# CHAPTER TWO - FINANCIAL SYSTEM OVERVIEW

## 2.1 THE ISC'S ROLE IN AUSTRALIAN INSTITUTIONAL ARRANGEMENTS

The main supervisory institutions of Australia's financial system are the Reserve Bank of Australia (RBA); the Insurance and Superannuation Commission (ISC); the Australian Securities Commission (ASC); and the State Supervisory Authorities operating under the umbrella of Australian Financial Institutions Commission (AFIC). These agencies are together responsible for supervising over 95 per cent of total financial system assets. A breakdown of financial institutions and assets by supervisory organisations is at Appendix A.

**Profile of the ISC**

The ISC is the financial supervisor of the insurance and superannuation industries in Australia. Collectively these industries account for $327 billion or 31 per cent of total financial system assets (as at December 1995). This places the ISC second amongst the four main financial regulators, the RBA, AFIC, ASC and ISC, in terms of the asset size of the financial entities supervised (see Chart 1).

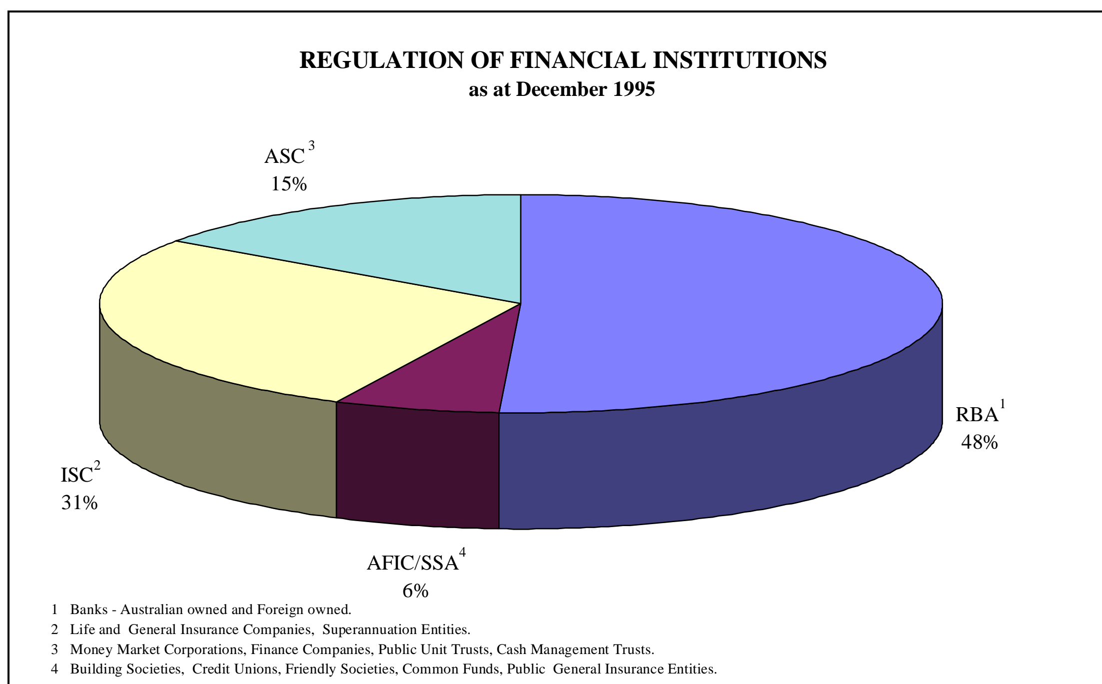
Specifically, the ISC supervises:

- 120,400 superannuation funds controlling $243.8 billion in assets (including $91.2 billion in life offices), as at March 1996;
- 51 life insurance companies, controlling $124 billion in assets (including superannuation assets of $91.2 billion) as at December 1995;
- 160 general insurance companies, controlling $35 billion in assets, as at June 1995; and
- 105 registered life insurance brokers and 1,003 registered general insurance brokers as at 30 June 1996.

The Insurance and Superannuation Commissioner is an independent statutory office-holder appointed by the Treasurer under the *Insurance and Superannuation Commissioner Act 1987*. Staff of the ISC, including the Australian Government Actuary, are employed under the *Public Service Act 1922*.

As at 30 June 1996, there were 508 staff at the ISC; 309 were located at the head office in Canberra with the balance spread across the ISC's regional offices in all State capital cities, except Hobart.

**Chart 1**




The ISC's charter is to promote:

- public confidence in the insurance and superannuation industries by protecting the interests of insurance policyholders and superannuation fund members;

- saving for retirement and capital formation through insurance and superannuation; and

- fair and open dealing between the insurance and superannuation industries and their customers.

The ISC derives its supervisory powers from a number of Acts of Parliament that aim, in various ways, to promote the traditional objectives of financial supervision viz., stability, efficiency and consumer protection. Classified in terms of their primary objectives (as some ISC administered legislation aims to achieve a number of interrelated objectives), these Acts of Parliament are as follows[1]:

- to promote **stability** or **soundness** in the insurance and superannuation sectors, the ISC administers the

  - *Insurance Act 1973;*

  - *Superannuation Industry (Supervision ) Act 1993;*

  - *Life Insurance Act 1995;*

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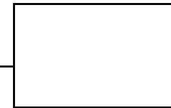
[1] Further details have been provided separately to the Financial System Inquiry secretariat.



- to promote **efficiency** in the insurance and superannuation sectors and, in particular, to avoid market power falling into the wrong hands, the ISC administers the

  - *Insurance Acquisitions and Takeovers Act 1991*[2]*;* and

- to promote **consumer protection** or **fair trading**, the ISC administers the

  - *Insurance (Agents and Brokers) Act 1984;*

  - *Insurance Contracts Act 1984.*

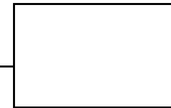
The ISC also promotes fair trading through particular provisions of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) (especially Part 18), and through non-statutory guidelines in relation to product disclosure and Codes of Practice for the general and life insurance industries. The Codes cover sales advice and practices, agent and broker training, disclosure of capacity, claims handling and complaints resolution. The ISC also monitors the operation of industry based complaints handling schemes in the general and life insurance industries, and provides policy advice to the Government and administrative support and funding for the statutory based Superannuation Complaints Tribunal.

A summary of the main features of the legislation administered by the ISC and the life and general insurance Codes of Practice, including some historical background, has been forwarded separately to the Financial System Inquiry Secretariat.

The ISC is funded through direct outlays from Consolidated Revenue. However, these are recouped by the Commonwealth through annual levies on regulated entities in the life, general and superannuation industries. As at 1 July 1996, the life and general insurance levies were $70 000 and $16 300 respectively. The superannuation levy is $200 per $500 000 in superannuation assets or part thereof, up to a maximum of $14 000.

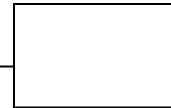
Two features of the ISC are worth noting. First, the ISC is essentially already a mini 'mega-supervisor' with three divisions, namely life insurance, general insurance and superannuation, and therefore has experience with inter-divisional harmonisation and coordination. Second, the ISC in its present form is a relatively young organisation, comprising supervisory groups with different histories and degrees of experience. For example, the life and general insurance groups (whose existence predates the ISC) have long histories and deep reservoirs of supervisory skills honed over decades, whereas prudential supervision of superannuation only commenced in 1993 and, the ISC is still learning the practical art of how to best conduct supervision of this industry.

[2] It should be noted that the *Insurance Acquisitions and Takeovers Act 1991* can be regarded as having an essentially prudential role insofar as it prescribes a screening process designed to ensure unsuitable persons are not placed in a position of influence over Australian insurance companies.



It is difficult to generalise about the ISC's approach to supervision because there are some important inter-divisional differences, based on the respective structures, balance sheet characteristics and risk profiles of the life insurance, general insurance and superannuation industries. However, some important common features are as follows:

- Market oriented approach
  - the ISC seeks to maximise the scope for competition and innovation in insurance and superannuation and aims to make the markets themselves work better, rather than to substitute Government decisions for market ones. Generally speaking, the ISC does not interfere in the design of products, or their pricing/fee structures ('member protection' of small superannuation amounts is an exception). The ISC consults closely with industry to assess the cost-effectiveness of regulatory proposals.
- Accountability of private sector management
  - consistent with the market oriented approach, the supervisory frameworks administered by the ISC each place primary responsibility for the viability and prudent operation of supervised entities with the relevant company directors or trustees. This includes inter alia responsibility for adequate internal risk management policies and practices.
- Self assessment
  - Insurance companies and superannuation entities are subject to requirements for regular reporting to the ISC. Insurance companies report on their financial position on a quarterly basis and superannuation entities lodge annual returns certifying compliance with the prudential and retirement income standards. The ISC relies on the management of the entity (company directors or trustees) to prepare those reports, and on the professional judgement of external auditors to certify their accuracy. The ISC's self assessment approach to supervision is also evident in the 'whistle-blower' obligations of auditors and actuaries. Actuaries also play a major role in life insurance supervision and reporting to the ISC.
- Transparency
  - The ISC attaches great importance to information disclosure requirements as a regulatory measure. In addition to financial reporting, there are extensive disclosure rules governing the relationship between fund members and superannuation entities, and between insurance consumers and companies. Information disclosure is the most benign form of regulation, because it enhances the natural workings of the market, reinforces the accountability of senior management, and is less intrusive or



restrictive than other measures such as entity licensing, price fixing, product vetting or investment targeting.

- Prudential judgements

  - Financial supervision is an art, not a science, and the ISC must necessarily make value judgements about the capacity of a supervised entity to maintain the security of fund member or policyholder interests into the future. The ISC's role in this regard supplements the responsibilities that the management of a superannuation entity or insurance company have for maintaining effective internal controls and risk management systems. The capacity to make sound prudential judgements and arrange appropriate remedial action where necessary are critical core competencies for the ISC, and are specialised skills that are most often patiently acquired by ISC staff through actual 'hands-on' experience.

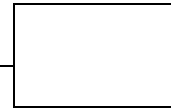
- Enforcement strategies

  - The ISC has extensive powers at its disposal and has to determine, on a case by case basis, which are the most appropriate ones to exercise in any given situation. As a general rule, the ISC attaches the highest priority in its enforcement activities to preserving member entitlements or policyholder interests in the event of actual or likely wrongdoing. This means in the superannuation regime, for example, that the most important enforcement mechanisms in many instances are the removal of fund trustees, the freezing of assets or the winding up of funds.

  - While the ISC will not avoid prosecution action against wrongdoers if circumstances warrant this, it is critical to the safety of member entitlements that dubious persons are not left in control of funds. Gathering evidence to mount a successful prosecution in conjunction with the Director of Public Prosecutions takes time; earlier intervention is usually required to safeguard member benefits. Legal proceedings are also costly and have uncertain outcomes.

  - Also, given the relative newness of the superannuation supervisory regime, the ISC has preferred a co-operative approach of assisting honest and well-meaning trustees in achieving compliance, rather than punishing them for minor breaches of the rules (note that trustees can only be prosecuted for an offence where their conduct is wilful and reckless).

  - Apart from giving trustees access to expert ISC review staff on a case specific basis, the ISC has had a major education and training role since 1994 in informing trustees about duties and responsibilities under SIS. This cooperative approach also reflects the fact that somewhere in the order of 10,000 new trustees assumed duties as member representative



trustees of employer sponsored funds from 1 July 1995, many on an unpaid basis.

In discharging its supervisory functions, the ISC has regard to various obstacles which can inhibit effective and efficient regulation in the finance sector. These include:

- Heavy Handedness - the risk that regulatory responses to market problems will generate more costs than benefits, eg. because they are intrusive, bureaucratic or counterproductive in application.

- Moral Hazard - which refers to the incentive financial institutions have to take excessive risks if their losses are covered by a guarantee from a government or another third party. The market needs to understand that superannuation entitlements and policyholder interests are not guaranteed or underwritten under ISC administered legislation.

- Regulatory Capture - unwary regulators may over time become ‘captive’ to the narrow commercial interests of the industries they regulate. This can have negative consequences including overuse or partiality of discretionary powers, not enforcing legislation in a timely and appropriate way, and failing to exercise independence and judgement in consultative processes.

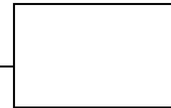
- Community Expectations Gap - community expectations about the adequacy, accessibility and security of insurance and superannuation can be unrealistically high. Such expectations, if disappointed, can lead to a loss of consumer confidence and a weakening of supervisory authority, despite the existence of a sound and well developed supervisory framework.

The ISC’s practical approach to supervision of the insurance and superannuation sectors may be summarised as follows.

*Insurance*

The ISC’s supervision of the insurance industry is characterised by licensing (entry and ownership) restrictions and procedures for close monitoring of the solvency or financial soundness of individual insurance companies. The ISC monitors the condition of insurance companies through regular financial reporting, company lodgement of audited accounts and frequent company visits and inspections by ISC officers. The insurance distribution system is also covered by ISC supervision through licensing and reporting requirements on insurance brokers, and rules governing the practices of agents, which aim to encourage competent and ethical advice. Regular discussions with companies and professional associations keep the regulator in touch with market developments and ensure that regulation is practitioner based.

*Superannuation*



The size and structure of the superannuation industry (which is large and diverse) necessarily restricts the ISC's ability to maintain close and frequent contact with every individual fund (although the Commission keeps in close contact with certain parts of the industry, eg. the public offer segment). Accordingly, the supervisory framework for superannuation is based on the principle that trustees are primarily responsible for the viability and prudent operation of funds and for compliance with standards. Fund members, auditors and actuaries also have important watchdog roles in monitoring the operation and performance of funds and notifying the ISC of significant irregularities.

The SIS regime contains various 'checks and balances' on trustees to enhance the prudent management of fund assets and includes a system of annual reporting by trustees and a national program of ISC fund reviews, which involve assessing the fund's capacity to maintain the security of member entitlements into the future.

The ISC also has a revenue protection as well as prudential supervision role for superannuation; various standards (including the sole purpose test, preservation, vesting and restrictions on acquiring assets from or giving financial assistance to members) aim to ensure that tax assisted superannuation is used for genuine retirement income purposes.

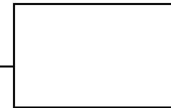
*Key Points*

Three key points should be highlighted in respect of the supervisory arrangements administered by the ISC. First, the Government does not guarantee the security or performance of superannuation fund member or insurance policyholder entitlements. The ISC's regimes have been structured so that the autonomy and transparency of an institution's management with respect to commercial decisions are maximised whilst ensuring that management is made accountable for breaches of important prudential obligations. This means that failures and losses can occur. The relevant ISC administered legislation makes provision for the orderly exit of an insolvent insurance company and the dissolution of a failed superannuation fund.

Second, the ISC and its antecedents have, on the whole, a very sound track record in respect of its supervisory responsibilities.

The general insurance industry has, since the introduction of prudential supervision of the industry in 1973, been marked by stability and minimal losses to policyholders through company collapses. With a handful of exceptions (two involving outright fraud - which is the province of State criminal law), the prudential supervision of general insurance companies has provided security to policyholders in an industry characterised by price competition, considerable turnover of participants, poor underwriting profit margins and high reserve requirements.

The life insurance industry has, since the introduction of prudential supervision in 1945, also been marked by stability. The only company failures (Occidental Life and Regal Life) have involved fraud, and in the final wash-up only a small proportion of policyholders suffered minimal losses. The prudential supervision of life insurance



companies has provided security to policyholders in an industry characterised by strong competition for market share and a heavy reliance on expensive distribution methods.

The superannuation industry, particularly in its current form, is much younger than either the general or life insurance industries, and effective supervisory arrangements have been put in place only quite recently, in 1993. Under the former *Occupational Superannuation Standards Act 1987*, the ISC's regulatory powers were limited to removing a non-complying fund's tax concessions, a penalty which hurts fund members rather than trustees who were responsible for the breach. Nonetheless, there have been no large scale or widespread losses due to fraud or mismanagement in the superannuation system: over the past eight or so years, there is evidence of members losing entitlements in only a handful of cases, with losses amounting to around $17 million in total, compared with total industry assets in the order of $244 billion.

Finally it should be noted that both the life insurance and superannuation supervisory regimes are modern and relevant pieces of legislation (being enacted in 1995 and 1993 respectively with substantial industry input).

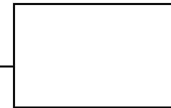
## 2.2 COSTS AND BENEFITS OF FINANCIAL DEREGULATION

Following deregulation in the early 1980s, the financial system grew rapidly, both in size and complexity. The banking sector expanded with the introduction of foreign banks and the conversion of large building societies; and more recently, the funds management industry, aided by tax and other policy measures favouring superannuation, has taken off. The period following deregulation has been characterised by some initial excesses in the form of overly ambitious growth and diversification, by gradual increases in effective (ie. price) competition in the retail sector, and by significant product development, differentiation and innovation. As in other countries, traditional boundaries between financial institutions and products have begun to blur.

*Benefits of deregulation*

Some sectors, namely banking and managed funds have flourished, while others such as pastoral finance companies have atrophied. The broadest manifestation of all the changes in the retail sector is product innovation and (to a lesser extent) increased effective competition. In retail commercial banking, increased competition and reduced margins have been much slower to arrive than many expected. However, the financial system has undoubtedly been opened up in a number of major ways:

- collusive practices outlawed;
- the entry of additional 'traditional' players (eg. foreign banks) and domestic firms expanding off-shore;



- funds moving freely across countries so that interest and exchange rates are internationally determined and more volatile;

- institutions able to set their own prices and control their own portfolios subject to broad prudential requirements;

- the previous segmentation of the market into specialised groups (banks in banking, life offices in contractual saving) replaced with financial conglomerates, with subsidiaries crossing industries and borders;

- emergence of new suppliers of traditional products (eg. regional retail banks and mortgage originators for housing loans);

- an end to the ‘rationing’ of cross-subsidised cheap home loans;

- the development of new products, offered by both established and new players (eg. home equity loans, securitised loans, complex derivatives);

- new delivery systems (eg. phone banking, ATMs, EFTPOS and stored value cards) with a bigger role for non-financial entities, such as Australia Post and telecommunications companies; and

- the growth of funds management relative to intermediation (funds managers now control 39 per cent of financial system assets compared with 26 per cent in 1980), and an increasing share of household financial saving flowing into the managed funds sector (including life insurance and superannuation) each year.

While creating both opportunities and challenges for established suppliers of financial services, these changes have also been generally beneficial for the community. Financial deregulation has increased the accessibility, range and sophistication of financial products, allowing services to be tailored more closely to the needs of customers and, more recently, promoting competition in pricing (not just brand image and market share).

*Costs of deregulation*

Of course there were adjustment problems associated with deregulation. Australia has historically relied upon foreign capital for its economic development and Australians have taken advantage of deregulation to borrow extensively overseas and to diversify internationally their investment portfolios.

**TABLE 2.1[3] Savings, Investment and the Flow of Funds in Australia, 1979/80-1988/89 ($billion)**

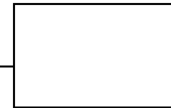
[3] M.K. Lewis & R.H. Wallace, *The Australian Financial System*, Longman Cheshire, Melbourne, 1993, p.15.

| | Gross saving | Gross investment | Net Lending Net Borrowing |
|---|---|---|---|
| Corporate Trading Enterprises | 123.4 | 166.5 | -43.1 |
| Governments | 70.7 | 139.4 | -68.7 |
| Financial Institutions | 7.6 | 25.2 | -17.6 |
| Households | 219.5 | 197.4 | +22.1 |
| Overseas | | | +96.8 |
| Unidentified | | | +10.5 |

Table 2.1 shows the sectoral imbalances over the 1980s and the substantial share of funds that has come from overseas to finance corporate and government borrowings, turning Australia into one of the most indebted countries in the world. Severe financial distress followed deregulation in the years 1989 to 1991. Victoria's largest group of building societies - the Farrow group - collapsed, and its State bank was forced into a sale to the Commonwealth Bank due to the magnitude of the loan losses of its subsidiary, the Tricontinental Merchant Bank. Other institutions running into serious trouble included Estate Mortgage, State Bank of South Australia, and a number of unlisted property trusts.

Under regulation, banks were cautious lenders: under deregulation, many banks were not, as lending standards slipped, notwithstanding the Reserve Bank's new prudential rules. Despite its fiduciary responsibilities and special position of trust, the financial industry generally performed much like any other industry undergoing deregulation with competitive margin cutting (at least in the corporate market), reduced profitability and mounting bad debts.

With the benefit of hindsight, it seems clear that the authorities underestimated the extent to which the overall risk characteristics of the financial system would increase due to increased competition for market share among institutions previously cosseted by regulatory constraints. There was insufficient appreciation of the extent to which increased competition and threats to profitability would encourage diversification into new business activities without knowledge of the risks involved. Supervisors were also required to deal with the added complexities of assessing risk exposures associated with new complex financial instruments, and handling fast moving situations where substantial portfolio adjustments, with potential implications for stability, could occur overnight.



## Deregulation and supervision

As well as impacting on both suppliers and consumers, financial system change requires adaptation in regulation and supervision. The experiences of the post-deregulatory era led to intense scrutiny of supervisors, prudential regulatory requirements, and supervisory arrangements.

Deregulation increased the overall risk characteristics of the financial system, which led to some instability in the system, and generated pressure for tighter rules and regulations and a more interventionist approach by governments and supervisors. As a result, there was a significant tightening in prudential supervision across most of the financial system and a rationalisation in the supervisory framework. In the banking area, this tightening took the form of prudential guidelines covering banks' involvement in funds management and securitisation, guidelines for derivatives business, and the development of an RBA capacity to conduct on-site reviews of banks' operational and risk management systems. In the superannuation and life insurance industries, new legislation to modernise and strengthen the relevant prudential frameworks was enacted in 1993 and 1995 respectively.

Much new regulation has been introduced. National coordination was sought for State-based supervisors (the SSAs) and for industry funded liquidity support mechanisms for non-bank financial institutions, through a new national body (AFIC). The ASC was created with a mandate to clean up accounting standards and arrest a decline in corporate morality. As indicated in the description of the current supervisory framework, three (ISC, ASC and AFIC) of the four principal supervisory organisations involved in prudential supervision (and the Council of Financial Supervisors itself) have been established in a new form since 1987.

## Deregulation in the insurance and superannuation sectors

While there have never been comprehensive investment controls in the insurance and superannuation sector, substantial tax incentives were provided to funds and life offices prior to 1984-1985 under the '30/20 rule'. Under this rule, tax concessions were provided to life offices and superannuation funds under the *Income Tax Assessment Act 1936* if 30 per cent of the fund's assets were invested in public securities, of which at least 20 per cent were invested in Commonwealth securities.

Since the removal of the '30/20 rule' in 1984-85, following recommendations of the Campbell Report, and consistent with the contemporary spirit of financial deregulation, there have been no direct investment controls on insurance companies and superannuation funds. The only exception to this are those controls imposed on such entities for prudential reasons, eg. rules in respect of related company assets and statutory fund gearings for general insurers and life offices respectively. Also, funds regulated under the SIS Act are required to formulate and give effect to an investment strategy which takes into account various factors such as risk, return, the benefits of diversification, the need for liquidity and the fund's current and prospective liability.

This generally results in the adoption of diversified 'balanced' portfolios (eg. with a mix of bond, stock, property and overseas investments) by large superannuation funds.

In addition, superannuation funds are subject to some investment limitations for prudential or revenue protection purposes, such as restrictions on borrowing, lending or giving financial assistance to members or making loans to or investments in an employer-sponsor of a superannuation fund ('in-house assets').

From time to time, calls are made for the imposition of direct investment controls on superannuation funds to reduce the flow of investment overseas, or increase the availability of capital for venture and development capital and infrastructure projects. The superannuation industry has vigorously resisted proposals of this kind on the grounds that it would constrain the ability of trustees and fund managers to freely adjust and diversify their portfolio in response to market developments and changing economic conditions, and ultimately reduce investment returns and end benefits for members. The Government announced in its pre-election superannuation policy statement that it 'will not direct superannuation funds on where to invest and what to invest in'.[4]

## 2.3 FINANCIAL MARKET DEVELOPMENTS

Market developments in the insurance and superannuation industries over the last decade or so either have had, or continue to have, substantial regulatory implications (some of which are detailed in chapters 3 to 5). Chapter 6 refers to contemporary market pressures in the areas of electronic commerce and mergers amongst financial majors. Before itemising the market developments in the insurance and superannuation sectors, it would be useful to present a brief snapshot of the life insurance, general insurance and superannuation sectors.

### Superannuation

The overwhelming majority of superannuation funds are small in size with less than $250,000 in assets. The largest 1,100 funds - roughly all those with assets over $10 million or large membership - cover 85 per cent of the industry by assets, and about 97 per cent of members. Only 15 per cent of superannuation assets as at March 1996 were invested overseas.

The superannuation industry can be regarded as consisting of five major functional segments: corporate, industry, public sector, retail and excluded (ie less than 5 members). Retail funds hold 23 per cent ($57.4 billion), public sector 26 per cent ($62.9 billion), corporate funds 20 per cent ($48.9 billion), excluded funds 9 per cent ($22.5 billion) and industry funds 6 per cent ($13.7 billion) of all superannuation assets regulated under SIS. The remaining 16 per cent ($38.4 billion) of superannuation assets represent the balance of life office statutory funds, which comprise annuity

[4] D. Connolly, *Super For All - Security and Flexibility in Retirement*, 1996, p.18.

products, fund reserves and unallocated profits of life office statutory funds ( a significant part of this residual could be regarded as 'retail').

While around 6 million Australians are covered by superannuation, there are 15 million separate superannuation accounts in Australian superannuation funds. This suggests that each member has on average around 2.5 accounts. In contrast, in 1992-93 each member had 1.9 superannuation accounts. This increase is most likely due to the Superannuation Guarantee arrangements, growth in the number of part time workers, and workforce mobility (especially for private sector workers).

**Life insurance**

The Australian life insurance industry has been dominated by large mutual life insurance companies selling products through tied agency networks. At December 1995, the three largest life insurance groups accounted for 52 per cent of the industry's Australian assets. Two major life offices (National Mutual and Colonial Mutual) are in the process of demutualisation and listing, and a third (AMP) is considering its options in this regard.

The life industry is relatively concentrated with the top 10 groups of companies accounting for about 80 per cent of industry assets (but not as concentrated as retail banking). The past decade has seen banking groups emerge as an important segment of the industry. By forming life insurance company subsidiaries mainly selling single premium products (for example superannuation rollovers), banks have gained 15 per cent of life insurance market assets and 24 per cent of annual premium income.

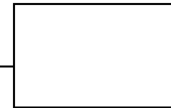
Total assets of the life insurance industry as at December 1995 were $124 billion, with annual premium revenue at $20.4 billion. Superannuation assets managed by life offices totalled $91.2 billion. Some 44 per cent of all superannuation assets are provided under life insurance policies. (Refer to Appendix A)

**General insurance**

The Australian general insurance industry accounts for around 2 per cent of the much larger integrated international market. Australian general insurers are also active in overseas insurance and reinsurance markets.

The general insurance industry controls $55 billion in assets, including private and public sector assets, (as at December 1995); this has increased from $29 billion in 1988.

The number of general insurers as at December 1995 totalled 160. There has been a gradual increase in the number of general insurance companies since 1992. The longer term trend, which can be traced back to the 1970s, is however toward fewer general insurers. Low profitability, poor underwriting performance, and low returns on capital have encouraged mergers and rationalisations as companies have sought to cut costs and generate acceptable returns for shareholders. In recent years, mergers and



rationalisations have been offset by a continuing flow of privatisations of Government owned insurers and new authorisations for niche operation insurers.

**Key market developments**

Some of the key market developments in the insurance and superannuation industries post-deregulation are as follows:

- 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 financial assets going more into managed funds (including life insurance and superannuation), and less into bank and NBFI deposits

- An increasing trend in life insurance towards the provision of short term capital guaranteed or investment linked products (as distinct from the traditional long term capital guaranteed savings or risk products);

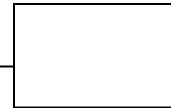
  - These short term life products, which can be written directly in life office statutory funds under the *Life Insurance Act 1995*, are functionally similar in some respects to bank deposits (capital guaranteed policies) or unit trust products (market linked policies), and have generated some calls for greater consistency in both prudential and sales conduct standards. However, the role of taxation arbitrage and distribution cost differentials should not be underestimated.

- Changing patterns in the distribution of banking and insurance products;

  - Following the excesses of the late 1980s, 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 either cutting their high cost distribution networks (of banks branches and life agents), or else driving them harder by cross-selling.

  - Historically, life insurance companies distributed their products through ‘tied’ agents; now, around half the new business written by life companies is distributed through multi-agents, ASC licensed dealers and their representatives, and bank branches (operating as distribution channels for the bank’s subsidiary life office). Technological change has the potential to further transform distribution systems (particularly by encouraging direct marketing of simpler products through interactive software, telephone, and the use of computer technology).

  - Traditionally, insurance advisers were remunerated through commissions on products sold, including volume bonuses. Increasingly (but slowly and from a very low base), financial advice is being provided on a fee for



service basis which, when combined with enhanced disclosure, facilitates greater independence and transparency of the advice and sales process.

- Notwithstanding a growing consumer preference for truly independent advice, it can be hard to find in practice. Of the top 10 life broking and investment advisory firms, which collectively account for well over half of the so called 'independent' retail investment advice market, probably only two are free of ownership and control links with investment product providers; the others are owned/controlled by major banking, insurance or funds management groups.

• Consumer demand for specialised dispute resolution;

- The complexity of financial products, the costs and delays associated with the judicial system and heightened consumer awareness more generally, have all helped create a substantial push for low-cost, alternative dispute resolution mechanisms in the finance sector. Industry based schemes have proliferated and those schemes, together with the statutory based Superannuation Complaints Tribunal, now provide consumers of most retail savings products with convenient, informal, speedy and low cost access to justice.

• Globalisation, convergence and the emergence of financial conglomerates;

- Deregulation and technology have globalised wholesale financial markets, but in doing so have also increased settlement and systemic risk which has become of considerable concern to the G7 Ministers. At the same time, the international associations of financial regulators, the Basle Committee (banking), IOSCO (securities) and now IAIS (insurance) have arisen or increased in importance, and have stepped up their cooperative initiatives.

- Consistent with overseas trends, financial conglomerates are becoming an increasingly important feature of the Australian financial scene. For large specialised financial institutions such as banks and life offices, the formation of a diversified financial group enables the provision of a broader range of products under a common logo, and the scope to economise on back office and distribution infrastructure.