CHAPTER ONE - RATIONALE OF FINANCIAL SUPERVISION

1.1 INTRODUCTION

The ISC is pleased to have the opportunity to make a submission to the Inquiry into the Financial System. The ISC expects to make a supplementary submission in response to the Discussion Paper foreshadowed for November 1996 and to make further comments in response to issues as they arise. We would also be pleased to provide further information on any issue raised in this submission. On some topics which lie outside its mandate and expertise, the ISC expects to offer relatively little or no comment.

The ISC understands from the terms of reference that the Inquiry will undertake a stocktake of financial regulation, seek to establish a common framework for overlapping financial products, and propose ways and means of encouraging competition and innovation in the financial sector. It is understood that the Inquiry will make recommendations on the regulatory arrangements for the financial system.

The ISC has approached its consideration of the issues with an open mind as to how the regulatory framework might best be rearranged to improve consistency and liberality in the rules, and to promote competition and innovation in the marketplace. However, in the comments that follow it is clear we have come to favour some options over others.

The submission consists of six chapters. The first outlines the rationale for prudential supervision of the insurance and superannuation sector. The second provides a broad description of the institutional arrangements for financial supervision in Australia and recent market developments. The third focuses on regulatory structures for prudential supervision and discusses the advantages and disadvantages of the main options for reorganising those structures. The fourth focuses on regulatory structures for consumer protection and discusses options for improving the regulation of financial advice, product disclosure and complaints handling. The fifth sketches a broad outline of how a new consumer protection agency for the financial sector might work in practice. The sixth contains some comments on two other issues, viz mergers amongst major financial institutions and regulatory implications of developments in electronic commerce.

ISC Prior Propositions

In organising its thoughts on how the regulatory arrangements might best be improved, the ISC has used as a starting point the following propositions:

- <u>scope for change</u> - the current arrangements are imperfect and could be usefully improved. The time is right for some change. The most scope for change is in the area of retail investment advice, where there are presently major gaps, overlaps and inconsistencies in the regulatory regimes;

- prudential supervision is an art not a science - the current solo supervisors have developed their industry expertise and institutional memory in a specialised way over a lengthy period. Familiarity with the historical culture and the commercial practices of each industry is fundamentally important to the art of supervision. Care should be taken in any regulatory re-arrangements not to lose the specialised expertise and techniques of the solo supervisors;

- ‘blurring’ and ‘convergence’ are essentially group (not entity) level phenomena - while there is some product blurring at the entity level (eg. market linked savings products), convergence of financial industries and diversification across national boundaries are primarily issues for international financial conglomerate supervision, not solo supervision;

- some academic models for a regulatory framework are too simplistic for practical policy-making - while the current arrangements are imperfect, they exist, and policy-making does not start from a blank page or fit neatly into a simple set of boxes. For example, superannuation would not fit into a model which put institutionally based prudential supervision in one box, and functionally based consumer protection in another;

- the institutional structure for financial regulation is a second-order issue - a more important issue than the number of regulators per se is the question of enhancing coordination, information exchange and harmonisation;

- international consistency - it is essential to keep in step with the rest of the world, not least because Australian institutions wishing to expand overseas may be blocked if our home country supervision is out of line with international standards. The work of the international associations of financial regulators is assuming increasing importance in this regard; and

- transition costs - the adjustment costs of moving to a ‘brave new world’ should not swamp the practical benefits. Radical change can be traumatic in terms of administrative stress and commercial disruption. It is important to keep in mind that the marketplace is inherently untidy, and the regulatory arrangements can never reach perfection.

1.2 OBJECTIVES OF FINANCIAL SUPERVISION

The broad objectives of financial supervision can be expressed as:

- to safeguard the *stability* of the financial system, especially the safety and soundness of the payments system;

- to promote *efficiency* in the operation of financial markets, including in the provision of financial products and services; and

- to provide adequate *protection* to consumers of financial services, particularly those who are at a disadvantage because of inadequate and unequal information.

Financial system stability

Financial system stability is the reason why certain financial institutions, particularly banks, have been supervised especially closely. The need for stability is based on the notion that the failure of a financial institution could, through confidence and contagion effects, undermine the functioning of the financial system as a whole. Particular characteristics of banking - such as the importance of depositor confidence in institutions which borrow short and lend long, the difficulties of objectively valuing many bank assets, and the interconnection of banks through the payments system - mean that one institution's problems can spread quickly to others. Similarly, but to a lesser degree, major losses in a large superannuation fund or insurance company could have serious flow on effects for public confidence, particularly if a bank is an affiliate or a counterparty of the troubled entity.

The vital importance of the financial system to economic activity, and the potential national interest consequences of market failure leading to financial instability, provide a strong case for the imposition by governments of some minimum prudential standards and a degree of official surveillance. It also means that supervisors need to take expeditious action whenever developments are discovered which threaten the existing or future stability of the system. However, the precise form and intensity of supervision across the banking, insurance and managed funds industries is ultimately a matter of international practice, community preference and political choice.

In pursuing the objective of stability, care should be taken to avoid creating the impression that there is no risk associated with financial products or that financial institutions will never be allowed to fail. Perceptions of an implicit Government guarantee would give rise to moral hazard, that is, institutions could be tempted to take excessive risks in the knowledge that they would reap the rewards if the bet paid off, while the Government would pick up the losses if it did not. Similarly, under a guarantee, consumer expectations would become unrealistic and the *caveat emptor* principle with regard to relative risks among institutions and markets would be abandoned. The imposition of uniform prudential requirements across the financial system could lead to a narrowing of the risk spectrum, limiting the scope for consumers to make a choice between risk and return.

In pursuing the stability objective, it is also important to recognise the potential for conflict with the efficiency objective. The imposition of unnecessarily high prudential standards and over-intrusive monitoring of institutions and markets can seriously inhibit competition, innovation and flexibility in the marketplace.

The cost-effectiveness of supervision is important, but hard to measure. Some of the difficulties are highlighted in the following comment from the former Executive Director of the Bank of England:

> A more complete answer ...[to measuring the costs of supervision]... would involve showing how supervision had added to or reduced the number and costs of failure. Supervision is, after all, a prophylactic activity. You need to know the opportunity costs of intervention to get a true measure of the benefits of supervision. But this is not feasible, at least not at present.
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> A regulator may be able to point to a number of cases where his or her intervention clearly prevented disaster; where an institution was clearly heading for the rocks and he intervened and turned it round. There are quite a few of those, although legal constraints usually preclude supervisors from disclosing them. The more difficult ones to identify are where you have said something to an institution across the table, face to face, saying perhaps “We think your appetite for risk has increased greatly in relation to your capital base and management skills and controls”. Or you might give them a ticking off. You might say to them, “your reputation in the city is not high at the moment and we are hearing that you are putting yourself about in a rather aggressive way. You should be aware of this because you will get yourself into trouble”. There are other cases where they say, “we heard your speech or we heard the Governor’s comments” on such-and-such an issue and it made us think we should take a look at a particular activity to which the Bank was drawing attention. They may go away and change their behaviour as a result. These are real supervisory successes but identifying and measuring them is obviously pretty well impossible.[1]

Financial system efficiency

The market orientated approach to financial supervision requires effective competition between providers of goods and services. Effective competition means cost efficiency and price restraint, not the pursuit of market share through high-cost distribution. Competition enhances efficiency by improving the accessibility, design and pricing of financial services, by limiting the scope for harmful restrictive practices, and by leading to the most productive allocation of resources. Offsetting major market failures and limiting unnecessary barriers to entry will maximise competition and innovation within the financial services industry. Competition encourages institutions to become strong, profitable and dynamic, and leads to more satisfied customers.

Attainment of the efficiency objective also requires competitive neutrality among financial organisations whenever they are competing in the same market segment. This means avoiding the situation where an organisation can secure a competitive advantage or suffer a disadvantage through being unfairly and unnecessarily subject to differential supervisory requirements. Such a situation is more likely - but not inevitable - when particular institutional groups diversify into activities lying outside their traditional boundaries and overlapping with ones in another jurisdiction. Competitive neutrality should therefore be pursued for efficiency reasons in domestic, and where possible,

[1] B. Quinn, *The Financial Regulator*, Vol. 1 No. 1, Central Banking Publications, London, 1996, p.30-33.

international supervisory arrangements, but not merely to meet industry special pleading.

The objective of competitive neutrality does not, however, necessitate a single regulatory regime. Indeed, having functionally similar products provided under institutionally different regimes provides variety and expands choice. Dr Alan Greenspan, Chairman of the United States Federal Reserve Bank Board, explains this as follows:

> The Board does not believe that competitive equality requires that an identical oversight regime be applied to all players in the marketplace, provided competition from whatever source ensures adequate consumer choice.[2]

There can be tensions between market efficiency and stability objectives. For example, laissez-faire competition could lead to excessive risk taking and therefore reduced investor security and public confidence. On the other hand, heavy handed regulation in the interests of safety could stifle the ability of firms to innovate and respond quickly and efficiently to market developments.

Consumer protection

The principal rationale for protecting consumers of retail financial services is to redress the market imperfections which arise from inadequate and unequal information, and to thereby allow consumers to properly assess the risks, quality, and relative prices of diverse and often complex financial products and services.

The interests of consumers can also be prejudiced by the superior bargaining power of large financial institutions, which are naturally in a position to exploit their more vulnerable customers. For example, the unsophisticated consumer can suffer from bad advice due either to inadequate staff or adviser training within financial organisations, or to undeclared conflicts of interest on the part of persons selling a product or service. They can also be victims of misrepresentation or fraud.

These market imperfections and the scope for incompetent and unethical practices can be substantially reduced, however, by information disclosure requirements and codes of practice relating to business behaviour.

The policy objectives of market efficiency, system stability and investor protection are interrelated. Prudential supervision is fundamentally about minimising ‘institutional risk’, that is, the risk that the institution which manages the money or operates the scheme will collapse. However, industry efficiency and consumer protection are also valid objectives for a financial regulator to pursue. Competitive, informed markets operating under fair trading rules on a level playing field will not only improve efficiency and protect consumers, but also enhance public confidence in institutions and contribute to system stability more generally.

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[2] A. Greenspan, *Federal Reserve Bank Bulletin*, January, 1996, p 38.

1.3 RATIONALE FOR FINANCIAL SUPERVISION IN THE INSURANCE AND SUPERANNUATION SECTORS

Insurance companies and superannuation entities do not have the central role in the payments system that banks and other deposit taking institutions have. Assets are generally not 'at call' and the risk of contagion is less acute. Nevertheless, as explained below, the nature and characteristics of life and general insurance, and superannuation, justify a level and type of supervision which is unequivocally 'prudential' in character (ie, designed to enhance the security of policyholder and fund member entitlements).

While systemic risk essentially arises from banks, there are at least two obvious instances where insurance and superannuation entities can have a systemic impact. First, within a financial conglomerate, contagion may spread trouble from an insurer/fund manager to a bank member of the group, because of the adverse impact the failure of a subsidiary would have for the parent where both are identified with a common brand name, and where fire-walls are not foolproof. Second, there is a possible knock-on (domino) effect from a failed insurer/fund manager to a bank, for example where the bank is a counterparty to a derivatives transaction (the G7 Ministers have expressed concern about the systemic risk posed by complex international linkages in banking, securities and insurance activity).

Systemic risk within the superannuation sector could be exacerbated by the proposed Government initiatives to increase consumers' choice of superannuation fund and enhance the portability of contributions. Retail superannuation funds will become increasingly vulnerable to withdrawals and liquidity pressures which were not so much a concern when superannuants were more locked into particular funds.

Notwithstanding these points, the ISC accepts that systemic stability is essentially a matter for banking and NBFI supervisors. However, there remains a strong case for insurance and superannuation supervision on both prudential security and fair trading grounds.

Many insurance companies and superannuation funds are substantial players in financial markets and provide products which are of considerable significance for Australian businesses and households. Domestic consumers of retail insurance and superannuation products are commonly not sophisticated enough to assess the capacity of the product provider to fulfil their side of the bargain, or to make sound comparisons between products. And, there are strong public expectations that the product provider - who has a fiduciary role and responsibility - will have the commitment and financial capacity to pay claims and benefits as and when they fall due.

Life insurance

Companies registered to write life insurance business in Australia offer savings products, provide risk cover against the financial consequences of early death or disability, and run superannuation funds to provide benefits in the form of retirement income. Premiums and contributions paid to life companies form a part of the national savings pool which is available to fund the development of Australian resources and industries.

Life insurance has characteristics which make it quite different from everyday commercial transactions. There is an important **long-term element** in life insurance business. Ordinary whole of life policies can be regarded as a form of long-term saving as the timing of the event which will trigger payment under the policy (ie, the insured's death) is uncertain. In endowment and superannuation, the savings element is more explicit. Life insurance policies are usually purchased for the purposes of financial security and reflect an important social virtue, viz., thrift and the self-provision of income for dependants after the death or disablement of the policyholder (note that consumers are known to be myopic in this regard, ie they have a natural tendency to under-provide).

Because traditional life insurance contracts have tended to be **long-period contracts** during which funds are accumulated to meet distant but (on average) fairly predictable obligations (eg. death as expressed in mortality tables or total and permanent disability based on occupational risk categories), the consequences of maladministration are usually serious. Very few claims occur in the early years of life insurance policies, so a life insurance company may be potentially insolvent for a long time before its income becomes insufficient to pay its claims. Policy owners are generally not in a position to determine in advance whether a life insurance company will be able to pay claims.

A life insurance contract, unlike a product which is delivered on purchase, essentially involves the **acquisition of a promise**. The value of a set of promises to the purchaser depends partly on what is promised and partly on the likelihood that the promise will, when it falls due, be fulfilled. As far as the former is concerned, the purchaser who has been properly advised is in the best position to make the appropriate evaluation. But as far as the latter is concerned, it is generally very difficult for the purchaser to make an accurate assessment. The further into the future the promises are expected to fall due, the more difficult this task; yet the purchaser rarely gets a second chance. Because the costs to the individual of a mistaken assessment are very high, there is a strong case for government regulation to protect policyholders.

General insurance

This uncertainty - about whether the company will honour the promise - also applies to general insurance. General or 'non-life' insurance covers a wide range of commercial and domestic insurance types, eg. motor vehicle, fire, marine, householders and employer and public liability. Workers' compensation and compulsory third party motor vehicle insurance in some States are underwritten by State Governments rather than the private sector. Health insurance is, for social policy reasons, subject to special arrangements at the Commonwealth level. These latter arrangements, as such, are not subject to ISC supervision.

General insurance provides protection against the risk of monetary loss caused by unexpected accidents, catastrophes, and other misfortunes. Many of these events are highly unpredictable, complicating the nature and riskiness of the various types of general insurance liabilities (eg. earthquakes and bushfires). Contracts therefore tend to be short, typically for one year, at the end of which they are open to competition and are sometimes changed. General insurance providers reinsure their liabilities to ameliorate localised risks on a highly competitive international reinsurance market.

The overriding aim of supervision of general insurance is to ensure that insurers and reinsurers have the capacity and commitment to meet their obligations to pay the present and future claims of policyholders. There are no fundamental differences between the ISC's approach to the authorisation of insurers as opposed to reinsurers, or domestic insurers as opposed to international insurers. The ISC is also concerned to maintain the international reputation and standing of the Australian insurance market; the regulation of both insurers and reinsurers improves public confidence in the market and raises the quality of business being offered without (hopefully) easing the pressure for price restraint.

An insurance broker, that is, a person who acts on behalf of a consumer by providing objective professional advice about insurance products, must be registered under the *Insurance (Agents and Brokers) Act 1984*. Insurance brokers are supervised to ensure that the broker's impartiality is not influenced by incentives or volume based remuneration, and to ensure that the broker's obligation to its client is not compromised. Brokers are also required under the legislation to possess professional indemnity insurance covering breach of their professional duty as an insurance intermediary.

Superannuation

Superannuation is the process of setting aside income during a person's working life for the payment of benefits on retirement, resignation or death. Around 87 per cent of working Australians belong to superannuation funds as a result of the Government's policy of mandating superannuation saving to promote retirement incomes and national savings policy objectives. From a funding perspective, superannuation funds can be classified into two broad categories: 'defined benefit' and 'defined contribution'.

In a ‘defined contribution’ fund, the benefit paid by the fund on retirement or resignation represents the accumulation of contributions paid into the fund by the member and/or employer-sponsor and the investment earnings generated by those contributions over time. A critical determinant of the end benefit is the average rate of return obtained by the fund on the contributions, and this ‘investment risk’ is borne by the member. Investment risk is, however, moderated by SIS regulation which seeks to discourage incompetence, recklessness and lack of portfolio diversification. Employer (and member) contributions are allocated to the individual member accounts. While 80 per cent of all superannuation fund members now belong to ‘defined contribution’ funds, they presently account for only 48% of total superannuation assets .

By contrast, under a ‘defined benefit’ funding arrangement, the benefit payable on, say, retirement or resignation is specified in advance (usually as a multiple of salary at or near the time of the person’s exit). The fund is subject to regular actuarial valuations to determine the contribution required by the employer-sponsor(s) to meet the promised benefits. The employer sponsor bears the ‘investment risk’ and can reduce or even temporarily cease contributions to the fund if its assets are actuarially determined to be significantly in excess of its liabilities. Employer contributions are not allocated to specific accounts, but form part of a pool of assets used to pay members’ promised entitlements.

Three features which distinguish superannuation from other forms of investment in the managed funds sector are its tax preferred (and preservation) status, its mandatory nature under the Superannuation Guarantee Charge arrangements, and the existence of a compensation arrangement (at the Treasurer’s discretion). **These three characteristics supply a justification for regulation designed to ensure that superannuation assets are managed more prudently than managed funds generally.** Given the macroeconomic importance of superannuation for the Government’s national savings and retirement incomes policies, financial supervision reduces the likelihood of dissipation of superannuation assets, and the associated tax concessions, through dishonest, negligent or inefficient management. This is not to deny that community expectations may demand a comparable level of protection for other managed funds.

The element of Government compulsion involved in requiring the redistribution of income from a person’s working life to their retirement years arguably places a public duty on the Government to provide a degree of protection to superannuation entitlements. As mentioned later in the submission, the design of this framework of protection must carefully balance the need for market discipline against the catastrophic consequences for members of large-scale fraud or theft akin to the 1991 UK Maxwell scandal.

Professor David Llewellyn has remarked:

> The dilemma of safety nets is that they reduce the social costs of failures but at the cost of raising portfolio risk due to moral hazard. In an extreme case the cost of failure is reduced but the probability is increased. Insurance or protection without regulation removes the market discipline on both institutions and their customers.[3]

Other considerations underlying the supervisory framework for superannuation include: the long term nature of superannuation savings, which means that there can be little scope to 'bounce back' from a loss of entitlements late in a person's working life; and the relative lack of choice at present for many members as to which fund the employer will deposit contributions into, which means that the usual opportunities for ameliorating manager risk through diversification (ie membership of different funds) may not be as readily available (although it is noted that current Government policy to allow for greater choice of fund will help address this issue).

It should also be noted that the ISC's prudential supervision techniques with respect to superannuation have differed from those of other regulators. While other regulators have been primarily concerned with the solvency of an institution, the ISC has placed considerable stress on prudent business conduct, ie the soundness of the management and the systems of the organisation. In other words, while prudential supervision of deposit takers and insurers has focused more on solvency, prudential supervision of fund managers has focused more on business conduct. However, in recent times, there has been a common trend towards a greater reliance on internal risk management systems.

Very clearly, in the case of employer funds, financial soundness of the trustee entity itself is not a consideration. Where defined benefit funds are involved, the solvency of the fund is important, but that is dependent largely on the capacity of the employer to continue to fund the scheme at an appropriate level. In the case of retail superannuation managed by public offer funds, the ISC is concerned about the soundness of the approved trustee (including its management and systems), but only from the point of view of it having a commitment to the industry, the capacity to manage the monies being held in trust for members and to rectify any problems, and the expertise to comply with the fiduciary responsibilities and 'prudent person' requirements of a scheme operator.

In the final analysis, therefore, the ISC's task in respect of superannuation prudential supervision is not so much consideration of the capital adequacy of institutions, but more the minimum business practices required for the protection of the benefits of individual members of funds. It needs to be satisfied that the management and systems of the trustee have the capacity to correctly identify, allocate and protect the benefits due to each member so that the correct amount will be paid to them when the benefits fall due.

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[3] D. Llewellyn, *Rationale and Institutional Structure of Financial Regulation*, Commissioned Report for the ISC, Canberra, August 1996.

Is prudential supervision of the insurance and superannuation sectors really necessary?

Notwithstanding the considerations outlined above, it may still be argued by some that prudential supervision of the insurance and superannuation sectors is unnecessary. In essence, so the argument would run, insurance and superannuation arrangements involve an agreement between an individual investor and a financial institution to pay monies at regular intervals, on the one hand, in exchange for the promise to pay benefits in the event of certain contingencies, on the other. Given the contractual character of this relationship, there may be no rationale for the intervention or oversight of any third party, especially a public authority, and the principle of 'caveat emptor' should prevail.

Those putting this position would presumably favour a 'twin peaks' model comprising bank supervision for systemic stability, and sales conduct supervision for investor protection. It is the ISC's submission that this view is grossly misconceived. In particular, it overlooks three critical reasons for some degree of supervision in this sector to enhance the safety of member entitlements. These are market failure in the form of information deficiencies and asymmetries; community expectations of a 'safe haven' for 'mum and dad' savings; and the importance of certain public policy goals. These reasons have been cited in the above discussion, but they are important enough to bear repetition (and crystallisation) as follows.

Market failure in the form of information deficiencies and asymmetries

There are two key market failures that would make pure reliance on 'caveat emptor' unworkable in practice. These are, first, the information deficiencies and asymmetries caused by the complexity of the product and, second, the inability of retail customers to adequately assess the 'institutional risk' of the product provider. As alluded to above, products in the insurance and superannuation sector are complex in terms of their risk/return profile, fee and benefit structures, early exit penalties and taxation (and possibly social security) consequences. Government intervention is warranted to ensure that product features are transparent, thereby facilitating informed choices, effective price competition and the efficient allocation of resources (ill-informed markets do not generally produce optimal outcomes).

Second, the structure, size and complexity of the industry make it impossible for most consumers to adequately assess the 'institutional risk' of the product provider. Unlike consumer durable transactions (eg. buying a car, refrigerator or hi-fi system), a risk assessment of the product provider is a critical element in the decision to purchase an insurance or superannuation product. This is because the consumer does not walk out the door with the product, but is essentially buying a 'promise' and therefore needs assurance that the promise can and will be fulfilled in the future.

This point has been reinforced by the OECD Insurance Committee as follows:

> In a non-technical sense insurance is purchased in good faith. Consumers implicitly rely on the integrity of the insurers with which they deal. ... The mission of insurance is security. If the suppliers of the security are themselves perceived as insecure, the system could easily break down. Private insurance cannot flourish without public confidence that it will function as promised. Government's duty is to ensure that this confidence is neither misplaced nor undermined.[4]

It could be argued that this 'quality assurance' function could be provided by a third party other than the Government (eg. a private ratings agency). However, while private ratings are useful indicators, the jury is still out on the degree to which they can substitute for statutory supervision. A private entity may not have the authority to obtain the necessary information from the market players to make the relevant assessment, and there is an ever present danger of conflicts of interest. Also, pressure would develop for the private sector assessors themselves to be supervised. It is also true that for the life insurance and other contracts, which are not easily portable, there are different needs for customers buying and those who have bought. Those buying want frequent and good assessments of an organisation's security level. Those who have bought prefer a continued high level of security.

For the time being at least, there needs to be some public authority to oversee the financial soundness of those entities who are making insurance and superannuation 'promises'. Financial regulation is too important to be subjected to radical experimentation; the financial sector is not a university laboratory, and evolutionary change is more appropriate than radical change.

Similarly, in the superannuation area, it could be argued that prudential reviews could be undertaken by contracting out to the private sector. The ISC accepts that elements of the process should be contestable; for example a major accountancy firm has been engaged along with insolvency practitioners to help benchmark ISC review procedures. However, the overall function cannot be properly contracted to the private sector without compromising the quality and independence of supervision, and losing valuable institutional memory.

The ISC experience with external auditors, particularly in relation to superannuation funds, indicates that the level of skills in carrying out financial and compliance audits is very uneven. Prudential auditing is only in its early stages of development in the private sector, and only in a few large accounting practices. There is no textbook on how to supervise superannuation; rather the practical skills have to be acquired, and the techniques refined, through 'hands-on' experience. Putting aside the question of capacity, there would be serious conflicts of interest involved in using the private sector for prudential supervision, and even more so with respect to enforcement action. In particular, it would be difficult for private sector auditors to separate their

[4] Joint Working Group on Insurance Services of the CMIT and of the Insurance Committee, *Mutual Regulatory Recognition in Insurance: Opportunities and Issues*, OECD, June 1996.

regulatory responsibilities from their commercial interest in maintaining good relations with industry participants.

As an alternative, the regulator could recruit private sector accountants and actuaries for temporary (2 or 3 year) placements as inspectors. This can inject a healthy degree of cross-fertilisation into the organisation and ensure that financial supervisors in the public sector can encounter, at first hand, state of the art techniques and practices from the private sector. This approach has been adopted to some extent by the ISC, but is limited by standard public service employment conditions and pay rates.

Another option - in common use overseas - is to put in place a comprehensive investor compensation scheme, akin to the deposit insurance arrangements in, for example, the USA or UK. However, this does not obviate the need for prudential supervision (to prevent moral hazard), as the US Savings and Loan debacle clearly demonstrated.

Community Expectations

The intensity of supervision in the insurance and superannuation sectors in Australia will ultimately be determined by public expectations. Australians have traditionally demanded a relatively high degree of prudence and safety from large financial institutions holding themselves out as a haven for small investors (be they banks, insurance companies or superannuation funds). Over the years, just as the community has come to demand a higher level of health, education and environmental quality, it has also demanded an increasingly narrower range in the risk spectrum. Although the question as to whether this is desirable from an economic efficiency point of view is arguable, there can be little doubt that politicians and Parliaments have routinely acted to strengthen supervision in response to instances of destabilising failures in the insurance and superannuation sector. This phenomenon can be illustrated by three examples.

First, with regard to the general insurance sector, there were virtually no supervisory requirements for companies wishing to conduct insurance business in the Australian market prior to the introduction of the *Insurance Act 1973*. All that was necessary to gain access to the market was the lodgement of a deposit with the Treasurer. Due to the ease of entry into the market, some 484 insurers were registered to operate in the market prior to the introduction of the Act.

During the three year period to May 1973, 16 Australian general insurers collapsed causing major financial loss to policyholders and a widespread loss of confidence in the industry. The development of the Act was in response to these failures, and to avoid the possibility (or minimise the impact) of future policyholder losses through company failures.

The Act attempts to strike a balance between the public interest of maintaining a financially sound general insurance industry and the free enterprise rights of companies to carry on business in a largely deregulated environment. The approach taken by the Act involves financial supervision of companies in a manner which attempts to identify financially unsound companies and to provide for their reconstruction or orderly withdrawal from the market. The Act does not prescribe how companies should operate, but attempts to supervise them with a minimum of disturbance to companies' existing activities.

Second, the fraudulent removal of $65 million of statutory funds during the 1990 aborted sale of two life insurance companies, Occidental Life and Regal Life, served as a catalyst for improvements in the life insurance legislation. The Federal Parliament passed two Acts - the *Life Insurance Policy Holders' Protection Levies Act 1991* and the *Life Insurance Policy Holders' Protection Levies Collection Act 1991* - to form a safety net through a levy on member companies of the life insurance industry. However, in the event, the business of Occidental Life and Regal Life - under the scheme of court appointed judicial management initiated by the ISC - was transferred to Mercantile Mutual Life, such that policyholders generally received full (or very near full) value for their policies on transfer. Accordingly, it was not necessary to impose a levy under either of the two Acts, which were subsequently repealed.

Following the Occidental and Regal collapse, a major review of the *Life Insurance Act 1945* was undertaken, involving extensive consultation with industry, professional and consumer groups, which in due course led to the introduction of the new *Life Insurance Act 1995*. The new Act introduced more modern and sophisticated operational, solvency and capital adequacy requirements for life insurance companies, which will start to take effect from 31 December 1996.

Third, the combination of the 1991 Maxwell pension fund scandal in the UK, the compulsory nature of superannuation saving and the perceived laxity of pre-existing supervisory regulation, were the principal catalysts for the enactment of the *Superannuation Industry (Supervision) Act 1993*.

In short, it is clear that the Australian public has traditionally demanded, through their elected representatives in Parliament, some degree of Government prudential supervision of the insurance and superannuation sector, and it seems unlikely that they would tolerate any significant downgrading of the supervisory controls.

Public Policy Goals

As mentioned, superannuation has a key role to play in the Government's retirement incomes and national savings goals. It is critical to the effectiveness of this policy that the stock of superannuation assets are managed so as to achieve reasonable real rates of return on average, with an appropriate regard to risk. The absence of a framework to enhance the prudent management of superannuation assets would jeopardise the achievement of this policy goal.

Although the superannuation system is highly decentralised, and therefore losses due to imprudent management or fraud can be isolated, exaggerated media reporting of such losses could undermine public confidence in the system more generally, and the political legitimacy of compulsion in particular. Moreover, unless people have confidence in the security of the superannuation system, they are unlikely to respond as favourably to the existing tax incentives to encourage voluntary superannuation saving. It is our view therefore that the explicit policy objectives, the compulsory element and the structure of the superannuation system demand some degree of Government supervision.

It can be argued that the rationale for Government supervision for prudential reasons is less compelling in the case of small superannuation funds, defined as those with less than five members. Such funds, which represent a large proportion of the system in terms of number of funds (97%) but only a small proportion in terms of asset size (9%), are usually set up by small business proprietors, professionals and self-employed persons and generally contain non-arm's length members. Whilst greater reliance can be placed on the principle of 'caveat emptor' for this segment of the market, Government oversight is nonetheless required to ensure that the tax concessions afforded to such funds are used for genuine retirement income purposes and not merely for tax minimisation or to prop up an employer's business.

In summary, therefore, we would argue that some degree of prudential supervision in the insurance and superannuation sector is necessary to address market failures, to meet community expectations and to achieve public policy goals.

This conclusion can be reinforced by reference to overseas experience, which indicates that supervision of insurance companies (and pension funds) is the norm in OECD countries (except for New Zealand, which we argue in Chapter 3 is an atypical case). The United Kingdom and European countries that are members of the OECD comply with EC Directives on (life and non-life) insurance solvency margin supervision. In the context of EC insurance undertakings, the third generation directives which came into effect in July 1994 lay down rules which confine the list of acceptable assets to certain categories; specify the maximum amount of insurance liabilities certain assets may represent; and set out the guiding principles to be followed in the valuation of assets.

Other OECD countries such as the United States and Japan also directly secure the solvency of insurance companies. For example:

> The primary objectives of insurance regulation in the United States are to protect the interests of policyholders, assure insurance company solvency and assure that rates are not inadequate, excessive or unfairly discriminatory. Of these objectives, the one that is perhaps the most fundamental to protecting consumers is solvency regulation.[5]

[5] Organisation for Economic Cooperation and Development, *Insurance Solvency Supervision*, France, 1995, p 38

The broad consensus within OECD countries as to the need for some form of Government supervision of the insurance sector is reflected in the following statement:

> Notwithstanding these differences, ...[in approaches to supervision]...there are many areas where, in the opinion of all Member countries, insurance supervision must be active. It is generally accepted, for instance, that insurance companies intending to write direct insurance business must be licensed and afterwards subject to on-going supervision, that it must be possible to perform on-site inspections of insurance companies, and to transfer insurance portfolios to another insurance company, and finally that the supervisory authority has to take part in the winding up procedure of an insurance company.[6]

Professor David Llewellyn has also noted that the net costs of regulation may be less than commonly supposed. According to Llewellyn,

> The key benefits include welfare gains through correcting for market failures and imperfections; economies of scale through the supply of collective monitoring and supervisory services by a specialist regulator and the enhancement of consumer confidence through a raising of overall industry competence by virtue of regulatory administration of 'competency standards'. The benefits must, however, be offset by various costs including 'institutional costs' (the costs of running regulatory agencies); compliance costs (costs imposed on firms through regulation); and structural costs (costs imposed on the efficiency of the economy (excess burdens and stifling innovation).
>
> In balancing the costs and benefits, it should be noted that the economic costs can be minimised to the extent the regulation enhances overall competition and efficiency in the supervised industry. That is, competition is also likely to induce business to shift from the less to the more efficient suppliers which has the effect of increasing the overall efficiency of the industry; in this respect efficient firms have more to gain through regulation.[7]

Also, the 'management consultancy' role of the supervisory agency in promoting best practice standards, together with the correction of market flows, can in theory offset the institutional costs of supervision and compliance costs for industry.

Because the supply of regulatory and supervisory services is not itself a market activity (and therefore subject to market disciplines), accountability is a key issue in the design of regulatory frameworks. Care needs to be taken that the supervisor's mandate is clear, that the process of formulating regulatory reforms is open, transparent and consultative, and that regulators are responsive both to market players and Government.

Finally, Professor Llewellyn has noted that the benefits of regulation in breaking a 'gridlock' situation should not be overlooked. This refers to instances where industry

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[6] Organisation for Economic Co-Operation and Development, *Policy Issues in Insurance*, France, July 1993.
[7] Llewellyn, p 27.

participants knowingly operate in ways that are not in consumers' long term interests, but are not prepared to be the first to change for fear of losing competitive advantage and market share as a consequence of adopting higher standards. Regulation can break this gridlock by offering a guarantee that all participants will have to behave within certain standards.[8]

1.4 CONCEPTUAL APPROACHES TO FINANCIAL SUPERVISION

In reflecting on the fundamental principles and objectives underlying the structure of financial supervision, reference is sometimes made in the literature and debate to concepts and dichotomies such as prudential supervision versus product regulation, or institutional versus functional supervision, or generic supervision versus 'solo plus' supervision. These abstract categories can be useful in the theoretical debate as a means of simplifying the complex and dynamic reality that is the real world financial system. Nevertheless, they each have certain limitations in practice, and care should be taken in using them as the sole basis for reorganising regulatory structures. A brief explanation of several of the concepts and some of their limitations is set out below (note that, while a useful distinction can be made between the framework of **regulation** and its day-to-day application in the form of **supervision**, the two terms are used interchangeably in this submission).

Prudential supervision versus product regulation

Prudential supervision is a form of regulatory activity which has as its object the promotion of the viability and financial soundness of financial institutions and investment schemes. The tools traditionally associated with prudential supervision include market entry controls, capital and solvency standards, close scrutiny of the quality and strategy of management, requirements for risk management controls, external audits, regular reporting and disclosure, and strong surveillance and enforcement powers for the regulator.

This kind of regulatory activity is sometimes counterposed with product regulation, which focuses on the manner in which certain financial products are marketed, and primarily aims to address information asymmetries and bargaining inequalities between financial institutions and their less sophisticated customers, particularly at the retail level.

While this distinction can be a useful analytical tool in some circumstances, it does raise some significant practical questions. These include the scope of prudential supervision in Australia - that is, which financial institutions are in fact, and should be, prudentially supervised. The answer to this question has significant implications for possible regulatory structures.

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[8] Ibid, pp 23, 24.

For example, it is possible to approach the scope of prudential supervision from two different perspectives, each of which turns on the definition given to the term. First, one could adopt an academic and 'outcome' orientated definition and argue that prudential supervision is limited to the minimisation of 'systemic risk'. On the assumption that only deposit-taking institutions present this kind of risk - because of their pivotal role in the payments system, the risks associated with crises of depositor confidence, and the loss of liquidity as panic spreads and 'runs' occur - it could be argued that only deposit taking institutions should be prudentially supervised.

One of the difficulties of such a narrow definition is that non-deposit taking institutions can, at times, also pose systemic risks (albeit on a smaller scale), as explained in the previous section. However, the major difficulty (as also outlined above) is the strong case for enhancing the security of insurance and superannuation for reasons other than systemic stability (market failure, public policy and community expectations).

Another approach to the scope of prudential supervision is to start from a 'process orientated' definition of the term. That is, one could argue that prudential supervision is a form of regulatory activity that is distinguished by its use of specific tools and techniques to minimise imprudent business conduct and encourage effective risk management. From this starting point, it can be argued that a much broader range of financial institutions are 'prudentially supervised' given the broad similarities in many of the tools and techniques (as distinct from the stringency with which they are applied) between banks, NBFIs, insurance companies and superannuation funds.

It is sometimes argued that prudential tools and techniques are fundamentally different for institutions which provide capital guaranteed products and institutions that manage funds on a 'best endeavour' basis. While this may hold to a point, insofar as the former institutions have traditionally been subject to strict capital adequacy and solvency standards, whereas the latter are subject to rules of a more 'business conduct' character, it overlooks the fact that at an operational level, many of the techniques are the same. These operational similarities - which are not arbitrary, but reflect a common focus on prudence - include systems of reporting to the regulator, visits to the entity to inspect internal controls and risk management systems, and examination of balance sheets and investment strategies.

Institutional supervision versus functional supervision

A variation on this theme is institutional supervision (a compartmentalisation of regulatory activity by institutional type) versus functional supervision (the regulation of the business activity or products of these institutions). Supervision in Australia has traditionally been conducted on an institutional basis. This reflected an earlier financial system where there tended to be a close parallel between institutions and functions on the one hand, and products and risks on the other. It involved specialist supervisors administering requirements specific to a particular institutional group.

For a financial system characterised by less differentiated institutions and more multi-functional activity, and a substantial managed funds sector, questions arise about the appropriateness of a purely institutional approach. Further, consumer protection in the financial sector can be viewed as suiting functional or product based regulation more than institutionally based regulation. A hybrid institutional/functional approach to supervision might be better suited to a financial system characterised by financial conglomerates, managed funds and consumer protection, as well as by traditional banking and insurance institutional safety.

The limitations of the distinction can be illustrated by reference to the ISC. While the ISC adopts an 'institutional' approach to prudential supervision in respect of insurance companies, its prudential supervision of superannuation is both institutional and functional, but mainly the latter insofar as it prudentially supervises the activity of superannuation managers (legally structured as discrete trust-based entities) irrespective of the institution (eg. bank, building society, life company or funds manager) that is commercially standing behind the business. In addition, apart from some limited capital adequacy rules for trustees of public offer funds, supervision is directed more at the conduct of the superannuation business rather than the viability of the institution managing the assets per se.

The ISC's broader role both as a prudential and functional supervisor in respect of superannuation will be clearly illustrated under the Government's policy for the supervision of Retirement Savings Accounts. In particular, where these accounts are already subject to prudential protection in another regime, the ISC will confine its superannuation supervision to the matter of compliance with the retirement income standards on a functional or product basis.

Generic supervision versus 'Solo Plus' supervision

The ISC subscribes to the 'solo plus' model of prudential supervision, where 'solo' refers to specialised supervision 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.

Solo supervision means that the tools and techniques employed by the regulator are tailored to the particular type of institution or scheme, eg general insurer, life office, (superannuation) funds manager. Each type of institution or scheme belongs to an industry which is unique in its structure, practices and risks. While some inter-industry differences result from tax treatment and regulatory arrangements, others reflect deeply ingrained historical, cultural and commercial characteristics which combine to give the industry its own distinctive 'look' or 'flavour' **irrespective of the tax and regulatory treatment applying at the time**.

For example, the general insurance industry, among other things, has to deal with natural catastrophe and long-tail exposures, where the estimation of future liabilities is particularly problematic. On the other hand, it benefits from its access to the international reinsurance market. The life insurance industry has been substantially shaped by its traditional products (eg. death and disability cover, long-term capital guaranteed savings plans) and its traditional distribution methods (ie, networks of agents), even though new product types and distribution methods are now gaining favour.

The superannuation industry is fragmented by commercial forces into numerous and diverse segments. It also has certain features (eg. concessional taxation, preservation, compulsion) which flow from retirement income policy. In its current form, superannuation is a relatively new industry which lacks the tradition and coherence provided by the longstanding cultural characteristics of life insurance or commercial habits of general insurance.

The solo supervisory regimes for insurance and superannuation are not rigid or static, but have evolved over time in response to market developments and industry input. In particular, the new legislative frameworks for superannuation and life insurance - the *Superannuation Industry (Supervision)* (SIS) *Act 1993* and *Life Insurance Act 1995* - are a result of major redesigns based largely on contemporary industry characteristics and practices. The institutional structure of financial supervision has also evolved with the ISC, ASC, AFIC and the CFS all coming into existence within the past decade.

In recent years, the trend towards ‘blurring’ and ‘convergence’ in financial service markets has prompted financial regulators worldwide to turn their attention to the additional problems for effective supervision posed by the cross-border and cross-industry activities of international financial conglomerates.

These problems - which go to matters such as adequate information flows, group capital adequacy, appropriate group structures and coordination of crisis management - create a need for an additional layer of supervision at the group level to supplement (but not detract from) the traditional solo supervision at the entity level. This double layered framework is referred to as the ‘solo plus’ model of financial supervision.

Within Australia, a ‘solo plus’ model for the supervision of (domestic) financial conglomerates is being progressively developed by the Council of Financial Supervisors (see Chapter 2).

1.5 CONCLUSIONS

The following key conclusions can be drawn from the preceding discussion:

- the objectives of financial supervision are <u>stability</u> (achieved by prudential supervision), <u>efficiency</u> (encouraged by liberal and consistent rules), and <u>consumer protection</u> (promoted by institutional safety and regulation of business conduct);

- although systemic risk is primarily a banking matter, financial supervision of insurance and superannuation is still justified for three other reasons, viz, market failure (information gaps), public policy (eg. compulsory superannuation) and community expectations (of a safe haven for long-term savings); and

- conceptual approaches to the regulatory framework are useful only up to a point. The ISC sees a prudential supervision versus a consumer protection split as practical, and considers that the only sensible course for the former is 'solo plus' supervision (whether conducted by separate agencies or separate divisions of the same agency).