Executive summary

The financial services industry is of fundamental importance to Australia's economic performance. It is responsible for the mobilisation and intermediation of the nation's savings and investments, and it is in the best interests of the country that it remains efficient and stable.

The 1981 Campbell Committee of Inquiry resulted in a major liberalisation of the regulatory system. In essence, regulations designed to achieve the Government's monetary policy objectives and to advantage particular sectors of the economy were dismantled in favour of a reliance on market forces. The result has been a substantial benefit to consumers in terms of greater product diversity, innovation and supplier responsiveness.

However, in the past 10 years, there has also been a rapid growth in both prudential and consumer protection regulation. This has imposed considerable compliance costs on the financial services industry and is leading to regulatory inconsistencies and concerns that competitive neutrality is not being achieved. Another impact of this re-regulation has been the requirement for certain segments of the industry, particularly life insurance, to hold increased amounts of capital that seem incongruent with the level of commercial risk. In other areas of financial services, such as banking, the changes in prudential regulation have been largely positive.

The operation of the regulatory system needs to be reconsidered in light of substantial changes that are occurring within the industry, driven by: industry convergence, technology, globalisation and international competition. These factors are tending to blur previously sharp distinctions between institutions, re-define markets and promote the entry of new (and potentially unregulated) players into financial markets.

Colonial believes the Inquiry is timely and provides an appropriate opportunity for reviewing developments in the financial system since the Campbell Inquiry. Colonial fully supports the objectives of removing regulatory duplication and inefficiency in the financial system and substantially reducing the cost of compliance. A simpler and more efficient regulatory system would substantially benefit consumers, who ultimately bear the costs of regulation.

Main issues

Colonial's submission addresses three main issues:

- the basis for financial system regulation, the appropriate form of regulatory supervision and the intensity of regulation;
- the approach that should be taken to competition in the financial services industry and to mergers and acquisitions; and
- other issues such as those relating to the introduction of new technology, the operation of the payments system and depositor protection.

Colonial recommendations

The financial system and its accompanying regulatory framework is critical to Australia's wealth accumulation, as well as being the medium through which economic transactions occur. As such, while Colonial recommends some areas of substantial change, any changes must be implemented in a manner that ensures the fundamental stability of the financial system is maintained and reinforces Australia's international competitiveness.

We recognise that in those areas where substantial change is recommended, while the outcome should be a much simpler and more efficient system of regulation, to achieve certain changes will be both time consuming and complex.

The prudential and consumer regulatory frameworks must operate within broader macro-economic and other policy objectives of the Government, including objectives to increase the level of national savings, protect the national interest, and ensure Australia remains internationally competitive.

In terms of micro-economic issues, the regulatory system should:

- promote local competition, to the benefit of the consumer;
- ensure competitive neutrality, among financial products and the suppliers of such products;
- promote efficient and stable capital markets;
- deliver low cost compliance;
- provide flexibility, to allow financial institutions to meet the needs of consumers and to innovate; and
- meet consumer protection and financial stability objectives.

Basis of regulation, regulatory supervision and intensity of regulation

Our concern is with the structure and basis of regulation rather than the performance of Australian regulators, who we believe are competently meeting their statutory responsibilities.

Colonial has considered the option of moving from the present institutional-based system of regulation to a functional approach. We have concluded that such an approach is not practical for prudential regulation, although it can and should be applied to consumer protection regulation. To streamline the current regulatory system, we consider that a ‘Twin Peaks’ approach should be adopted with responsibility for prudential regulation being allocated to a single supervisor and responsibility for consumer protection to another supervisor.

To avoid confusion in the regulation of consumer protection in respect of financial services, the ACCC's mandate should be directed towards overseeing competition policy, while a separate body, possibly the ASC, should be responsible for consumer protection.

Consumer protection is an area where the intensity of regulation is excessive, duplicative and inefficient. Colonial proposes an approach which simplifies disclosure and clearly relates disclosure requirements to the presence or otherwise of prudential regulation and the nature of the promise implicit within a product.

Similarly, Colonial believes the prudential regulatory framework is unnecessarily inconsistent, does not take sufficient account of internal risk management techniques and controls in determining capital requirements and, in certain respects, increases the cost of capital in the Australian financial system. Colonial proposes, therefore, a number of changes to the prudential regulatory framework. Such changes should be consistent with international developments as well as enhancing Australia's competitive position in international markets.

Competition policy

The financial services industry should be treated no differently to other industries, in terms of being subject to scrutiny by the ACCC in order to ensure local competition. It should remain a matter for the ACCC to examine proposed mergers and acquisitions in terms of its existing processes and criteria. Colonial sees no need to change the ACCC’s mandate or guidelines. For reasons of financial system stability and the maintenance of ownership diversity, Colonial believes the provisions of the Banks (Shareholdings) Act should continue to apply.

We also believe that it is in Australia's interests that the ownership of financial institutions operating in Australia remain largely Australian owned, given the significance of the industry to Australia’s financial stability and long-term economic well being.

Australia should not unilaterally allow unsupervised foreign ownership, while many of its trading partners continue to maintain significant restrictions on foreign entrants.

This means achieving an appropriate balance between encouraging new foreign entrants to enhance competition and protecting the national interest.

Other issues

Colonial's submission also considers a range of other issues. Three are singled out for mention. First, regulatory authorities should closely monitor and seek to prevent unsupervised institutions from using technology to bypass the existing regulatory system. Second, all participants in the payments system should be subject to the same prudential regulation. Third, the current depositor protection arrangements and restrictions on the range of institutions that can issue deposits should be maintained based on the need for confidence and stability in the banking system.

Recommendations

Prudential Regulation

Recommendation 1	*Colonial recommends the creation of a 'Twin Peak' regulatory approach involving the creation of two super-regulators—one to maintain financial stability through prudential regulation and the other to protect consumers.*
Recommendation 2	*Colonial supports the continuation of institutionally-based prudential regulation, with separate balance sheets for its life, banking and general insurance businesses.*
Recommendation 3	*The prudential super-regulator should regulate all financial institutions, oversee integrated financial services providers and ensure, where possible, prudential regulation is consistent across financial sectors (including capital adequacy standards).*
Recommendation 4	*An independent advisory board should be established to report regularly to the Government on the operation of the super-regulators for prudential and consumer issues. The members of the advisory board should be appointed by the Government and include representatives from a range of financial services providers.*
Recommendation 5	*A true, single purpose holding company of financial institutions should not be subject to specific prudential regulation of a bank or a life insurance company. Instead, the regulation should occur at the individual operating entity level and be undertaken by the prudential super-regulator. Although, consistent with Recommendation 3, the prudential super regulator would be responsible for overseeing the total activities of the financial services group.*
Recommendation 6	*Given the unique role superannuation has played in promoting the macro-economic policy objective of increased national savings, and in order to ensure confidence in superannuation as a form of long term savings, it should continue to be subject to regulation and the existing tax incentives should also be retained.*

Consumer Regulation

Recommendation 7	*A functional (or product group) based, consumer protection super-regulator should be created to ensure a more consistent approach is adopted across the financial services industry.*
Recommendation 8	*The consumer protection super-regulator should be given the mandate:*

- *to rationalise existing consumer protection regulation;*
- *to simplify disclosure requirements, e.g., for products requiring prospectuses, introduction of a single page, user friendly 'short form' prospectus;*
- *to review regulatory intensity for consumer protection generally;*
- *to reduce disclosure requirements regarding credit worthiness and liquidity for products and services provided by entities that are subject to stringent prudential regulation (regulated promises);*
- *to ensure advice requirements reflect market realities and customer preferences, e.g., consumers should not have to pay for advice they do not want;*
- *to oversee the development of common regulation of selling competencies for the entire financial services sector with competencies established by grade relating to the advice component of a product (with greater competency required for highly complex products and more sophisticated financial planning services);*
- *to act as the licensing body for all financial service providers in order to harmonise competencies (ensuring all advisers or product sellers have similar competencies for similar products) and strengthen advisers' competencies across the board;*
- *to grant licenses to principal distributors, including multi agents, rather than to individual agents (with licensed principals in turn 'sub-licensing' agents to sell specific products for which they have acquired the relevant competency based training).*
- *to ensure that when advice is given, the identity of the principal distributor is disclosed to the consumer.*

Recommendation 9 — *The consumer protection super-regulator should require all principals to have adequate insurance or capital as a licensing precondition.*

Recommendation 10 — *Replace the existing plethora of complaints resolution tribunals with a single complaints resolution tribunal for financial services.*

Competition Policy

Recommendation 11	*Proposals for mergers and acquisitions in the finance sector, as for other industries, should be subject to scrutiny by the ACCC.*
Recommendation 12	*For the purpose of testing whether mergers and acquisitions should be allowed to proceed, the relevant local markets should be defined to ensure the full range of competition and substitution possibilities are taken into account. The ACCC's existing merger thresholds should continue to apply.*
Recommendation 13	*The specific ownership and shareholdings requirements of banks and life insurance companies should remain as defined under the Banks (Shareholdings) Act and the Life Insurance Act.*
Recommendation 14	*Ownership requirements under the Banks (Shareholdings) Act should be applied to holding companies.*
Recommendation 15	*Decisions about who should sit on bank boards should be made by shareholders and should be subject to the same rules which cover all corporate bodies in Australia.*
Recommendation 16	*Due to the fundamental role that banks and other financial institutions play in maintaining the stability of the financial system, proposals by foreign interests to undertake direct investment in financial services businesses in Australia should remain subject to examination by the Foreign Investment Review Board on the basis of national interest.*
Recommendation 17	*Foreign entrants into the banking sector should continue to be subject to the same regulatory requirements as the domestic banks.*

Technology

Recommendation 18	*Both super-regulators should monitor and actively seek to prevent unsupervised institutions from using technology to bypass the regulatory system.*
Recommendation 19	*Greater consumer education as to the risks involved in dealing with unsupervised organisations should be considered. The Wallis Inquiry should consider what form of education program is appropriate and how it might be funded. Other means to ensure that all suppliers to the Australian market comply with the same prudential regulations and disclosure requirements should also be investigated. Australia should actively promote the development of minimum standards of prudential and consumer protection regulation through multilateral*

agreements to improve regulation of cross border financial service activity.

Privacy and Trade Practices Act

Recommendation 20	*To reduce compliance costs and promote national consistency, Colonial supports the introduction of a national uniform code on privacy, to replace existing State and Federal regimes that conflict and overlap.*
Recommendation 21	*Legislation should be enacted that will enable entities in the same corporate group to share customer information unless the customer specifically requests otherwise.*
Recommendation 22	*To increase competition and allow consumers to benefit from lower effective prices, Colonial supports amendments to the third line forcing provisions of the Trade Practices Act so that third line forcing would only be illegal where it substantially lessened competition.*

Payments System Access

Recommendation 23	*It is Colonial's view that access to the settlement system and Real Time Gross Settlements should be restricted to holders of a banking licence.*
Recommendation 24	*Direct access to clearing systems such as EFT should be available to those prudentially regulated financial institutions meeting the technical and administrative criteria.*
Recommendation 25	*Regulatory authorities should monitor and actively prevent circumscription of the current restrictions on payment system access through use of new technologies (e.g., stored value cards, sophisticated selling systems).*

Depositor Protection

Recommendation 26	*Colonial supports the maintenance of the current depositor protection arrangements. It also supports new institutions entering the deposit taking market, provided they satisfy the necessary requirements for a banking licence.*

Capital Adequacy Standards

Recommendation 27	*Although welcoming recent concessions by LIASB, Colonial believes the Life Insurance capital adequacy standards are not commensurate with the risks such capital is required to support. The introduction of the new Life Insurance standard should be delayed until:*

- *an analysis comparing Australia's standards with international standards has been undertaken; and*
- *the other findings/recommendations of the Wallis Inquiry have been released to ensure consistency in approach.*

Colonial also supports a periodic review of Life Insurance capital adequacy requirements to take into account improvements in risk management techniques and international trends.

Recommendation 28 — *The capital adequacy standards for Life Insurance companies should reflect a greater reliance on risk management and monitoring techniques for asset and liability mismatch and market risks.*

Life Insurance Reporting Standards

Recommendation 29 — *The differences between the accounting standards proposed for the Life Insurance industry by the Australian Accounting Standards Board and the ISC should be resolved such that a common set of reporting standards apply in the industry.*

FID/Debits Tax and Stamp Duties on Life Insurance

Recommendation 30 — *The Government should abolish FID/Debits tax, as well as stamp duties on life insurance as part of the broad tax review. Short of this, current attempts to harmonise the tax treatment of financial transactions at the State level should be accelerated.*

2. How has the financial system performed since Campbell?

The Campbell Inquiry recommended a shift from direct quantitative controls of the banking system to a market-based system. This approach was gradually introduced by the Fraser and Hawke governments in the first part of the 1980s. The main steps were:

- removal of ceilings on interest rates;
- abolition of banks' lending limits;
- floating of the Australian dollar;
- abolishing of nearly all exchange controls;
- allowing banks to offer a wider range of products;
- licensing 16 foreign–owned banks; and
- conducting monetary policy through open–market operations.

Argy (1995), in a study for CEDA, grouped financial regulations under four categories, according to their basic goals:

Categories	Regulation
A.	Regulations designed mainly to support broad macroeconomic management.
B.	Regulations designed mainly to further particular social or sectional goals.
C.	Regulations aimed mainly at protecting investors and safeguarding the stability and viability of the financial system.
D.	Regulations designed principally to protect consumers of financial products and services from misleading or inadequate information.[1]

Financial regulations of category A and B have now virtually been eliminated (although superannuation regulation has been designed to address the macroeconomic policy objective of promoting national savings). At the same time regulations of category C and D have gradually been strengthened and broadened.

1 Fred Argy, Financial Deregulation: Past Promise, Future Realities, CEDA Research Study ,1995.

The main benefits of financial market deregulation in the 1980s were the much greater choice and diversity it produced within the banking system. There is now a wider choice of financial products available to consumers and the banks have become more responsive to consumers' needs. A major benefit of financial deregulation has been a fall in the costs of financial services. For example, net interest spreads charged by banks have fallen from in excess of four per cent in the 1980s to significantly less than four per cent currently.

Another major benefit was that it created the competitive pressure necessary to reduce gradually the internal cross–subsidisation of bank services. These cross–subsidies had become substantial because of the way regulation operated; for example, the ban on the payment of interest on cheque accounts. There have been some marked increases in fees and charges; this was inevitable as the banks have moved to set prices closer to marginal costs. However, it has led to pressure from consumer advocates which culminated in the Prices Surveillance Authority report into bank fees and charges.

The major criticism of deregulation in the 1980s concerned the too rapid expansion of credit and asset price inflation in 1986 and 1987 and the subsequent tightening of monetary policy, and the experience of banks with non–performing loans. This should properly be seen as part of a learning experience in which both the monetary authorities and banks were adjusting to a more competitive and open environment.

2.1 Trends to intensified prudential and consumer protection legislation

While the financial system has been exposed to substantial deregulation, at the same time there has been considerable growth in prudential and consumer protection regulation of financial services institutions. This list identifies the array of only the most significant legislation (and related regulation) that currently applies to the financial services sector.

Table 1 - Financial Services Legislation

Intermediary	Legislation
Banks	Banking Act 1959 Banks (Shareholding) Act 1972 Banking Legislation Amendment Act 1989 Banking Code of Practice Bills of Exchange Act 1909 Cheques & Payment Orders Act 1986 Credit & EFT Codes of Conduct Credit Acts Financial Transaction Reports Act RBA Guidelines
Authorised short-term money market dealers	Financial Corporations Act 1974 Corporations Act 1989
Building societies	Australian Financial Institutions Commission Act 1992 (Qld) Australian Financial Institutions Commission Code Financial Institutions (Queensland) Act 1992
Credit unions	Financial Institutions Code Application of Laws Acts (All States) Credit Acts (All States)
Excluded Corporations	Corporations Act 1989 Financial Corporations Act 1974
Life Advisers & Brokers	Insurance (Agents & Brokers) Act 1984 Life Insurance Code of Practice
General Insurance Agents & Brokers	Insurance (Agents & Brokers) Act 1984 General Insurance Code of Practice
Securities Dealers Reps	Corporations Act 1989 ASC Policy Statements & Practice Notes
Futures Brokers	Corporations Act 1989 ASC Policy Statements & Practice Notes
Stock Brokers	Corporations Act 1989 ASC Policy Statements & Practice Notes
Finance Brokers	Finance Brokers Acts (State)
Mortgage Originators	Credit Code
Loans Officers	Credit Code
Asset Consultants	Nil
Finance companies	Financial Corporations Act 1974 Credit Acts
Money market corporations ('merchant banks')	Financial Corporations Act 1974 Corporations Act 1989
Other non-bank intermediaries	Financial Corporations Act 1974 Corporations Act 1989

Intermediary	Legislation
Life insurance companies	Life Insurance Act 1995 Insurance Contracts Act 1984 Insurance (Agents & Brokers) Act 1984 Life Insurance Code of Practice Life Insurance Circulars Actuarial Standards Insurance Acquisitions & Takeovers Act 1991 SIS Legislation
Superannuation (ex-life companies)	Superannuation (Industry) Supervision Act 1993 Superannuation (Resolution of Complaints) Act 1993 Income Tax Assessment Act 1936 ISC Circulars
Public unit trust managers	Corporations Act 1989 ASC Practice Notes
Listed Investment Companies	Corporations Act 1989 ASX Listing Rules
Trustee companies	Corporations Act 1989 Trustee Acts (State) Trustee Companies Acts (State) SIS Legislation
Friendly societies	Corporations Act SIS Legislation Friendly Societies Acts (State)
General insurance companies	Insurance Act 1973 Insurance Contracts Act 1984 Insurance (Agents & Brokers) Act 1984 General Insurance Code of Practice
Health Insurance Companies	National Health Act 1953 PHIAC Circulars
Other Financial Institutions	State legislation

Of particular concern is the amount of re-regulation that has emerged, particularly in the area of consumer protection.

Much of the new prudential regulation has been warranted, but in some areas the intensity is not commensurate with the level of risk (particularly in regard to the capital adequacy requirements for the life insurance industry). There is also an increasing concern that regulation, especially consumer protection regulation, is highly intrusive, unnecessarily complex and may not be in the best interests of consumers who ultimately must pay the price of excessive regulation.

3. Pressures for change

The financial services market is being affected by a number of major change drivers: technology and marketing advances; growing international competition and integration of financial markets; more intense domestic competition; and changing consumer needs and demands.

Their affect is reflected in changes to:

- the range of products and services on offer;
- the way products and services are marketed and delivered;
- the number and types of market entrants; and
- global influences on the Australian market.

Advances in information and communications technology are changing the way financial institutions are accessed by their customers. ATMs and EFTPOS mean that many transactions can be completed without a customer entering a branch.

Electronic systems may allow new entrants to avoid the high capital costs of establishing extensive distribution networks. In some niches, new entrants can take significant market share from more traditional players in a short time, especially if they are subject to a less demanding regulatory regime.

This can result in markets facing stronger international competition, or at least a potential threat of stronger competition. The Internet is one example by which consumers in the future will be able to readily access many financial services from offshore providers.

International competition between nation states to attract financial services activities also has implications for the regulation and taxation of financial transactions. An attempt to operate a regulatory system out of step with world best practice is likely to result in a loss of business to competing jurisdictions. The same consideration applies in the case of transaction taxes such as the Financial Institutions Duty and the Debits tax.

Domestic competition is increased by broadly-based financial services organisations (such as Colonial) that want to access cross-selling opportunities by combining activities in different financial services sectors. These organisations can offer a complete range of financial services in ways that were not previously possible.

Consumer demand is another factor driving change. Consumers want financial services which are better attuned to their needs and which are distributed in ways that are more user friendly and convenient. Small businesses, for example, are attracted to dealing with companies which can meet their complete financial services needs for business loans, superannuation and insurance.

However, not all consumers can easily adapt to rapidly evolving information technology and will require access to more traditional delivery systems for some time. For example, they are likely to continue to require some degree of face to face service. This may act as a brake on the speed at which the banks reduce branch networks:

> "While technology is changing, it is far from clear what services will be taken up by consumers, and how they will be used. People will not move in droves to use services that do not yet exist, or that do not have their confidence. Research in the United States revealed that only 5% of personal computer users were comfortable sending a credit card number over the Net. Clearly, people are yet to be wholly convinced that making payments on the Net is secure."[2]

Limited on-line services are now provided by the banks, with only Advance Bank, offering real time fund transfers between personal accounts. Similarly, Internet banking has yet to substantially replace the use of cheques (which still accounts for about 38% of all cash payments).[3]

3.1 Implications of change drivers for regulation

The convergence of financial institutions, reflected in banks offering insurance products and other financial institutions offering bank-type products, has important implications for a regulatory system based on institutions. It also has implications for the way those responsible for competition policy define relevant markets for considering mergers and acquisitions.

New technology has wide ranging implications for regulation. Some of the most significant are:

- broadening the market by allowing the entry of new financial services providers;
- allowing foreign financial services providers to compete in Australia without the need to locate here and potentially by-pass local regulation;
- redefining the nature of basic financial products such as cash;
- enabling the development of a non-traditional payments system which by-passes existing regulations; and
- substantially changing the advising and selling processes for financial products.

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2 Peter Kell, "Whose Financial Future?", Consuming Interest, Winter 1996 p10.

3 Ibid.

The following table summarises the major industry trends, their impacts and the resulting issues Colonial believes are relevant to the Inquiry.

Table 2 - Industry Trends and Impacts

Trends and Impacts	Regulatory Issues
New Technology ***Impact:*** • Markets are no longer purely physical, i.e., the Internet • Technology lowers the barriers to entry and expands the market (globalisation) • Substantial product innovation (e.g., stored value cards) • Consumers demand more information • Convergence of customer information allows delivery of integrated financial solutions	• How do we regulate new entrants utilising the Internet and other forms of new technology? • Are existing definitions of the market adequate? • How do we ensure the regulatory framework is sufficiently flexible to account for new product development? • How should integrated financial services providers be regulated?
Globalisation ***Impact:*** • New entrants and industry rationalisation • Potential concentration of ownership • Lowering industry pricing • Re-defining customer expectations • Encouraging significant product substitution	• How do we ensure industry rationalisation does not substantially lessen competition? • What ownership rules should apply to financial institutions in Australia? • How do we ensure Australia remains internationally competitive?
Financial Services Convergence ***Impact:*** • Diversification of traditional players • Maximise revenues from existing customer base by cross-selling • Invest in business segments with a lower cost of capital • Invest in growth markets	• How do we achieve more consistent prudential and consumer protection regulation across industry segments? • How should privacy and other relevant laws operate to enable the delivery of integrated financial solutions to consumers?

4. Principles of regulation

Colonial believes competition in the financial services market is the most powerful means of ensuring that consumer needs are met at the lowest cost. The reforms made after the Campbell Inquiry were based on this philosophy.

4.1 Sources of market failure: systemic, contagion and information asymmetry risks

There are, however, particular areas of market failure in financial services which establish a prima facie case for a degree of Government intervention. The first is systemic risk, or the risk that the failure of one institution will lead to the failure of others, which could result in a loss of confidence in the financial system and high costs to society.

Contagion is a further risk when in a business conglomerate the risks associated with financial networks and non-financial activities could magnify each other. This would jeopardise the stability of the financial services arm. Regulators have acted to meet this problem by stopping banks owning non-financial services businesses, or non–financial services businesses owning banks.

A third risk is associated with information asymmetry, which puts one party to a financial transaction at a disadvantage compared with the other. Regulators have dealt with this problem by imposing disclosure requirements and other consumer protection regulation.

Financial regulation serves essentially two objectives: maintaining systemic stability, or the soundness of the financial system, and protecting consumers by ensuring the fair treatment of individual depositors, investors, and policyholders. The maintenance of systemic stability is achieved by prudential regulation (capital adequacy and solvency standards, credit exposure and other risk management techniques). Consumer protection is achieved through a system of disclosure and codes of marketing and selling practices to provide individuals with the information necessary to make informed decisions.

According to Deputy Governor Thompson of the Reserve Bank:

> "To put it baldly, prudential supervision is about techniques of risk management, while the other (product regulation) is about standards of customer service. It follows that the skills and knowledge required for the two types are also rather different, and are likely to reside in different agencies."[4]

The objectives and methods to achieve prudential and consumer protection are separate and distinct (albeit related). This paper addresses them independently and our recommendations for each differ in certain regards.

4.2 Broader policy objectives and financial regulation

The prudential and consumer regulatory frameworks must operate within broader macro-economic and other policy objectives of the Government. The major policy objectives and the role of the regulatory system are included in Table 3 below.

Table 3 - Broader Policy Objectives of Financial Regulation

Broader Policy Objectives	Role of Regulatory System
Promote greater national savings.	Savings are promoted through tax incentives and the prudential regulation of superannuation to preserve "special" long term savings status.
Protect the national interest.	The Foreign Investment Review Board (FIRB) assists the Treasurer to evaluate foreign ownership requests.
Prevent ownership concentration that would substantially lessen competition.	The ACCC operates to ensure competition policy meets the policy objectives of the Government.
Ensure Australia remains internationally competitive.	Australia's regulatory system should be consistent with international standards.

It is critical that any changes to the financial system enable Australia's Government to continue to promote broader policy interests, as well as meet the more specific objectives of financial stability and consumer protection.

4 G J Thompson, Deputy Governor, The Reserve Bank of Australia, "Prudential Supervision and the Changing Financial System", Talk to Monash University Law School Foundation, Melbourne, 28 March 1996.

4.3 Desirable properties of the regulatory system

The multiplicity of agencies involved in regulating the Australian financial market raises the question of whether the existing system possesses the appropriate attributes. The regulatory system should:

- promote competition, to the benefit of the consumer;
- ensure competitive neutrality, among financial products and the suppliers of such products;
- promote efficient and stable capital markets;
- deliver low cost compliance;
- provide flexibility, to allow financial institutions to meet the needs of consumers and to innovate; and
- meet consumer protection and financial stability objectives.

4.4 Organisational principles—The principle of regulation by promise

The extent of financial regulation should ultimately rest on the nature of financial contracts. In essence, financial contracts are promises; promises to make payments at specified times, in specified circumstances and for specified amounts. The extent of regulatory intervention should be commensurate with the degree of regulatory burden in financial promises (or the nature of the regulatory promise underlying a product), rather than be tied to the nature or identity of the product supplier. Traditionally, Australia's basis of regulation both prudentially and as it relates to consumer protection, has been institutionally based (supplier of the product) rather than functionally driven (nature of the product).

The important distinction from a regulatory point of view is between those products which imply some form of a guarantee in their promise (‘regulated promises’) and those which have no implied guarantee (‘other promises’). In the case of products in which there is an implied guarantee, there is a need for prudential regulation because:

- the need for financial stability in the economy demands that these types of promises must be fulfilled; and
- consumers are not privy to all the information necessary to make an informed decision and it is not efficient to provide all this information in a manner acceptable to all consumers.

In Colonial's view, prudential regulation should only apply to these product groups (regulated promises):

- Deposit taking products—promise to repay the principal sum plus interest on demand or at a specified point in time;
- Payments system products—promise to give value to an economic exchange;
- Risk products—promise to meet the liability insured under the policy at all times, assuming the event insured against occurs.

In addition, superannuation although not strictly containing a financial guarantee, is a special long term savings vehicle that funds individuals' retirement (and so reduces the burden on the State), involving a promise to deliver defined or accumulated benefits. Hence, the unique role superannuation plays in national savings policy supports its treatment as a regulated promise.

Any number of industry players should be able to provide regulated promises, providing they adhere to a common set of prudential standards and conform with appropriate ownership standards.

The second category of products (other promises) fall mainly within the existing prospectus disclosure regime. Colonial believes they should be regulated mainly by a system of uniform disclosure and a common code of selling practices. Consumer protection regulation, not prudential regulation, is appropriate to other promises as they do not influence the stability of the financial system.

4.5 Overview—Prudential regulation and consumer protection

Australia's institutionally-based approach to prudential regulation should continue. But it should be enforced by a new super-regulator to ensure a harmonised regulatory approach is adopted across institutions and to respond to the unique regulatory requirements of integrated financial service providers.

In the area of consumer protection, Colonial sees greater potential for a fundamental restructuring of the existing regulatory framework, with a functional approach to regulation. This should be organised by function or product group and be enforced by a single (super) regulator.

The separation of financial services regulation into two main bodies—one with the objective of maintaining financial stability through prudential regulation and the other to protect consumers—resembles in some respects the 'Twin Peaks' proposal outlined by Michael Taylor, formerly of the Bank of England. According to Taylor, building financial regulation around the 'Twin Peaks' of prudential regulation and consumer protection has a number of advantages.

> "The benefits of 'Twin Peaks' are clear. The proposed structure would eliminate regulatory duplication and overlap; it would create regulatory bodies with a clear and precise remit; it would establish mechanisms for resolving conflicts between the objectives of financial services regulation; and it could encourage a regulatory process which is open, transparent and publicly accountable. As such, it is consistent with the current philosophy of 'unbundling' the functions of pubic sector agencies to achieve greater transparency, efficiency and clearer lines of responsibility. In all these respects, it marks an advance over the existing institutional structure."[5]

The creation of super regulators would help ensure a consistent approach is adopted for products with similar regulatory promises and functions. In the case of a super prudential regulator, this objective would be served if the regulator had a clear mandate to harmonise regulatory treatment of similar products across its institutional-based divisions. The proposed structure of the super-regulator for consumer protection would lend itself more readily to such harmonisation as its divisions would be defined along product or functional lines, as opposed to institutional lines. The harmonisation process will help ensure competitive neutrality in the financial services market.

5 Michael Taylor, 'Twin Peaks': A regulatory structure for the New Century, Centre For the Study of Financial Innovation, December 1995.

5. Main issues

5.1 Prudential regulation

5.1.1 Description of issue

The objective of prudential regulation is to maintain the integrity and stability of the financial system through management of systemic and contagion risk. Ideally, prudential regulation should also:

- avoid imposing undue costs on financial institutions through excessive regulatory intensity (e.g., capital adequacy standards should be set at a level commensurate with the risks associated with an institution's business);
- be consistent with the approach adopted internationally to avoid competitively disadvantaging Australian financial institutions;
- pass the competitive neutrality test—e.g., place a similar regulatory burden on similar regulated promises independent of the institution providing them, where appropriate.

Despite certain concessions by the Life Insurance Actuarial Standards Board (LIASB) recently, Colonial believes that the proposed capital adequacy regulation of the life industry is too conservative. (This will be discussed in further detail in section 5.9). Colonial also believes these standards are not consistent with international trends, and will handicap the Australian life industry vis 'a vis international players. Rules governing the capital adequacy standards of banks throughout the world, on the other hand, are established by the Bank for International Settlements. These rules have been progressively introduced into Australia since 1988. The Australian system of prudential regulation will need to continue to be compatible with international obligations to remain associated with this international framework.

There are also a number of overlaps and differences in approach to prudential regulation which have resulted in a system that is inflexible in some respects and costly in others. Inconsistencies in regulation encourage 'regulatory arbitrage', where investors move out of heavily regulated institutions (where product costs are relatively high) and into institutions with less strict prudential regulation. This creates inefficiencies in instances where the less regulated institution is not the most efficient provider of the product or service in question. It also runs counter to the principle of competitive neutrality.

Another trend increasingly relevant to prudential regulation is the growth of integrated financial services providers, such as Colonial. Despite this fact, there is no regulatory body which has the institution-wide perspective needed to oversee the full range of activities by these providers. This make Colonial's strategic decision making more complex and unwieldly, as it currently involves discussing strategic options with a number of regulators who may not always share the same view.

5.1.2 Introduction of a super-regulator

Recommendation 1 *Colonial recommends the creation of a 'Twin Peak' regulatory approach involving the creation of two super-regulators—one to maintain financial stability through prudential regulation and the other to protect consumers.*

There are three main reasons to introduce a super-regulator in the area of prudential supervision:

- the rise of integrated financial services providers and the resulting need to provide some form of consolidated oversight of institutions;
- the need to promote consistency in principle, framework and implementation of prudential regulation to ensure competitive neutrality among different financial sectors; and
- to facilitate strategic decision making of integrated financial service providers by simplifying the regulatory approval process and information process more generally.

The rise of integrated financial service providers presents a powerful case for the creation of a super-regulator. Although financial conglomerates are far from a new phenomena, they are becoming more common and tend to encompass a broader range of activities than in the past. At present, there is no regulatory body that has the institution-wide perspective needed to supervise integrated financial service providers.

Such a bird's eye view is important to gain early warning of 'contagion' risks between the subsidiaries of a conglomerate and to assess whether the combination of risks requires more or less prudential supervision. Without this overview, there is a risk of over regulating institutions where aggregate risks are reduced when combined within a conglomerate, and under regulating when combining risks has the opposite effect. Stability requires some global oversight of institutions to monitor the aggregation or correlation of risks.

Secondly, the creation of a super-regulator would help ensure that a similar regulatory burden was imposed on products with common characteristics and whose nature of promise were also broadly similar.

While the risks faced by different types of financial institutions are not identical, and therefore warrant some differences in approach to prudential regulation, the degree of variability applied in approach to capital adequacy between banks and life insurance companies, for example, seems inordinate. It is simply not possible under the existing regulatory structure to promote more common approaches where it is appropriate to do so.

AFIC provides a salient example of regulatory inconsistencies. It writes the financial standards for building societies and credit unions, but their implementation is left to State Supervisory Authorities. Each authority has its own Board of Directors and policies and procedures for implementing the standards. These differences in approach between and within regulatory structures are exacerbated by the assignment of regulatory responsibilities to a wide range of ministerial portfolios. Banking, insurance and corporate regulation fall within the responsibilities of the Federal Treasurer. At the State level, non-bank regulation rests with the Treasurer in some States, the Attorney-General in others and to specialised portfolios in yet others.

Colonial also believes that the existence of separate regulators, with whom it must negotiate major strategic developments, has prolonged and complicated its decision making process. A single point of negotiation within a super-regulator will go a long way to simplify, clarify and reduce the cost of this process. It seems inappropriate that the senior management of broadly based financial institutions increasingly must have the capacity to address the broader portfolio of issues, but regulators must not.

A proposed super-regulator would monitor all the operations of a company (to ensure appropriate levels of regulation given the combining of risks) and ensure a consistent approach is adopted across financial sectors. A super-regulator model is preferred over less structured co-ordinating efforts because it confers the real authority required to settle turf disputes and eliminate overlaps between existing regulatory regimes. This is an authority lacking in the current co-ordinating role held by the Council of Financial Supervisors.

The Council has established broad principles for supervising conglomerates, which inter alia commit its members to liaise with each other if a problem affecting any entity in a group is judged likely to impact on other areas. However, the Council relies largely on the goodwill of institutions with different—and sometimes conflicting—objectives. Early warning of problems would be less problematic for a super-regulator which had direct links and authority over its institutional divisions than for the Council (which relies on periodic high level liaison between members—senior representatives of the ASC, ISC, Reserve Bank, and AFIC). Progress on rationalisation and other reforms is also likely to be more rapid under a super-regulator, whose principal mandate would be to achieve such reform.

5.1.3 Role of the super-regulator

Recommendation 2 — *Colonial supports the continuation of institutionally-based prudential regulation, with separate balance sheets for its life, banking and general insurance businesses.*

Recommendation 3 — *The prudential super-regulator should regulate all financial institutions, oversee integrated financial services providers and ensure, where possible, prudential regulation is consistent across financial sectors (including capital adequacy standards).*

The number of integrated financial services providers continues to increase.

Regulators both in Australia and internationally, however, require these financial services groups to provide separate balance sheets for financial products offered by various prudentially regulated subsidiaries such as banks and life insurers.

Colonial supports the retention of separate balance sheets for prudential purposes as:

- industry segments, such as banking, require regulatory systems which are internationally compatible in order that they and their customers can operate in global markets;[6]
- particular industry segments have specific risks (and consumer perceptions) and as such require some differences in prudential regulation;
- the combining of different types of risks into a single balance sheet may increase the prospect of contagion risk.

Colonial also believes that the current approach adopted by regulators to define different types of financial institutions, such as banks and life insurance companies, is largely appropriate.

By accepting that balance sheets should remain separate for life insurers and banks because of the fundamentally different risks they represent, it follows that the skills and expertise required to prudentially supervise each other are also distinct.

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6 In the very longer term, it is possible that internationally there will be some convergence of prudential regulation across banks and life insurance companies. As such it may be appropriate to revisit the maintenance of individual prudential balance sheets for separate components of financial services groups.

According to the Deputy Governor of the Reserve Bank:

> "The characteristics of a bank balance sheet and an insurance company balance sheet remain very different, and the relevant supervisory techniques are correspondingly dissimilar."[7]

Institutionally-based regulatory authorities have developed specialised skills and techniques to address the specific requirements of the financial sector they are supervising. Life insurance company regulators are unlikely to have the skills needed to regulate banks, and vice versa to regulate life companies. Rather than trying to fill these skill gaps, by making most regulators expert across all sectors, the super-regulator should draw from existing skills, and put them under the new super-regulator in institution-specific divisions.

Divisions organised along institutional lines would have the twin advantage of maintaining unique, institution-specific skills and knowledge. At the same time they could pool, as appropriate, the scarce specialist expertise needed to supervise increasingly sophisticated trading operations (e.g., derivative products) . However, senior regulators would need to keep abreast of risk profiles and methodologies across the full spectrum of financial sectors.

5.1.4 Independent advisory board

Recommendation 4 *An independent advisory board should be established to report regularly to the Government on the operation of the super-regulators for prudential and consumer issues. The members of the advisory board should be appointed by the Government and include representatives from a range of financial services providers.*

Given the significant level of ongoing change in the financial services industry and the desire to ensure that the regulatory framework does not inhibit Australia's ability to compete internationally, it is appropriate for the super-regulator to have a mechanism for discussion and feedback on the performance of its role.

Colonial believes an independent advisory board should be established to report regularly to the Government on the operation of the super-regulator for prudential issues. The members of the advisory board should be appointed by the Government and include representatives from a range of financial services providers.

7 Thompson, op. cit.

5.1.5 Regulation of holding companies

Recommendation 5 *A true, single purpose holding company of financial institutions should not be subject to specific prudential regulation of a bank or a life insurance company. Instead, the regulation should occur at the individual operating entity level and be undertaken by the prudential super-regulator. Although, consistent with Recommendation 3, the super prudential regulator would be responsible for overseeing the total activities of the financial services group.*

Some financial services providers maintain a holding company structure which in turn owns the major operating entity / entities of the group.

Colonial believes that where the holding company is a true, single purpose holding company, and simply operates to collect dividends from prudentially supervised subsidiaries, that company should not be subject to prudential regulation of either a bank or a life insurance company. While a clear objective of the prudential super-regulator is to be able to step back and take a complete view of the prudential management of a financial services group, it would seem inefficient to establish a further regulatory framework for a true, single purpose holding company.

A complex issue that will need to be addressed over time by the prudential super-regulator, is having determined that the prudential risk at a financial services group level differs to the sum of individual balance sheet risks across the group, how should it then act to alter the regulatory requirements placed on the group. Again, it would seem imprudent to impose regulation on the holding company, and this issue would be better addressed within the operating balance sheets of the prudentially regulated subsidiaries.

5.1.6 Superannuation subject to prudential regulation

Recommendation 7 *Given the unique role superannuation has played in promoting the macro-economic policy objective of increased national savings, and in order to ensure confidence in superannuation as a form of long term savings, it should continue to be subject to regulation and the existing tax incentives should also be retained.*

Colonial believes that superannuation should continue to be subject to prudential regulation and that the existing tax incentives should also be retained as:

- superannuation plays a unique role in supporting the macro-economic policy objective of improving national savings;

  In the past 25 years, Australia's national savings level has fallen from 25 per cent to 17 per cent of GDP. Household saving as a percentage of household disposable income has declined to 3 per cent, which places Australia at the bottom end of the OECD table and well below Japan's 15.2 per cent and Germany's 11.7 per cent.

- the confidence in superannuation as a long term savings vehicle could be harmed by the withdrawal of regulatory supervision of superannuation funds;

  Australia, like most OECD countries, faces the prospect of gradual ageing of the population and a reduction in the ratio of people in the receipt of pensions to people in the workplace. This is leading to a much greater interest in individuals making adequate provision for retirement. Superannuation is becoming an increasingly important vehicle for long term savings to provide retirement income.

- the taxation incentives provided, balance the regulatory requirements to deny access to the funds until retirement.

5.2 Consumer protection regulation

5.2.1 Description of issue

Consumer protection has two main features: disclosure of product information necessary for consumers to make informed decisions and the provision of adequate product or financial planning advice.

There are primarily four major disclosure aspects of a financial product that consumers need to understand: credit worthiness/liquidity risk (e.g., relating to the soundness of the institution supplying the product), return or interest cost, other related costs (including fees and charges) and flexibility (e.g., to exit investment). The amount of advice required for a particular product or service depends first on its complexity and second, on whether the consumer wants a single product or sophisticated financial planning services.

Colonial recognises the importance of disclosing relevant information (risk, return, cost, flexibility) to ensure consumers understand their rights and obligations, and to protect them from unscrupulous actions. We also acknowledge the importance of providing adequate and sound advice for sophisticated financial products. The standards of disclosure and advice need to be:

- consistent across financial sectors
- simple, so that the information is understood by consumers
- not be onerous and so represent an excessive ‘tax’ on complying companies.

Colonial believes existing consumer protection regulations do not adequately meet the criteria of efficiency, effectiveness and competitive neutrality. Regulations are highly complex, making compliance costs high and compliance difficult.

Overlapping and inconsistent regulations have lowered the operating efficiencies of financial institutions, undermined regulatory effectiveness and distorted the market by increasing costs for heavily regulated products relative to less regulated products. The existence of separate regulatory systems for life agents and securities dealers, for example, inevitably creates inconsistencies, particularly in regard to advice and selling practices and the way liability frameworks work.

Separate compliance and disclosure systems make problematic Colonial's strategic objective of offering a broad range of financial solutions to consumers and our aim to respond to consumer demands for a 'one stop shop'. Without industry-wide competency based licensing, the ability to clearly define, strengthen and harmonise adviser and product selling competencies is necessarily constrained.

Importantly, consumers are not benefiting from the existing system. Consumers are overwhelmed and confused by the quantity of information that is often disclosed with products. For certain life products, customer are required to provide information (for customer needs analysis, fact sheets, etc) that they may not need or want to disclose. Many regulations as they are now structured meet neither the needs of consumers for clear, succinct and relevant information, nor those of the industry for an efficient and simple regulatory regime. Ultimately, the consumer bears the costs incurred by unwieldy company compliance systems.

Previous and ongoing attempts to reform the system have not produced tangible results. Certain efforts are continuing across the financial services sector such as the harmonisation process initiated last year to achieve broad consistency between the ASC's Good Advice report and the ISC's Life Insurance Codes of Practice—but are seen as not going either far or fast enough.

5.2.2 A super-regulator for consumer protection to regulate on basis of functions, not institutions

Recommendation 7 — *A functional (or product group) based, consumer protection super-regulator should be created to ensure a more consistent approach is adopted across the financial services industry.*

Rationalising and simplifying regulation governing existing disclosure and selling practices is more likely to be achieved under a single regulator. A super-regulator for consumer protection would have the authority to implement reform otherwise left in the hands of regulators with little incentive and authority to take quick and decisive action. Savings would not only be achieved by accelerated rationalisation and simplification of existing regulation, but by the rationalisation of the support services of the various regulatory bodies concerned with consumer protection.

The creation of a super-regulator would also ensure consistent enforcement of ‘front end’ advisory and product selling responsibilities across the industry. For Colonial, which has numerous delivery channels providing a range of financial services, this flexibility is critical. Customers would also benefit by being better served by persons who have a demonstrated competency to advise on specific products.

Our preferred candidate for this role is the ASC, as it is now responsible for issuing prospectuses as well as licensing financial dealers.

The super-regulator should control consumer protection by function, or group of products, rather than by institution. Maintenance of institutionally-based consumer protection regulation, in so far as the intensity of regulation differs between similar products offered by different financial sectors, encourages regulatory arbitrage and jeopardises competitive neutrality. As argued by the Deputy Governor of the Reserve Bank:

> “Effective competition requires similar basic rules of disclosure etc to apply as widely as possible to similar products, regardless of who offers them.”[8]

Short-term annuities and savings term deposits are examples of similar products with different disclosure provisions. Disclosure requirements for a bank deposit, for example, are minimal compared with that of a life company’s annuity product, yet both products are subject to intense prudential regulation.

This issue of inconsistent regulatory treatment is becoming more relevant with a growing trend for financial institutions and other retailers of financial services to make multiple sales of different products to the same customer. This is particularly true for a broad financial solutions company, such as Colonial. As a result, function provides a better basis for regulation rather than an institutionally-based system of consumer protection.

5.2.3 Rationalise consumer protection legislation

Recommendation 8 *The consumer protection super-regulator should be given the mandate:*

- *to rationalise existing consumer protection regulation.*

At present, there are numerous methods of consumer protection.

They are sometimes duplicate, inconsistent and frequently highly complex and include a variety of codes and legislation that apply to banks and life insurers.

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8 Thompson, op. cit.

According to Professor Ian Harper, consumer protection regulation is a mix of institutional, functional and transactor-based rules. The result is overlap and duplication. Similarly, the Deputy Commissioner of the Insurance and Superannuation Commission stated:

> "As you know, there are some significant overlaps and inconsistencies between the ISC and the ASC regimes covering financial advice, product disclosure and complaint handling, even though the policy objectives are broadly similar."[9]

The complexity of consumer protection regulations makes compliance costly and difficult. Colonial estimates that its direct compliance costs relating to the various consumer protection legislation and codes in its banking and insurance businesses runs to tens of millions of dollars. These costs result from regulatory—rather than market—requirements, and represent lower economic efficiency and heightened distortions.

Differences in the ASC's Good Advice report and the ISC's Life Insurance Codes of Practice means duplication of paperwork in relation to capacity disclosure and sales practices for securities advisers who are also multi-agents. For example, the ASC requires that advice to customers on life insurance policies is provided in a separate letter from advice on securities.

In practice, advice on both types of products is part of any financial planning exercise and allows the consumer to make an informed choice between a life policy and a security. According to John Fox of MLC:

> "To require the artificial segmentation of the advice frustrates the ability of the consumer to evaluate the advice and compare his or her investment options. An adviser should be able to provide a multi product advice in one instrument."[10]

The complexity of the Codes also makes compliance problematic, with ensuing breaches involving not only stiff penalties, but also difficult to quantify, but nonetheless significant, damage to the corporate reputation.

5.2.4 Simplify disclosure requirements

Recommendation 8 *The consumer protection super-regulator should be given the mandate:*

- *to simplify disclosure requirements, e.g., for products requiring prospectuses, introduction of a single page, user friendly 'short form' prospectus.*

Colonial favours brevity as the essential characteristic of useful information. Simplification of disclosure requirements, and in particular the introduction

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9 Address by Bob Glading, Deputy Commissioner, Life Insurance and Superannuation Commission, "Adjusting Regulatory Structures to Market Needs," 26/27 June 1996.

10 John Fox, General Counsel, MLC, Ltd, Comments From the Regulated: Are We Over Regulated?, 1996 ASC Summer School.

of shorter, user friendly prospectuses, will benefit both consumers and the industry. Consumers will benefit from more transparent, comprehensible information about products and the industry will win because compliance costs will be reduced. Colonial also supports a move to a less prescriptive approach where possible. However, it acknowledges that such an approach will involve greater management responsibility in interpreting broad regulatory requirements on the basis of common sense and good practice.

Some efforts have been made to simplify information disclosed to consumers, for example the ISC's Key Features Statement. However, as the Statement is not substitute for—but is combined with—full prospectuses, it does not significantly meet the industry's need for greater simplification of prospectus disclosure.

5.2.5 Review regulatory intensity of consumer protection generally

Recommendation 8 *The consumer protection super-regulator should be given the mandate:*

- *to review regulatory intensity for consumer protection generally;*
- *to reduce disclosure requirements regarding credit worthiness and liquidity for products and services provided by entities that are subject to stringent prudential regulation (regulated promises);*
- *to ensure advice requirements reflect market realities and customer preference, e.g., consumers should not have to pay for advice they do not want;*

In addition to removing overlap, inconsistency and unnecessary complexity, Colonial believes there are also areas where the intensity of regulation can be reduced without sacrificing consumer protection objectives.

In particular, for prudentially supervised institutions, lower disclosure requirements are justified for the component relating to the integrity of an institution, such as credit worthiness or liquidity risk. This is because regulated promises and prudential controls are real protection for consumers, and mitigate the need for detailed disclosure about the financial integrity of the provider. A common example which Colonial supports continuing, is the exemption for banks and supervised non-banks from prospectus provisions of the Corporations Law.

Clearly linking disclosure regulation to the financial contract or promise underlying a product helps eliminate unnecessary disclosure by minimising 'double counting', that is, the requirement for extensive credit worthiness risk disclosure for products already protected by prudential regulation.

Colonial also considers that the requirements placed on financial service advisers, particularly of life products, are often too onerous and not of great value to consumers. A consumer wanting advice from an agent in regard to a simple investment, for example, is required in most cases to provide a full range of information for a fact finder. The agent is then required to produce a customer advice record which explains, according to the client's stated needs, the rationale for the choices made. Similar requirements do not apply to someone making a bank or building society deposit, withdrawing funds, or purchasing and selling shares. In many instances it is likely that information contained in disclosure material accompanying products will meet consumers' needs.

Rather than requiring detailed needs analyses to be conducted for all consumers of a given product, it should only be required where the consumer specifically requests it. This would avoid providing advisory services (at a cost) to sophisticated consumers not in need of them.

The requirement to provide unnecessary and time consuming fact finds or advice processes, also means new and less expensive forms of distribution such as telephony cannot be used to sell certain products. This limits the ability of suppliers to lower costs. Similar difficulties are faced in other countries such as the UK, according to Graham Bannock:

> "Some insurance companies, for example, have withdrawn from direct selling because of these [regulation created] costs, while some new entrants have decided to sell financial products without the provision of any advice to consumers so that they may enjoy lighter regulation."[11]

As part of a more fundamental review of regulatory intensity, Colonial believes that advice should match product complexity. Accordingly, the advice component would be greater for complex products than it would be for simpler products. Similarly, more advice would be expected to accompany the provision of a full financial plan than would accompany a simple product transaction. This matching of advice to product complexity would help reduce unnecessary regulatory requirements.

11 Graham Bannock, "Regulation on a Collision Course", The Financial Regulator, 1996, Central Banking Publications, London, 1 June 1996.

5.2.6 Competency-based licensing of financial advisers and product sellers

Recommendation 8 *The consumer protection super-regulator should be given the mandate:*

- *to oversee the development of common regulation of selling competencies for the entire financial services sector with competencies established by grade relating to the advice component of a product (with greater competency required for highly complex products and more sophisticated financial planning services);*
- *to act as the licensing body for all financial service providers in order to harmonise competencies (ensuring all advisers or product sellers have similar competencies for similar products) and strengthen advisers' competencies across the board;*

The new super-regulator should also be the sole licensing body (drawing on the ASC's current dealer licensing model) for all providers of financial product advice.

The basic objective underlying the licensing of advisers is that the advisers should be accountable for their advice and the product suppliers should be responsible for the product (and related product disclosure).

On this basis features of the licensing system would include:

- licences granted to principal distributors based on demonstrable qualifications, e.g., product knowledge, ability to manage advisers;
- identical requirements for securities advisers, life agents and other advisers;
- a common set of competency standards established for similar products;
- an education programme administered by the licensing body to assist in reaching the required competency.

The benefits of such a licensing scheme would include:

- improving the competency of all providers of advice;
- reducing the costs of regulation, currently borne by the consumer;
- ensuring consistency of advice and improving the efficiency of the regulator in monitoring advice provided;
- eliminating differing requirements of the dual systems of regulation of securities advisers and life agents;

- simplifying consumer remedies by avoiding the need to distinguish between differing regulatory regimes;
- clarifying and strengthening selling and advising competencies to the benefit of the consumer.

A single, uniform system of licensing advisers will be essential in facilitating the provision of integrated financial solutions to consumers.

5.2.7 Licence granted to principal distributor not to individual agents

Recommendation 8 — *The consumer protection super-regulator should be given the mandate:*

- *to grant licenses to principal distributors, including multi agents, rather than to individual agents (with licensed principals in turn 'sub-licensing' agents to sell specific products for which they have acquired the relevant competency based training).*
- *to ensure that when advice is given, the identification of the principal distributor is disclosed to the consumer.*

Previous experience with licensing of the adviser level resulted in greater costs and delays without any demonstrable advantage over licensing at the principal level.

Colonial believes that licensing of principals (including multi agent groups) is the most appropriate system as it allows them to develop more effective means of recruiting and retaining quality agents and assists in ensuring higher standards of regulatory compliance.

Multi agents should be subject to the same licensing system as principals.

The consumer should be able to identify the principal distributor who holds the licence and is therefore ultimately responsible for any advice given by the sub-licensed agents.

5.2.8 Monitoring adviser insurance

Recommendation 9 — *The consumer protection super-regulator should require all principals to have adequate insurance or capital as a licensing precondition.*

Smaller sized principals should be required to take out adequate insurance as a condition of licensing or be of an appropriate size financially. This would strengthen consumer protection from improper advice. The super-regulator would be responsible for ensuring that licensed principals were adequately insured. In turn, the principals would monitor professional indemnity insurance held by their 'sub licensed' advisers.

5.2.9 Creating a single external Complaints Resolution Tribunal

Recommendation 10 *Replace the existing plethora of complaints resolution tribunals with a single complaints resolution tribunal for financial services.*

There are numerous external complaints resolutions tribunals and mechanisms:

- The Australian Banking Industry Ombudsman
- Life Insurance Complaints Service
- Superannuation Complaints Tribunal
- Financial Planning Association Complaints Resolution Scheme
- Insurance Inquiries and Complaints Ltd
- Private Health Insurance Complaints Commissioner.

This is uneconomic and encourages ‘tribunal shopping’. As decisions are often binding on the insurer but not the client, it is possible that one complaint regarding superannuation could be heard before the Life Insurance Complaints Service and the Superannuation Complaints Tribunal. Complications also arise if a client buys a ‘package’ of several products (for example, containing a life insurance policy, a funds management product and a general insurance policy). If the advice offered with the package is flawed, it is not evident which of the several possible tribunals is appropriate to hear the complaint.

In order to adopt a more consistent approach to complaint resolution across the financial services sector, the multiple complaints tribunals should be replaced by a single complaints resolution tribunal.

5.3 Competition policy

5.3.1 Description of issue

The Inquiry provides an opportunity to reconsider the issue of ownership concentration in the financial services sector and the approach that should be taken by the ACCC to testing mergers and acquisitions in terms of their potential to cause a substantial lessening of competition.

In forming judgments about whether mergers and acquisitions are likely to result in anti–competitive behaviour, it is necessary to do two things:

- first, define the relevant market; and

- second, consider all the factors that bear upon market conduct, such as market structure, market concentration and ease of market entry for competitors.

Further discussion on both these issues is set out below.

5.3.2 ACCC scrutiny

Recommendation 11 *Proposals for mergers and acquisitions in the finance sector, as for other industries, should be subject to scrutiny by the ACCC.*

Colonial believes it is undesirable to allow anti-competitive behaviour (oligopoly/monopoly) in the financial services sector. Ownership concentration within the financial services sector, should be subject to scrutiny by the ACCC, as it is for other industries.

5.3.3 Mergers and acquisitions

Recommendation 12 *For the purpose of testing whether mergers and acquisitions should be allowed to proceed, the relevant local markets should be defined to ensure the full range of competition and substitution possibilities are taken into account. The ACCC's existing merger thresholds should continue to apply.*

Definition of the market

The ACCC's merger guidelines require "all sources of close substitutes for the merged firm's products (to be) included in the definition of the market." The issue is how this principle is applied in practice. For example, the then Trades Practices Commission, within the context of the Westpac takeover of Challenge Bank in Western Australia, distinguished a retail banking services market (and a regional retail banking services market) as separate from banking services and financial services generally. As the blurring across financial services continues, it is likely competitive conditions will change which may warrant a broader definition of the market.

Colonial believes the relevant market for judging mergers and acquisitions is only beginning to move beyond narrowly defined, albeit important, sub-markets such as retail banking services, to more broadly-based financial services. This is being driven by changes in technology, the convergence of financial products and the potential for new entrants. These changes, however, are not occurring as quickly as some might think.

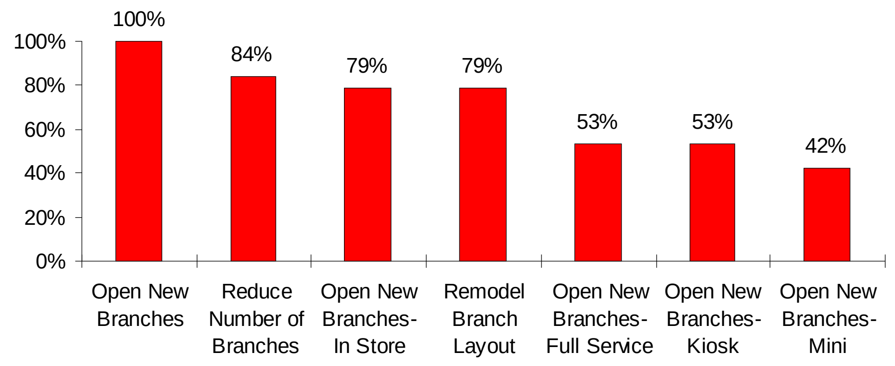
While some changes in technology are already having a demonstrable effect in the market; others have yet to assert themselves. The ACCC, in determining the relevant market, has to strike a balance between recognising technology changes that will impact on future markets, while taking into account that, in the interim, particular areas of market dominance can remain.

For example, it seems clear that bank influence is still essentially driven by branch presence and so that regional geographic markets are still important. If this is not the case, one questions why banks have not taken more dramatic action to reduce branch numbers.

A recent survey[12] of technology spending by US banks found that "the branch office is not dead - just under renovation: while 84% of banks intend to close conventional branches, 79% are planning to open redesigned and relocated branches". Chart 1 indicates the types of branches the US banks are planning over the next 3 years and confirms that branches will have a significant ongoing role.

Similarly, Chart 2 suggests that 56% of bank customers in the US still prefer to use a branch to perform their transactions and this is forecast to reduce to 41% by 1998, again highlighting the ongoing significant role of branches in the medium term.

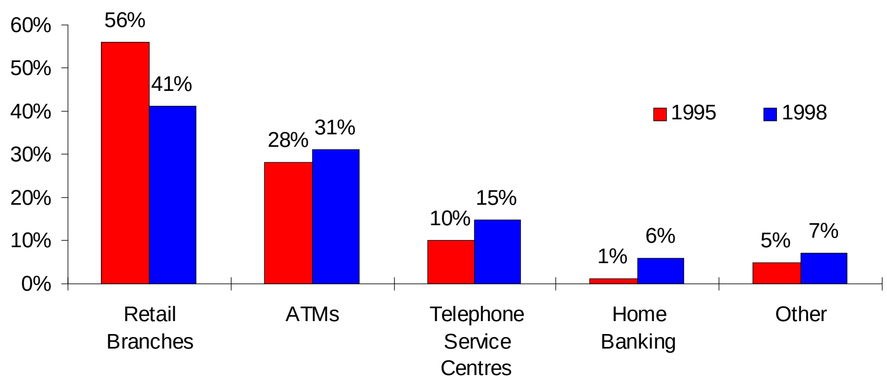
Chart 1 Branch Activities Planned Over Next Three Years (1995-1998)



Source: Ernst & Young, 1996

12 Ernst & Young/American Bankers Association Fifth Annual Special Report on Technology in Banking - 1996

Chart 2. Retail Transactions by Delivery Channels in 1995 & 1998



Source: Ernst & Young, 1996

Given the relatively early adoption of technology in the US compared to Australian banking, it is arguable that the Australian banking market will continue to be determined by physical branch presence for some time yet. Accordingly, to suggest that technology has substantially altered how one should define the market in a physical sense today, is perhaps erroneous.

The Industry Commission has proposed that the ACCC look at the possibilities of increasing the threshold market share for an individual merged firm from 40 per cent to 50 per cent. The Commission also believes the ACCC should consider granting a 'safe harbour' when the three largest suppliers have less than 75 per cent of the market, or when the largest three suppliers have 75 per cent or more of the market (provided that the merged firm has less than 20 per cent).[13] Colonial notes the decision by the ACCC that in 1996-97 it will review all mergers against both existing thresholds and those suggested for consideration by the Industry Commission and publish the results.[14] Colonial believes that no evidence has yet been presented that would justify making the suggested changes to the thresholds.

Importantly, Colonial also believes that the test of whether a proposed merger would substantially lessen competition, should remain paramount when assessing the appropriateness or otherwise of merger activity.

Economies of scale

There is an argument, particularly in manufacturing industry, that economies of scale and scope in production and marketing are so pervasive that to compete internationally Australian firms need to have the chance to build sufficient critical mass in the local market. Or, alternatively, that a substantial reduction in costs within an industry can only be achieved by obtaining

13 Merger Regulation: A Review of the Draft Merger Guidelines Administered by the Australian Competition and Consumer Commission, Industry Commission (1996).

14 "Competition Policy; Recent Developments", Speech to the National Press Club, Canberra, Professor Allan Fels (1996),

certain scale economies, and so that certain mergers and acquisitions should be allowed on this basis. There is clearly merit in this argument in sectors which are subject to marked economies of scale, such as steel and chemicals. In other sectors, where economies of scale are less important, the argument for allowing mergers to proceed on this basis where there is a risk of lessening competition is much less compelling.

The evidence on the importance of economies of scale in providing financial services is not clear cut. In fact, the weight of evidence suggests it has not been important in the past.

A recent study[15] undertaken on bank performance in the United Kingdom found no conclusive evidence of economies of scale and a 1994 US Federal Reserve Study [16] found that "despite substantial diversity among the 19 (merger) studies, the findings point strongly to a lack of improvement in efficiency or profitability as a result of bank mergers". Cost-to-income ratios—the industry benchmark of efficiency—"remain steady or actually deteriorate" the study said. Interestingly, the Bank of Melbourne, one of Australia's smallest retail banks, has the lowest cost to income ratio of all Australian banks.

It can also be argued that international economies of scale are not as easily achieved in retail financial services, as perhaps in manufacturing industries, due to:

- the need to maintain separate balance sheets in order to meet the prudential requirements of each country in which a group operates;
- the costs associated with maintaining different compliance, disclosure and prudential management structures in each country of operation;
- the need to maintain physical branch structures, together with distribution administration systems in each location.

It is recognised that new technologies may change this situation and make economies of scale much more important. This remains to be seen. At this stage, the evidence is not available to confirm this development. One needs also to counter this potential development with other emerging trends. While technology is a major cost to most financial services companies, outsourcing, alliances with technology companies and the increased availability of more advanced technology at a lower cost, means many smaller industry participants, are very able to capably introduce newer, developing technologies and are not hampered by their size. To date Advance Bank, for example, has led the Australian bank's Internet developments, not one of the larger national banks.

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15 Kevin Davis, Professor Finance, Melbourne University, August 1996.

16 Stephen Rhoades, "A Summary of Merger Performance Studies in Banking, 1980-93, and an Assessment of the "operating performance" and "Event Study" methodologies, Federal Resource Bulletin, July 1994.

Another obviously critical issue to consider, is even if significant economies of scale can be implemented through mergers, will the benefits of reduced costs be passed onto consumers if the merged entity can effectively dominate the competitive environment?

Colonial believes there is a real risk that certain merger and acquisition activities in the financial services market could result in substantial lessening of competition which could offset any enhanced efficiencies. Table 4 indicates that by one measure, Australia's banking industry is one of the most concentrated in the world. These issues should be subject to testing by the ACCC. It would be up to the applicants to demonstrate that the efficiency gains of mergers outweighed a loss of competitiveness. This can be done within the existing legislative provisions.

Table 4 - Ratio of Average Size of Largest Four Banks to Average Size of Next Six Largest Banks

Netherlands	18.3	Portugal	4.0	Tunisia	2.8
Ukraine	16.9	Mexico	3.9	Spain	2.7
Finland	14.3	Malaysia	3.7	Saudi Arabia	2.6
Australia	**12.5**	Canada	3.6	USA	2.4
Switzerland	11.5	Egypt	3.6	Philippines	2.3
Bulgaria	11.4	Belgium	3.4	Chile	2.3
China	8.4	Hungary	3.4	Poland	2.3
Israel	8.3	Denmark	3.2	India	2.1
Ireland	7.1	Austria	3.2	Turkey	2.1
Norway	4.8	Luxembourg	3.2	France	2.0
Greece	4.7	Thailand	3.2	Germany	2.0
Argentina	4.5	UK	3.1	Hong Kong	2.0
Brazil	4.1	Russia	3.1		
Sweden	4.0	UAE	2.9		

Source: Prof. K Davis, University of Melbourne.

International competitiveness

In terms of the “national champions” argument for allowing mergers, Colonial does not believe that the existing approach has impeded Australian financial institutions from expanding internationally. AMP, ANZ, National Australia Bank, National Mutual and Colonial all have significant and growing offshore businesses. Similarly, the argument has been put that Australian banks require "critical mass" in order to be able to compete internationally. Table 4 above suggests that the Australian banking sector is already highly concentrated by international standards, and given the arguments mentioned above about economies of scale in retail financial services, Colonial believes current competition policy has not acted as a barrier to international competitiveness.

In our considered view, the Australian tax system is more likely to limit international expansion by Australian banks and other financial services companies than the so called need for critical mass. This is because imputation credits apply only to Australian, and not foreign corporate taxes. Australian companies want to provide shareholders with fully franked dividends. The existing rules, however, impart a bias in favour of investing in Australia, by placing a limit on international expansion proportional to the income tax that must be generated by a group's Australian businesses to pay franked dividends.[17] International dividend streaming to allow franked dividends to be biased towards Australian shareholders would greatly assist local companies competing in international markets and encourage the development of Australia as a key global financial centre.

5.3.4 Limits on ownership and control of financial institutions

Recommendation 13 — *The specific ownership and shareholdings requirements of banks and life insurance companies should remain as defined under the Banks (Shareholdings) Act and the Life Insurance Act.*

Recommendation 14 — *Ownership requirements under the Banks (Shareholdings) Act should be applied to holding companies.*

Recommendation 15 — *Decisions about who should sit on bank boards should be made by shareholders and should be subject to the same rules which cover all corporate bodies in Australia.*

Recommendation 16 — *Due to the fundamental role that banks and other financial institutions play in maintaining the stability of the financial system, proposals by foreign interests to undertake direct investment in financial services businesses in Australia should remain subject to examination by the Foreign Investment Review Board on the basis of national interest.*

Recommendation 17 — *Foreign entrants into the banking sector should continue to be subject to the same regulatory requirements as the domestic banks.*

The Banks (Shareholdings) Act generally limits the nominal amount of the voting shares of a bank in which a person (including a corporation) may have an interest to 10 per cent, or 15 per cent with the approval of the Treasurer. The rationale for this limitation, which Colonial supports, is that no one person or corporation should be in a position to exercise undue influence over

17 Industry Commission, Implications for Australia of Firms Locating Offshore, Draft Report, 21 May 1996

a bank. The presence of a dominant shareholder also creates a risk that public confidence in a bank could be compromised if that shareholder experienced business problems. The payments system also depends on banks having confidence in each other.

The situation created by the decision to allow Colonial to own State Bank raised the issue of whether safeguards on diversity of ownership of banks under the Act should also apply to a holding company owning a bank. Colonial believes the safeguards should apply to holding companies in the interests of avoiding the risk of undue influence being exercised by a person or corporation.

The risk of contagion if non–financial services groups are allowed to own financial institutions, is prevented by legislation. In the interests of maintaining stability in the financial system, there is a strong case for continuing this provision. In support of this argument, Colonial notes that most Western economies have this restriction in place, although there are some notable exceptions.

The composition of bank boards is regulated by both the Banks (Shareholdings) Act and the Reserve Bank’s Prudential Statement B1 (PSB1). This statement sets rules on who should sit on bank boards and who should be chairman. Colonial does not believe that banks require special regulation in this respect and believes that decisions about who should sit on boards should be made by shareholders, under the rules which cover all corporate boards in Australia. Other prudential regulated financial services participants are not subject to this regulation. It also seems unnecessary to the extent that the Banks Shareholdings Act, by ensuring ownership diversity of either the bank or its holding company, should preclude a single shareholder of the group from dominating the relevant board of directors.

As in other areas of the economy, proposals by foreign interests to invest directly in financial services businesses in Australia, are examined by the Foreign Investment Review Board (FIRB). In recent years there has been significant foreign investment in Australia's financial system, particularly the banking sector (as illustrated in Table 5).

Table 5 - Foreign Owned Banks in Australia

Foreign Parent	Australian Entity	Asset Sizes $M
Arab Bank	Arab Bank Australia	186
Asahi Bank	Asahi Bank	693
Bank of America	Bank of America NT & SA	1,600
Bank of China	Bank of China	1,940
Bank of Singapore	Bank of Singapore (Australia)	868
Bank of Tokyo	Bank of Tokyo-Mitsubishi (Aust)	3,011
Bank of Scotland	Bank of Western Australia	10,412
Bankers Trust Corporation	Bankers Trust Australia	6,143
Banque Nationale de Paris	Banque Nationale de Paris	5,675
Barclays Bank	Barclays	1,299
Chase Manhattan Bank	Chase Manhattan Bank (NA)	3,031
Citibank (NA)	Citibank	8,355
Citibank (NA)	Citibank (NA)	270
Credit Suisse	Credit Suisse	473
Dai-Ichi Kangyo Bank	Dai-Ichi Kangyo Bank	1,488
Deutsche Bank AG	Deutsche Bank AG	5,039
First National Bank of Chicago	First National Bank of Chicago	577
Hongkong Bank	Hongkong Bank of Australia	3,524
IBJ Bank	IBJ Australia Bank	2,758
Mercantile Mutual Bank	ING Mercantile Mutual Bank	703
Lloyds Bank	Lloyds Bank NZA	1,518
Midland Bank	Midland Bank	1,975
Morgan Guaranty Trust Company of New York	Morgan Guaranty Trust Company of New York	823
National Westminster Bank	NatWest Markets Australia	3,223
NBD Bank	NBD Bank	0
Overseas Union Bank	Overseas Union Bank	551
Standard Chartered Bank	Standard Chartered Bank Australia	819
United Overseas Bank	United Overseas Bank	524
Total Assets in Australia - Foreign Banks		67,478

Source: RBA Bulletin, August 1996 (Total Assets include foreign currency assets plus assets of subsidiaries)

Other sectors of the financial services sector also face significant foreign competition. This foreign investment supports the view that the application of FIRB's guidelines has not been an impediment to foreign companies investing in Australia. Colonial considers that the FIRB process should continue to apply to allow proposals by foreign interests to be considered in the light of the national interest.

Colonial believes that it is in Australia's interests that ownership of financial institutions operating in Australia remain largely Australian, given the significance of the industry to Australia's financial stability and long term economic well being. It would seem inappropriate for Australia to unilaterally allow unsupervised foreign ownership, while many of its trading partners continue to maintain significant restrictions on foreign entrants. This means achieving an appropriate balance between promoting new foreign entrants to enhance competition and promoting the national interest.

It is also in the interests of Australia's financial stability that foreign banks wanting to operate in Australia's retail market must do so through a subsidiary to protect the interests of Australian depositors. In the interest of competitive neutrality, it also seems fair that such banks be subject to the same prudential regulation as Australian banks.

5.4 Impact of new technology

5.4.1 Description of issue

New technology significantly affects the financial system in three areas. These include:

- the provision of financial services by an unsupervised institution using technology to bypass the system;
- related privacy issues;
- access to the payments system by unsupervised institutions.

The latter two issues are addressed separately later in this document (sections 5.5 and 5.6).

5.4.2 Financial service provision by unsupervised institutions

Recommendation 18	*Both super-regulators should monitor and actively seek to prevent unsupervised institutions from using technology to bypass the regulatory system.*
Recommendation 19	*Greater consumer education as to the risks involved in dealing with unsupervised organisations should be considered. The Wallis Inquiry should consider what form of education program is appropriate and how it might be funded. Other means to ensure that all suppliers to the*

Australian market comply with the same prudential regulations and disclosure requirements should also be investigated. Australia should actively promote the development of minimum standards of prudential and consumer protection regulation through multilateral agreements to improve regulation of cross border financial service activity.

Use of the Internet to provide financial services has significant consequences on systemic stability. Suppliers operating from outside Australia can potentially escape all forms of regulation. For example, in the US, the First National Bank of Pryor, Oklahoma, allows potential loan customers to apply for an aircraft loan over the Internet.[18] Colonial envisages Internet sites which will provide a full range of financial services. Systemic stability may be put at risk if theses services are provided by non-prudentially supervised institutions in Australia. Consumer protection regulation might also be just as easily by-passed.

Colonial's concern is not about maintaining local monopolies, but about protecting consumers and the stability of our financial system. It also wants to ensure competitive neutrality. It is important that overseas suppliers of financial services are subject to the same regulation as applies to local providers of both regulated and other promises. As indicated by Richard Dale:

> "Systemic risk may be increased through contagious financial disorders originating in poorly regulated financial centres, depositors/investors/ counterparties may be exposed to foreign jurisdictional risks which they are not in a position to monitor or control; and the co-existence of uneven national regulations and global markets may severely distort competition between financial institutions."[19]

We recognise that to regulate the Internet will be potentially extremely difficult. Nevertheless, regulators in Australia need to seriously address this issue, and where necessary will need to consider to what extent consumers can be educated as to the potential risks, and how multilateral agreements can be put in place globally to address the issue.

5.5 Privacy and Trade Practices Act

5.5.1 Description of issue

Increased use of electronic delivery for financial services is likely to heighten concerns about protecting consumers' rights to privacy. At the same time,

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18 James Dyer and Jay Hartzell, The New Electronic World of Non-Banking: The Role of the Internet, The University of Texas, Spring 1996, p8.

19 Richard Dale, "Regulating the New Financial Markets," March 1996, p11.

competitive pressures and greater customer service expectations will underscore the need for financial service providers to develop much better on-line customer information files. In such an environment, it will be incumbent on legislators to strike a balance between responding to legitimate privacy concerns, providing some degree of consumer choice and ensuring the flow of information necessary for the efficient delivery of customer services.

The Privacy Act 1988 (Cth) very severely restricts the circumstances in which a credit provider, may disclose personal information about an individual. The restrictions apply not only to the disclosure of a credit report, but extend to *any other record or information, whether in a written, oral or other form, that has any bearing on an individual's credit worthiness, credit standing, credit history or credit capacity*. It is one thing to argue that insurers should not obtain credit assessment reports for insurance purposes, or that employers should not have access to those reports in order to assess employment applications. It is quite another matter, however, to enact legislation preventing the use of information for marketing, research and planning purposes, when the customer has consented to that use.

5.5.2 Impact on Colonial of proposed amendments to the Privacy Act

Recommendation 20 — *To reduce compliance costs and promote national consistency, Colonial supports the introduction of a national uniform code on privacy, to replace existing State and Federal regimes that conflict and overlap.*

Recommendation 21 — *Legislation should be enacted that will enable entities in the same corporate group to share customer information unless the customer specifically requests otherwise.*

Colonial and the State Bank are introducing a procedure under which customers will be able to give their consent to the sharing of certain information within the Colonial Group. A proposed amendment to the Privacy Act, if enacted, would severely limit the use by an entity within the Colonial Group of any customer information gathered by another entity. If the proposal was implemented now, Colonial would not be permitted to use the information for marketing or profiling purposes.

Another proposed amendment calls for a penalty of up to $30,000 for knowingly or recklessly contravening the provision. The maximum penalty is disproportionate to any possible harm that could be done if an organisation was to use information for research and marketing and which has been approved by the customer.

A number of Commonwealth and State laws now govern the right of consumers to privacy. These include the Commonwealth Privacy Act 1988, Victorian, Queensland and South Australian legislation and the ACT Fair Trading Act 1992. Colonial believes that a coherent national approach to privacy regulation, based on co-operation between Federal and State governments, is critical. It will ensure a consistent approach to privacy is taken nationwide and simplify the compliance process.

It is critical that a natural privacy framework be introduced, and that it enables the sharing of appropriate customer information across the same financial services group, unless the customer specifically requests otherwise.

5.5.3 Trade Practices Act and Third Line Forcing

Recommendation 22 *To increase competition and allow consumers to benefit from lower effective prices, Colonial supports amendments to the third line forcing provisions of the Trade Practices Act so that third line forcing would only be illegal where it substantially lessened competition.*

The Trade Practices Act prohibits certain exclusive dealings, regardless of their effect on competition, and third line forcing is one type of exclusive dealing that is subject to this outright prohibition. Other types of exclusive dealing are only prohibited where they substantially lessen competition, full line forcing being one.

Full line forcing involves two products and two parties (the customer) and one supplier), where the first product is only offered or supplied on condition that the second product is taken from the same supplier. Third line forcing involves two products and three parties (the customer and two separate suppliers), where the first product is only offered or supplied on condition that the second product is also taken from a separate supplier.

Having different rules for the full line forcing and third line forcing is illogical within a financial services group, because the law differs depending on whether a business operates as a single company with separate internal divisions (full line forcing), or as a corporate group that divides operations into separate legal entities (third line forcing). If effective control is the same regardless of whether divisions or separate legal entities are the style, it is anomalous to have one rule for the former and a different rule for the latter.

In industries where competition is healthy, businesses will only succeed in convincing customers to buy forced products (third line or full line) if the customer obtains clear benefits from doing so - such as lower effective prices, the convenience of one liaison point for several products, and an increased range of product options.

5.6 Payments system access

5.6.1 Description of issue

Colonial believes that stability of the financial system should take precedence over any desire to increase unrestricted competition. Systemic stability is best achieved by restricting access to the payments system to institutions which are prudentially regulated. With the introduction of technology such as smart cards, non-prudentially supervised institutions can potentially gain access to the payments system. Although use of smart cards, for example, is unlikely to create systemic risks, they may adversely affect consumer confidence in the system.

5.6.2 Access to the settlements system & RTGS

Recommendation 23 *It is Colonial's view that access to the settlement system and Real Time Gross Settlements should be restricted to holders of a banking licence.*

The payments system, the network which interconnects banks and financial institutions, plays a pivotal role in the overall functioning of the banking system. According to Richard Dale:

> "Given this pivotal role, payment and settlement systems provide an early channel for the dissemination of systemic crises which may typically be triggered and spread by failure to settle obligations"[20]

Consequently, the integrity of the payments system is inextricably linked to systemic stability.

A major objective of central banks is to eliminate, to the extent possible, systemic risks associated with payment systems. Access, moreover, is an important element of risk control. In the case of banks, the Reserve Bank's prudential regulation is clearly designed to mitigate this risk and maintain confidence in the payments system. Colonial believes existing arrangements which limit access to the settlement system through banks are appropriate as:

- introduction of non-banks into the payments system may undermine existing controls on systemic risk;
- the system is working well, with a history of payments stability and non financial institutions getting access to the payments system through arrangements with the banks;
- while technology improvements means systemic risk may be lessening, a reasonable degree of risk remains; and
- only banks can raise a large amount of liquidity in a short amount of time, if necessary, which is a key factor in the ability to process unexpected third party debts.

Although the introduction of real time gross settlements (RTGS) eliminates certain risks associated with the payments system, technical and credit risks remain. Moreover, only high value Australian dollar payments will be settled

20 Dale, op. cit., p19.

through RTGS, with a third of domestic payments still settled on a deferred basis, including low value payments and cheques. Lastly, expected coordination of RTGS across national borders to reduce Herstatt risk (the risk that one party to a foreign exchange deal may pay irrevocably on one leg of a transaction before it has received funds from the other leg) is likely to be restricted to those sponsored by its operators—in Australia's case, the Reserve Bank. Limiting access to RTGS to holders of banking licences will assist and may be a prerequisite for international convergence of real time gross settlement systems.

5.6.3 Direct access to clearing systems

Recommendation 24 *Direct access to clearing systems such as EFT should be available to those prudentially regulated financial institutions meeting the technical and administrative criteria.*

Institutions not holding a banking licence, while not meeting the criteria for access to the settlements system, should still have direct access to some clearing systems, e.g. electronic funds transfer. Access at this level would require a high level of technical and administrative standards, and also a high level of prudential standards, as a failure by an institution at this level could have significant effects on the payment system as a whole.

5.6.4 Other emerging payment systems

Recommendation 25 *Regulatory authorities should monitor and actively prevent circumscription of the current restrictions on payment system access through use of new technologies (e.g., stored value cards, sophisticated selling systems).*

A number of products are being developed which can potentially bypass the system if they are provided by non-prudentially supervised institutions. Although these developments may not pose *systemic* risks as such, they may adversely affect consumers and consumer confidence in the stability of the financial system in the event of institutional failure. Examples of this include stored value cards which are now being trialed by four separate groups in Australia and are expected to be in public use within the next few years. The unrestricted provision of stored value cards could impose risks on both sides of the transaction if a non-regulated provider fails, as both customers and retailers involved in a transaction stand to lose their money.

The advent of stored value cards also raises policy issues as to whether cash reserves should be maintained by issuers against the "electronic cash" they have issued and the status of their promises to pay. Regulators will need to be vigilant in ensuring that electronic cash is not employed to evade the Cash Transactions Reporting Act. Regulatory policy will be under increasing pressure to respond to these issues as the technology becomes more prevalent.

The billing systems of public utilities and major retailers are another example of technology potentially capable of bypassing the system. The capability exists for these companies to extend their billing systems to become an extended payments system, and ultimately a means to provide customer credit. Unless these companies are obliged to conform to legislation pertaining to other financial institutions, their involvement could potentially disadvantage customers and create an uneven playing field. For example, if they were to provide credit, it follows that they should be subject, as would any other credit provider, to the Consumer Credit Code.

If these companies establish reciprocal arrangements with international companies, they could become part of an international payments system. Risks might arise if either their partners are not prudentially supervised or if they are able to escape the cash reporting requirements of AUSTRAK, the body responsible for monitoring international transactions to prevent money laundering and other illegal activities.

5.7 Depositor protection

5.7.1 Description of issue

At present, the Reserve Bank of Australia (RBA) is charged by legislation with responsibility for protecting bank depositors. The RBA has the responsibility of prudential supervision of the banks. If it believes depositors' funds are at risk in any bank, it has the power to take over its management. The law also provides that if an Australian bank fails, the depositors are preferred creditors with the first call on assets.

5.7.2 Maintenance of current depositor protection

Recommendation 26 *Colonial supports the maintenance of the current depositor protection arrangements. It also supports new institutions entering the deposit taking market, provided they satisfy the necessary requirements for a banking licence.*

The existing depositor protection arrangements and the restrictions on the range of institutions which can issue deposits should be maintained, based on the need for confidence and stability in the banking system.

Colonial believe this is appropriate because:

- depositor protection helps ensure a safe and convenient form of investment for small savers, as risk averse individuals need freedom of choice to put their money into almost risk-free investments;
- depositor protection also provides an efficient means by which depositors can avoid the need to evaluate the quality of the assets held on a bank's balance sheet;
- it enhances the efficiency of the payments system by helping sellers of goods verify that buyers can make good on promises to pay;
- the alternative of providing formal deposit insurance is potentially more costly to the consumer and may not be as effective as regulatory depositor protection.

5.8 Capital adequacy for life insurers

5.8.1 Description of issue

The impact of unnecessarily high reserving requirements for the life insurance industry is an issue with far reaching financial consequences. There is a substantial cost in providing additional capital to support liabilities.

Already, there are clear indications that the higher capital requirements are forcing companies to make decisions, which disadvantage policyholders, such as changing asset allocations to less volatile investment classes with lower expected investment returns and less attractive long-term benefits to policyholders. Similarly, product structures and crediting methodologies are being modified in response to the proposed capital requirements.

These changes will pass the increased costs to policyholders in the form of lower benefits. Colonial believes that a comparison of the life industry capital standards with those adopted internationally will show that Australia is adopting a more conservative approach which will disadvantage our industry.

5.8.2 Capital adequacy for life insurers

Recommendation 27 *Although welcoming recent concessions by LIASB, Colonial believes the Life Insurance capital adequacy standards are not commensurate with the risks such capital is required to support. The introduction of the new Life Insurance standard should be delayed until:*

- *an analysis comparing Australia's standards with international standards has been undertaken; and*

- *the other findings/recommendations of the Wallis Inquiry have been released to ensure consistency in approach.*

Colonial also supports a periodic review of Life Insurance capital adequacy requirements to take into account improvements in risk management techniques and international trends.

Recommendation 28 — *The capital adequacy standards for Life Insurance companies should reflect a greater reliance on risk management and monitoring techniques for asset and liability mismatch and market risks.*

While supporting LIASB's general methodology and acknowledging their recent concessions, Colonial believes that capital adequacy standards to apply from the end of 1996 are still too conservative. In light of increasingly sophisticated risk management techniques flowing from the greater use of advanced technology and financial derivatives, Colonial does not believe the standards reflect the industry's underlying risk. The proposed standards are determined on a basis which provides a higher level of security than policyholders should reasonably expect, resulting in an unnecessarily high capital requirement.

Decisions as to the appropriate reserving standard must balance professional judgment with commercial reality, and inherently trade off risk and return. However, if the capital levels required are not commensurate with underlying risk, making life products excessively costly, investors will redirect their money elsewhere. This has the consequence in turn of reducing consumer choice as providers progressively withdraw uncompetitive life products.

Colonial is not convinced that the proposed requirements are consistent with the standards of prudential risk accepted in other economies. For Australia to remain competitive internationally, it is critical that its life industry capital adequacy standards are consistent with those adopted internationally. Until these comparisons are better understood, Colonial believes that adoption of the proposed capital adequacy standards should be deferred. Deferral will also allow standards to be developed in a fashion consistent with other potential findings of the Wallis Inquiry.

We also believe the approach taken in respect of capital adequacy pays insufficient regard to the effectiveness of internal controls that management might have in place to address issues such as asset and liability mis-matching, which may work to limit the overall level of prudential risk. It may be that in some circumstances more effective risk management is a preferred and less costly alternative to simply requiring more prudential capital.

In summary, capital adequacy requirements should reflect the underlying risk of the life insurance industry and should be reviewed regularly to take into account improvements in risk management techniques. As with disclosure, the cost of capital adequacy is borne ultimately by the consumer, and as such there needs to be an appropriate compromise between ensuring high levels of policyholder protection and the cost of providing such protection.

Finally, as global competition becomes a reality, Australia's standards will need to be consistent with international levels if it is to be competitive internationally.

5.9 Life insurance reporting standards

Recommendation 29 *The differences between the accounting standards proposed for the Life Insurance industry by the Australian Accounting Standards Board and the ISC should be resolved such that a common set of reporting standards apply in the industry.*

In addition to the Insurance and Superannuation Commission's review of life insurance reporting standards, the Australian Accounting Standards Board (AASB) is charged with the task of developing a life insurance accounting standard that ensures that life insurance financial statements are "true and fair".

Life insurers are currently exempted from general purpose financial reporting by virtue of the Corporations Law on the proviso that they furnish financial information in accordance with the Life Insurance Act, i.e. the ISC reporting framework. With the introduction of a life insurance accounting standard, the exemption will be removed and life insurers will be required to produce general purpose financial accounts in accordance with that standard. Certain information will continue to be reported to the ISC.

In terms of reporting consistency, there are still some unresolved differences between the AASB Exposure Draft and the current ISC reporting framework as summarised in Table 6.

Table 6 Potential Differences in Reporting Frameworks

Issue	AASB Stance	ISC Stance
Revenue	Risk premiums and expense charges only	All premiums treated as revenue
Bonuses	Expensed	Appropriation of profits
Policy liability valuation	MoS is acceptable	MoS is mandatory
Treatment of policyholder funds not yet invested	Liability	Liability and equity
Valuation of investments in controlled entities	At net market value	At net market value for life insurance controlled entities, but NAV for other controlled entities
Consolidation	Consolidation of statutory funds	Non-consolidation of statutory funds

It is simply not logical for the life insurance industry to have to report under two different reporting frameworks and every effort should be made to prevent this from happening.

5.10 FID/Debits tax and stamp duties on life insurance

5.10.1 Description of issue

The tax regime of Financial Institutions Duty (FID) and Debits tax for banking and stamp duties for life insurers impose taxes on transactions. Transaction taxes distort consumer choice, financial transactions and resource allocation and are an inefficient way of raising revenue. According to a Coopers and Lybrand report on FID and Debits tax:

> "FID rates poorly against all five tax assessment criteria for either business or individuals; FID is inequitable, it is inefficient, its revenue base is unstable and it is not simple to administer."
>
> "Debits tax performs poorly in four of the five assessment criteria. Debits tax is inequitable and inefficient. Its revenue base is unstable."[21]

Transaction taxes are inefficient and distortionary because they discourage switching funds to alternative investments offering superior returns and encourage inefficient 'packaging' of products to avoid transaction taxes. They

21 Coopers & Lybrand, Financial Institutional Duty and Debits Tax: Constraints on Australia's Future in the Global Financial Market, March 1996.

also inhibit the proper functioning of the payments system by discouraging the move from less efficient paper to electronic transactions.[22]

Transaction taxes are also inequitable, because they are likely to represent a greater proportion of low income earners. For example, Debits tax makes bank accounts with cheque access expensive for low income earners. The revenue base is unstable as mobile, price-sensitive funds seek to avoid exposure to FID by banking in tax free or lower tax jurisdictions (as witnessed by shift of funds to Queensland to take advantage of its concessional FID regime). Similarly, with the growing integration of the global financial market, transaction taxes may disadvantage Australia's international competitiveness as a location for financial services activities by driving transaction banking offshore.

FID / Debits tax is also difficult to administer and is likely to become increasingly so as electronic transactions, which make it difficult to determine where a transaction occurs, replaces paper. A characteristic of an efficient tax is that it has relatively low compliance costs. Experience has shown that the FID / Debits tax have high compliance costs. Finally, FID / Debits tax creates confusion among customers, who often do not distinguish bank charges from taxes.

5.10.2 FID/Debits tax abolition

Recommendation 30 *The Government should abolish FID/Debits tax, as well as stamp duties on life insurance as part of the broad tax review. Short of this, current attempts to harmonise the tax treatment of financial transactions at the State level should be accelerated.*

Colonial believes that the overall objective of any taxation reform should be to achieve a more consistent and simple approach across all product types and to keep compliance costs to a minimum.

The Government should abolish FID / Debits tax, as well as stamp duties on life insurance as part of the broad tax review. Short of this, existing attempts to harmonise the tax treatment of financial transactions at the State level should be accelerated.

22 FID's ceiling rate for a minimum transaction size encourages the amalgamation of small paper based transactions to reach the threshold size. As this cannot be done with electronic transactions, FID provides a disincentive for this kind of transaction.

APPENDIX

Inquiry into the Financial System

Terms of Reference

Mission

The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.

Specifics

1. The Inquiry will report on the results arising from the financial deregulation flowing from the Inquiry into the Australian Financial System ('Campbell Report') published in 1981. This will involve examining and reporting the consequences for:
   (a) the choice, quality and cost of financial services available to consumers and other users;
   (b) the efficiency of the financial system including its international and domestic competitiveness;
   (c) the economic effects of deregulation on growth, employment and savings;
   (d) the evolution of financial institutions and products offered by them and the impact on the regulatory structure of the industry.
2. The Inquiry will identify the factors likely to drive further change including:
   (a) technological and marketing advances;
   (b) international competition and integration of financial markets;
   (c) domestic competition in all its forms;
   (d) consumer needs and demand.
3. The Inquiry will make recommendations on the regulatory arrangements and other matters affecting the operation of the financial system (including prudential and other regulations made by the Reserve Bank and other bodies) as will:
   (a) best promote the most efficient and cost effective service for users, consistent with financial market stability, prudence, integrity and fairness;
   (b) ensure that financial system providers are well placed to develop technology, services and markets and that the financial system regulatory regime is adaptable to such innovation;
   (c) provide the best means for funding the direct costs of regulation;
   (d) establish a consistent regulatory framework for similar financial functions, products or services which are offered by differing types of institutions.
4. The Inquiry in its consideration of financial system regulation may not make recommendations on, but will take account of:
   (a) the objectives or procedures of the Reserve Bank in its conduct of monetary policy;
   (b) retirement incomes policies;
   (c) the regulation of the general operation of companies through corporations law;
   (d) policies for the taxation of financial arrangements, products or institutions.
5. In carrying out its investigations, the Inquiry may invite submissions and seek information from any persons or bodies.
6. A final report is to be provided to the Treasurer no later than 31 March 1997.

The Colonial Group

Colonial is one of Australia's leading financial institutions, with strong market positions in banking, life insurance and funds management, and substantial offshore operations in the United Kingdom, Asia Pacific and New Zealand. It is a broad-based financial services organisation with operations in virtually all segments of the financial services industry and has a corporate goal of the seamless provision of financial services. It is well placed to provide views on the range of matters covered by the Inquiry's terms of reference and to make practical recommendations designed to ensure an effective and efficient system of financial regulation. Colonial is a member of the ABA and LISA and has sought to complement the submissions of those organisations by focusing on what it sees as the key issues and where it can add value to the Inquiry.

Colonial.

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