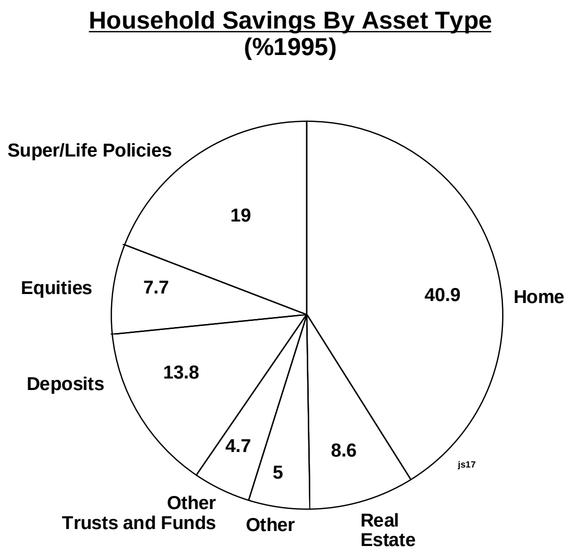
Source: National Savings, June 1993, ABS Cat No 5204.0

It is important for the future international competitiveness of Australia that the decline in household saving and also national saving is addressed. In particular

- relative to other OECD countries, Australia has invested a high proportion of its household savings in residential housing. In 1995 almost half of household saving was invested in the residential home. Furthermore, 'recent trends giving households increased access to credit using housing equity as security may have contributed to the household saving ratio falling to the lowest level in the OECD';[49]

[49] The National Commission of Audit Report to the Commonwealth Government (June 1996).

Figure 8.2



Source: RBA Bulletin July 1996, ABS Yearbook 1996, Australian social trends 1996, The Australian Financial Review 26 July 1996 page 7

- it is important that in future a greater proportion of household savings goes into investment to expand our capacity to produce more high quality goods and services for world markets, which is crucial if Australia is to reduce its reliance on imports, boost exports, and create jobs. If domestic savings continues to be too small relative to investment requirements, business investors will continue to call on offshore savings;
- upgrading and expanding the economy's productive capacity requires large and long term investment. Long lead times often apply before projects reach full production stage. Long term savings are the most effective source of finance for such investment. A shortage of patient investment funds can be a severe obstacle to investments which do not produce a quick pay off; and
- our low saving rate has been a contributory factor to higher real interest rates in Australia compared to countries with a better savings record. This has contributed to increased business costs and consequently weakens our international competitiveness. The result is circular as in turn it discourages business investment.

8.3 The impact of changes to the regulatory structure

Whilst the direct impact of regulation on the level of saving is not large (outside the compulsion to contribute to superannuation), it has the ability to either encourage or discourage saving. The volume, complexity and overlap in regulation create significant additional costs for consumers as well as confusing them and hence making them uncomfortable in investing in product areas that they do not fully understand.

By providing straightforward and consistent regulation of saving and other financial products and services, we believe that the regulatory environment can remove some inertia towards saving by Australian consumers.

We believe the adoption of the recommended regulatory structure and approach will achieve this, because:

- regulations must be as straightforward as possible, especially in their application. This applies particularly to regulations affecting the advice and sales processes;
- certainty and stability of regulation is essential, as consumers react very negatively to continually changing regulation;
- the flexibility to handle differing circumstances and innovative consumer products must be facilitated;
- less prescriptive regulations should provide the flexibility to meet different needs, whilst ensuring they are actually enforceable in the marketplace;
- consistency of regulation and application, including the philosophy and approach, must extend to a range of similar products and services; and
- neutrality in savings intermediation.

8.4 Conclusions

Whilst national saving is not central to this Inquiry, we believe that it is an issue of fundamental importance to the Australian economy and the international competitiveness of Australia. The recommendations we make for changes to the regulatory structure in Australia will, we believe help to some extent. However, in addition to the structural changes we recommend that the Inquiry seek every opportunity to promote national saving in its recommendations. We recommend, in particular, that the changes to regulation arising from this Inquiry do not unduly hamper the growing pool of long term savings.

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