# EXECUTIVE SUMMARY

**Introduction** *(Section 1.1)*

The ISC is pleased to have the opportunity to make a submission to the Financial System Inquiry. Current regulatory arrangements are imperfect, and the time is right for some change. The greatest scope for reform at present is in the area of retail investment advice, where there are presently significant gaps, overlaps and inconsistencies in the regulatory framework. Because forecasting beyond the medium term is hazardous, there is a case for holding an inquiry every 5 to 10 years.

A major purpose of regulatory reform should be to improve consistency and liberality in the rules, and to promote competition and innovation in the marketplace. Proposals for reform should have regard to international consistency (keeping in step with the rest of the world), industry peculiarities (accounting for institutional diversity), and adjustment costs (making sure that within the financial sector, the gain exceeds the pain).

**Objectives of financial supervision** *(Section 1.2)*

The objectives of financial supervision are stability, efficiency and consumer protection. Prudential supervision is aimed at stability; it encourages financial institutions to remain solvent and investment schemes to be well run. Liberality and consistency in the rules improve efficiency by fostering competition and innovation in the marketplace. Regulation of retail business conduct is intended to promote fair, open and honest dealing between companies and consumers.

**Rationale of financial supervision** *(Section 1.3)*

The justification for bank supervision is systemic risk (maintaining the stability of the financial system) and depositor protection (providing a safe haven for small savers). Systemic risk is of less concern in insurance and superannuation, but supervision - in the interests of both prudential security and fair trading - is required for three other basic reasons:

- <u>market failure</u> - insurance policyholders and superannuation members are seriously disadvantaged by the inadequate and unequal information available to them. They find it difficult to understand complex products and to ‘shop around’ for best value. They hand over their money in advance, but have to take it on trust that the company or fund will be around in the future to honour the payment as promised;

- <u>public policy</u> - Government policies in relation to retirement income, social security, taxation and national savings all work in one way or another to elevate the social importance, and justify the prudential protection, of long-term (insurance and superannuation) savings. For example, public confidence is crucial to maintaining the political legitimacy of compulsory superannuation; and

- community expectations - it is unlikely the community would tolerate any significant downgrading of the protection provided to their risk cover and lifetime savings: the loss of the family home or ‘nest egg’ because of a misunderstood insurance policy or an incompetent superannuation manager could be personally devastating for those involved. Over the years, the community has come to demand more rather than less protection against the mismanagement of their money.

**Conceptual approaches to financial supervision** *(Section 1.4)*

Conceptual approaches to financial supervision - such as the institutional versus functional dichotomy - are useful only up to a point. Policy making and financial supervision have to be practical; they do not start from a blank sheet of paper; they cannot capture an untidy marketplace in a neat set of boxes. The regulatory arrangements should be allowed to evolve in a measured manner; they should not be suddenly forced into a radically different ‘brave new world’.

The ISC considers that the only sensible course for prudential supervision in Australia is the ‘solo plus’ approach, where ‘solo’ refers to specialised supervision of deposit takers, insurers and fund managers at the financial entity level (whether by separate agencies or divisions of the same agency), and ‘plus’ refers to an additional layer of supervision at the financial group or conglomerate level.

Specialised solo supervision continues to be appropriate because of institutional diversity. For example, banks and life offices are quite different because of their business practices, risks and competencies, quite apart from their regulatory treatment. Treating them differently for regulatory purposes accommodates this diversity, provides consumers with a choice, and is consistent with international practice.

**ISC Profile** *(Section 2.1)*

The ISC is a relatively young agency (formed in 1987), and a relatively small agency (around 500 staff). It is, however, second among the financial regulators after the RBA in terms of the financial entities it supervises and the assets they manage:

- 120,400 superannuation funds ($244 billion in assets)
- 51 life companies ($124 billion in assets)
- 160 general insurers ($35 billion in assets).

There is a large overlap between life insurance and superannuation: $91 billion of superannuation assets (over 37 per cent of the total) is managed by life offices (over 73 per cent of their total). The superannuation and life insurance Acts are modern and relevant, being introduced in 1993 and 1995 respectively, with substantial industry input.

**Key market developments** *(Section 2.3)*

In the period following financial deregulation, market developments with a particular relevance for the regulatory framework have included:

- the relatively rapid growth of superannuation, and of managed funds more generally. Some of this growth is attributable to rising asset values. Even so, it is clear that compulsory superannuation and other factors have resulted in household saving in the form of financial assets going more into managed funds (including life insurance and superannuation), and less into bank and NBFI deposits;

- blurring and convergence - major financial institutions are increasingly diversifying across industries (banking, insurance and funds management) and across national borders. Life offices have, for taxation and commercial reasons, moved into non-traditional products which are similar in some respects to term deposits (short-term capital guaranteed policies) or unit trust products (market linked policies). However, convergence is essentially a group (not entity) level phenomenon involving a relatively new breed of financial organisation: the international financial conglomerate;

- international coordination - the rise of the international financial conglomerate has been accompanied by increasing regulatory coordination through the peak international associations of banking supervisors (the Basle Committee), securities supervisors (IOSCO) and insurance supervisors (IAIS). This cooperative activity is being encouraged by the G7 Ministers, who see globalisation and technology as having increased international systemic risk;

- changing distribution systems - following the excesses of the late 1980's, the major banks and life offices have been forced to shift their competitive focus from size and market share per se, to price restraint and profitability. This has meant cutting their high cost distribution networks (of bank branches and life insurance agents), or else driving them harder through cross-selling arrangements. Along with this, a new financial advice industry has emerged; and

- specialised dispute resolution - complex financial products and inaccessible court processes have created pressure for industry-specific, alternative dispute resolution schemes in the financial sector. An array of specialised schemes have evolved which now provide consumers with convenient, informal, fast and low cost access to justice.

**Overlaps in prudential supervision** *(Sections 3.2, 3.3, 3.4)*

The significance for policy making purposes of 'product blurring' (ie. financial entities writing non-traditional business on balance sheet) is very minor. There are no statutory restrictions in Australia on suitably structured financial groups conducting bancassurance and funds management, and 'blurring' and 'convergence' are therefore issues for conglomerate supervision, not solo supervision. However, there are three other notable areas where the present systems of prudential supervision overlap:

- superannuation - within the ISC, the life insurance group and superannuation group share a common interest in the prudent management of the $90 billion plus of superannuation assets held in statutory funds. While the solvency of the life company and the prudent conduct of the superannuation trustee can be regarded as separate matters, there is a synergy to be gained from a joint approach to the overall soundness of the life office/approved trustee combination;

- managed funds - the regulatory arrangements have driven a wedge into the managed funds industry, which falls under the ISC's SIS regime in respect of retail funds which qualify for superannuation status, and the ASC's collective investment regime for those which do not. The current split is commercially costly, but helps maintain the risk spectrum (which is desirable on general economic efficiency grounds). Moving unit trusts to the ISC would compress the risk spectrum, but the community may expect or demand this. Moving superannuation to the ASC could remove one inconsistency, but would worsen the life office/superannuation overlap mentioned above;

- deposit taking - the regulation of financial intermediaries, broadly defined, is split between the RBA (banks), ASC (merchant banks, finance companies) and AFIC/States (building societies, credit unions). There could be potential efficiency gains involved if the States were disposed to hand over their NBFIs to the Commonwealth.

At present, the coordination of financial supervision - including in respect of financial conglomerates - is undertaken on a non-statutory basis by the Council of Financial Supervisors. The ISC considers that the Council works well in practice, but accepts that it has a low profile and limited powers. There could be a case for upgrading the Council by giving it a statutory mandate and additional responsibilities.

**International experience** *(Section 3.5 and Appendix C)*

The ISC has drawn the following conclusions from its observation of international practice and debate.

First, the UK 'twin peaks' proposal of Michael Taylor - for a single systemic/prudential regulator and a single conduct of business regulator - would split the ISC: insurance would go to the bank supervisor; superannuation would go to the

ASC. A variation of this would be the South African model of a single supervisor for the non-banking sector, which would see the ISC merging with the ASC in toto.

The ISC considers both variations to be highly problematic in an Australian context. Splitting the ISC would create a new life office/superannuation overlap. Merging most or all of the ISC into the ASC would create a large and unwieldy organisation which would be internally fragmented by its multi-functional mandate, its conflicting cultures and competencies, and its mixture of Commonwealth and State based powers and structures.

Second, the New Zealand approach of minimal insurance regulation is not considered relevant because of: the high degree of foreign ownership of NZ insurers (which effectively shifts responsibility to home country supervisors, such as the ISC); the very small size of the local NZ market; and growing scepticism in the international literature about prudential supervision relying solely on disclosure and ratings in a period when complex financial transactions (eg derivatives trading) can create massive exposures overnight.

Third, international experience with mega-supervision, eg in Nordic countries, does not provide any clear evidence of major economies of scale or scope. Rather, the impression is that solo supervision continues to be conducted by separate divisions (albeit under the one roof), and that coordination tensions are internalised but not eliminated.

**Option - a lead supervisor model** *(Section 3.6)*

One option for prudential supervision would be to let the current system - of specialised solo supervision plus a layer of group supervision - continue to evolve along its present course, albeit with some adjustments. While each model has its pros and cons, and none is perfect, the ISC would on balance favour this approach because it is evolutionary and consistent with the international direction being taken by the Joint Forum on the supervision of international financial conglomerates.

A refined ‘solo plus’ model would involve formal arrangements for a ‘lead supervisor’, and could be based on the following key elements:

- the RBA would be kept intact, because of the synergies between central banking and bank supervision, and because of its overall responsibility for systemic stability. If the States agreed, the RBA would also supervise the non-bank financial intermediaries given the efficiencies to be gained from removing the Commonwealth/State overlap in the regulation of operationally similar institutions. Finding the best home for friendly society supervision requires further consideration;

- the ISC would prudentially supervise (life and general) insurance and managed funds including superannuation (and standard unit trusts if a wider risk spectrum is forgone), to account for life office superannuation, to minimise inconsistency in the regulation of market linked savings products, and to preserve its specialised expertise in insurance supervision;

- the RBA and ISC would concentrate on the core functions of prudential supervision under an upgraded Council of Financial Supervisors (and have no consumer protection role). In regard to bancassurance groups, the RBA would be lead supervisor except where the life office is dominant and the bank is small (in which case the ISC would be lead supervisor), and group supervisory arrangements would continue to evolve in line with international developments; and

- consumer protection - eg. the regulation of product disclosure and financial advice - would be separated from prudential supervision and consolidated in a new Retail Investment Commission (see below).

**Option - a mega-supervisor model** *(Section 3.7)*

The ISC does not favour a single prudential (mega) supervisor; but if this model were adopted, the ISC nonetheless believes it could be made to work effectively in practice. This option would involve merging the ISC, AFIC/SSAs and possibly parts of the ASC into the RBA. The ISC is strongly opposed to the separation of central banking and bank supervision, and would therefore see central banking remaining within the mega-supervisor.

The major arguments against a mega-supervisor are: the inevitable initial clashes between different cultures and skill sets and the likely loss (over time) of the institutional memory and expertise of the subsumed regulators; community perceptions of prudential regulation and protection being the same for all products (irrespective of whether they are risk or savings, capital guaranteed or market linked); and, the danger of a large, bureaucratic, cumbersome and insular organisation having too much power and too little accountability (eg. resulting in financial supervision which is less practitioner based).

**Overlaps and options in consumer protection** *(Chapter 4)*

There are clearly overlaps in consumer protection applying to financial services, both at the Commonwealth level, and as between the Commonwealth and the States. The ISC accepts that duplication and inconsistency - in the regulation of business conduct for fair trading purposes - can create unnecessary customer confusion, excessive compliance costs, and unfair competitive inequalities.

The current consumer protection regime is not only too fragmented, but in a number of areas it arguably has an overly prescriptive or ‘black letter’ style.

The ISC submission has outlined in some detail the current regulatory arrangements in relation to the three broad areas of: financial advice, product disclosure and complaints handling. Reference is made to an ASC/ISC harmonisation exercise, under the auspices of the CFS, which is making considerable progress in relation to common standards for the regulation of sales conduct.

However, three issues in particular remain outstanding: different regimes for licensing advisers; multiple rules for product disclosure; and the overlap between financial sector specific consumer protection at the Commonwealth level on the one hand, and the fair trading regimes of the ACCC and the States on the other.

The two main options for practical reform are: first, continuation of the present process of incremental, inter-agency harmonisation (particularly by the ASC and ISC); and second, consolidation of consumer protection measures into a single regime under one roof (whether the ACCC, ASC, or a new special purpose agency). While each approach has advantages and disadvantages, the ISC on balance has concluded that:

- a greater degree and faster pace of harmonisation could be achieved with a single regime administered by a single regulator. However, it should be noted that internalising tensions does not automatically resolve them - much work would still need to be done in relation to the licensing and supervision of financial advisers, in particular;

- financial sector specific consumer protection is preferable to the generic regimes of the ACCC and the States, because of the high degree of complexity in financial products, and the importance of not compromising the prudential security of the financial product providers. Therefore, financial products should be exempted from ACCC and State legislation, particularly section 52 of the Trade Practices Act (TPA);

- a new special purpose agency - a variation on the UK Personal Investment Authority model - would have a clearer mandate and sharper focus as the consumer protection regulator than the ASC, which is already a multi-purpose regulator with a very broad focus (encompassing economy wide company regulation and market integrity). Although a new agency would mean an extra regulator, it would more importantly result in fewer regulatory regimes; and

- external complaints handling schemes should continue to be industry based, to exploit specialised expertise, to provide maximum flexibility, and to encourage voluntary compliance.

**A new Retail Investment Commission** *(Chapter 5)*

The ISC proposes the establishment of a new Retail Investment Commission (RIC), to be the sole retail conduct of business regulator for financial advice, product disclosure and complaints handling in relation to savings products, and quite possibly risk products.

The RIC would be a statutory authority lying outside the Public Service Act, but within the Treasury portfolio and Council of Financial Supervisors. It would be funded by levies on product providers and financial advisers. There would be a board with equal representation from financial regulators, product providers, financial advisers and consumer groups.

The broad mandate of the RIC would be to regulate product providers and financial advisers for fair, open and honest conduct in the sale of savings products to retail customers. In doing so, the RIC would be required to have regard to the need for the prudential security of product providers, consistency and liberality in the rules, and competition and innovation in the marketplace.

The products falling within the RIC's (consumer protection) jurisdiction would include bank and NBFI deposits, life insurance policies with an investment element, retail superannuation, unit trusts and other retail securities. There would be a strong case for also including pure risk insurance (eg. term life and general insurance) products and general insurance brokers; this would need to be determined.

The RIC would seek, to the extent practicable, to shift the regulation of financial advice and product disclosure from a rules based approach to a less prescriptive approach based on broad principles and self-regulation.

The ISC's preferred model for the regulation of the financial system is set out (in a simplified form) in the attached table.

**Mergers among financial majors** *(Section 6.1)*

The ISC has a minimal role in competition regulation per se (the ACCC being the regulator in this area), but as a financial regulator does have a legitimate interest in broader questions of competition and efficiency across the financial sector, and would make the following observations:

- there is already considerable concentration in domestic retail financial services, with the top four banks accounting for more than two thirds of the banking sector, and the top three life offices accounting for more than half of the life insurance sector. Taking a wider view, the top four banking groups account for more than one third of the entire financial system;

- there is little or no support in the international literature for economies of scale in very large banks. However, there is no a priori reason for ruling out the possibility of economies of scale in insurance, and there is some likelihood of economies of scale in funds management;

- in terms of international competitiveness, the 'critical mass' and 'national champion' arguments have little intellectual rigour or economic credibility. Australian financial institutions wishing to diversify internationally already have the option of taking over, or otherwise linking up with, local companies in foreign markets; and

- the current regulatory framework - whereby the ACCC administers section 50 of the TPA, and the Treasurer has the discretion under banking, insurance and foreign investment legislation to reject a proposal, having regard to special public interest considerations applying in the circumstances at the time - works well in practice, and is appropriate for the future. It should be noted that the Treasurer's power to reject proposals needs to be retained for prudential supervision purposes (eg. 'fit and proper' considerations).

**Electronic commerce** *(Section 6.2)*

Forecasting the speed and manner with which the market will take up technological developments is notoriously difficult. The ISC does not 'crystal ball gaze', and is not proposing to speculate on the future shape or appropriate regulation of the payments system. The ISC's interests in technological and market developments in electronic commerce are presently:

- to maximise the electronic delivery of (and thereby reduce the compliance cost of) the statutory returns which insurance companies and superannuation funds are required to provide to the ISC under its prudential regimes;

- to monitor the commercial use of electronic networks (including the Internet), particularly in relation to the application of disclosure rules to direct marketing. For example, ISC product disclosure rules require that a Key Features Statement is included in sales material;

- to facilitate industry initiatives - such as the 'transfer protocol' - to streamline transfers of superannuation benefits between funds; and

- to monitor the local distribution of unregulated insurance products provided by unauthorised foreign insurers. If this practice were to become widespread and problematic, an internationally coordinated regulatory response could be required.