1. The need for change

Effective regulation and competition in the financial market is a key ingredient in creating an environment that gives confidence to Australia's consumers and contributes to future growth and rising living standards. Importantly for Australia at this time it is also a factor if we are to address our national savings problem, particularly the decline in household savings over the last two decades.

The Treasurer has acknowledged that taxation is an important aspect that the Inquiry will need to take account of, although the issue of the taxation of savings is outside the terms of reference of the Inquiry, and therefore has not been addressed in this submission. Nonetheless, addressing the taxation issues could have a greater impact on national savings than changes in the regulatory environment and competition policy, important as these are.

The Inquiry is an important opportunity to take stock and to act to shape the regulatory framework for the future. It is timely because of the substantial changes that have occurred in the Australian financial system in the last decade. These changes have in part been driven by the globalisation of financial markets and in part by the structural changes that have taken place, and continue to take place, throughout the Australian economy.

It is important to acknowledge that Australia's regulatory system and competition policy framework - the subject of the Inquiry - have not been static in the years since the opening of the Australian economy through deregulation in 1983.

During this time, prudential and consumer protection regulation have been strengthened and there have been major developments in achieving a national competition policy. It is against this background that the Inquiry will make its recommendations.

With the benefit of hindsight, one of the important lessons of the 1980s was that we should be proactive in anticipating change, rather than reactive. For example, the consequences of the collapse of the Pyramid Building Society and the state banks may have been averted if supervision by the Australian Financial Institutions Commission or the Reserve Bank of Australia had been in place.

This submission responds in most detail to the terms of reference relating to the effectiveness, cost, and efficiency of regulatory arrangements.[1] The economic impact of deregulation has been previously well analysed by others, notably Macfarlane (1991)[2] and Argy (1995).[3]

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[1] The terms of reference are set out in Appendix 1.

[2] Macfarlane, Ian (ed.) (1991) *The Deregulation of Financial Intermediaries* Proceedings of a Conference, RBA, Sydney.

[3] Argy, Fred (1995) *Financial Deregulation: Past Promise, Future Realities*, Council for the Economic Development of Australia, Research Study P42, 1995.

The factors driving change in the financial system are discussed in some detail in this submission, as these provide support for the recommended changes to regulation and competition policies.

The recommendations to the Inquiry have been framed with the following broad objectives in mind:

- consumers should have confidence in the financial system, and be able to make informed choices based on meaningful information;

- the stability of the financial system should be maintained;

- the financial system should be efficient, so that resources are allocated to sectors of the economy that contribute most to economic well-being; and

- competition in the financial sector should be improved.

The desirable outcome of the Inquiry will be to arrive at recommendations that are practical solutions to both current and anticipated problems, and where the benefits of change can be demonstrated.

To provide additional technical support for our submission, AMP commissioned three research papers:

- the first, by the Monash University Centre for Electronic Commerce, assesses the regulatory issues that arise from future developments in electronic commerce;

- the second, by Coopers & Lybrand, compares the capital adequacy regimes governing banks and life offices to demonstrate the potential for regulatory arbitrage; and

- the third study assesses in detail the potential impact of the removal of the prohibition on mergers of the six largest financial institutions on competition in the financial market.

The first two studies will be lodged as separate technical submissions to the Inquiry. AMP is finalising work on the third study; it will be made available shortly.

An overview of AMP is shown in Appendix 2.

2. Features of the Australian financial market

There have been a number of factors that have driven change in financial markets on a world-wide basis since the early 1980s including:

- deregulation, including the shift from fixed exchange rates;
- globalisation of capital markets, largely with impacts on wholesale markets rather than the flow of retail funds;
- technological advances, creating innovation in products and the means of distribution of those products;
- disintermediation, through direct and joint venture investments;
- consumerism, supported by the advances in technology and the enhanced competition from new market entrants; and
- securitisation, most notably in mortgage lending.

The most important influence driving further changes in the financial system will be the potential created by technological advances enabling innovation and an increase in so-called "electronic commerce".

It is worth noting also that those organisations that respond to or anticipate customer needs will have the greatest success in coming decades. Customers are likely to become more sophisticated, and better able to demand the service they expect.

Customers have embraced new technologies with enthusiasm. In Australia EFTPOS transactions increased annually by 41 per cent from 61,000 to 340,000 between 1990 and 1995.[4] The proportion of sales achieved via telephone also has been steadily increasing. The benefits to customers of this technology have been new, more accessible and often speedier avenues for financial transactions and distribution, and at a lower long-term cost.

In Australia, the ageing of the population will lead to more people in the retirement market with greater assets at their disposal, particularly as the "baby boomer" generation reaches pensionable age and as retirement income policy continues to focus on self-funded retirement.[5]

Further, ongoing changes to taxation, social security and retirement income policies will require people to make increasingly complex decisions about their financial future.

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[4] Compound annual growth rate, compiled from AMP research.

[5] The proportion of the population over the age of 65 is expected to increase from 11.2 per cent in 1990 to 13.3 per cent in the year 2010 and 19.1 per cent in 2030, according to figures from the Economic Planning and Advisory Council.

The impact of these developments is reflected in the changes that have taken place in Australia's financial institutions.

As in the rest of the world, financial institutions have diversified away from their traditional product base, with the result that conglomerates (both large and small) usually combine two or more of banking, insurance and securities businesses. This so-called convergence has also contributed to the blurring of distinctions between products as financial institutions seek the most favourable regulatory environment in which to offer particular products. Appendix 3 sets out the level of financial system assets now held by major institutions in life insurance, superannuation and deposit-taking (Australian funds under management).

The most significant growth in Australia has been in the managed funds area, most recently in superannuation. Not only has this displaced the traditional savings business of life offices, but banks have been able to actively increase their share of this market through their life and funds management subsidiaries.

The banking sector increased its superannuation assets from $243 million to $13.8 billion between 1986 and 1995. This is an increase from 1.23 per cent to 17.7 per cent in the banks' share of total superannuation assets, as shown in detail in Appendix 4. The sector's growth in the single premium life insurance market has been just as dramatic, rising from 6.5 per cent to 40.8 per cent of the market in the same period.[6]

Australian institutions are today competing actively against foreign-owned companies in the domestic market. Of the 30 largest financial institutions in Australia today, almost half are foreign-owned. Together, their assets under management total $139 billion, or 21 per cent of the assets held by the top 30 institutions in the Australian market.[7] Bankers Trust is now Australia's sixth largest financial conglomerate, and Australia's largest retail fund manager.[8]

While these foreign firms were initially most active in the expanding funds management and wholesale markets, they are now actively participating in the retail sectors of banking and insurance. The foreign-owned institutions account for around a third of total life insurance and superannuation assets, as shown in Appendix 5.

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[6] ISC returns 1990 to 1996.
[7] Council of Financial Supervisors (1995) *Annual Report.*
[8] As at April 1996.

AMP has responded to these developments with an expansion in its business operations, as shown in Appendix 6.

Ten years ago, AMP's competitors were life offices similar to itself; companies such as National Mutual, Colonial and MLC. Today its competitors range across the large and small specialist market participants, including the major banks, a major world scale competitor in Axa as the parent of National Mutual,[9] Bankers Trust, NM Rothschild Australia, and Citibank (who have been one of the most successful new foreign entrants in banking, life insurance and funds management, operate in 96 countries, with domestic scale in many of them).

AMP's competitors in the future could be expected to be even more diverse. They will include the banks and mortgage originators, but also communications companies such as Telstra, world financial conglomerate GE Capital, funds manager Fidelity, and utilities and software corporations.[10]

2.1 Future changes: the impact of technology

Advances in communications, computer and network technologies are driving change in the key areas of payments and transaction processing; and in the distribution of financial products and services. Technology also affects the nature and level of competition in the financial services industry. Competition in financial markets will be intensified in future by new entrants to the market, through an expansion in the channels of distribution and a lowering of the costs of distribution.

The regulatory issues that arise from developments in electronic commerce are reviewed in the research paper prepared by the Centre for Electronic Commerce research, to be submitted to the Inquiry. The following discussion includes some of its findings.

2.1.1 Transactions

Direct telephony, EFTPOS and ATMs will continue to transform financial transactions, as technology creates more rapid and diversified variants of existing services. ATMs, for example, are expected to become full-service financial kiosks available at non-financial outlets, such as supermarkets. Home telephones will interact directly with providers' computers once interactive voice response technology becomes available.[11]

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[9] Axa is among the world's top 10 life insurers, with $369 billion in assets worldwide.

[10] Fidelity recently announced it was seeking to enter the wholesale funds market in Australia, and use Australia as a base for the Asia-Pacific market (*Australian Financial Review*, 14 August 1996).

[11] See the Monash University's Centre for Electronic Commerce Research Paper, *Regulation Issues that Arise from Technology Trends in Electronic Commerce*, submitted to this inquiry.

The impact of new electronic payment instruments as they emerge is expected to be substantial. The most revolutionary are forms of electronic money and stored value cards.

- Electronic money is likely to be available as “e-cash” or electronic tokens transmitted via the Internet and other networks.

- Stored value or “smart” cards will allow cash to be stored on a plastic card. This process is currently used in closed systems, where defined value is provided for a specific service, such as in transport and phone cards. New open systems are being trialed in Australia, where providers issue reloadable amounts of cash on a card which is then used in various retail outlets. Smart cards will eventually be used in tandem with any chip-driven devices such as home computers, personal organisers and “smart” telephones. They will also become multi-function cards, used as a debit, credit and stored value system.

At the same time, a secure transfer system is being developed, called secure electronic transactions (SET), and is expected to be available in Australia in early 1997. SET will “quickly ‘kick-off’ an increase in credit card payments over the Internet”. [12]

2.1.2 Product distribution

Technology is expanding the avenues available to financial institutions to distribute their products and services, and decreasing the need for intermediaries in some circumstances. It is also broadening access for consumers and increasing the means of distributing information.

The Internet provides greatest potential for innovation in products and services. It not only allows the rapid, widespread and cost-effective dissemination of information, it can enable sales to be conducted directly. Most major Australian financial institutions already have a site on the world wide web, although these act mainly as billboards at this stage. Companies can provide information and prices for different products, and also place on-line analysis tools for people to permit a simple evaluation of their financial position.

[12] The Centre for Electronic Commerce paper describes the credit card SET-based system as the first real solution to problems posed by electronic money, p. 10.

As a worldwide network, the Internet enables customers to access information about overseas firms, and to purchase services. This raises the issue of how the distribution, delivery and payment of services occurring across national borders can best be regulated. According to a Washington-based researcher: "All regulators cited here express bewilderment at how they will adapt the current geographically based regulatory structure to a world where Internet transactions cross international and state boundaries."[13]

The Centre for Electronic Commerce report concludes that the regulatory challenges raised by information technology are global, and therefore an Australian approach will need to be developed within a global perspective.[14]

2.1.3 Penetration

The speed with which advances in technology are adopted in the marketplace is crucial i.e. its usage by the average consumer. Sales of home computers and modems and awareness and usage of the Internet, suggest that customers may be ready to use the computer for a broader range of purposes.[15]

Already more than a million Australians regularly use the Internet and more than one in 10 people aged over 15 years access the Internet for an hour a week.[16] The views of businesses also point to growing future use of the Internet. Most of the 5680 Internet users surveyed by research firm www.consult said they were willing to try on-line banking and shopping, with Visa and Mastercard being their preferred Internet payment method.[17] Twenty per cent of chief executives have also said they believed the Internet was useful for winning new business.[18]

2.1.4 New entrants

By reducing costs and creating direct distribution channels for financial products, technology may add potential for new entrants in the financial market.

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[13] Gora, Jean (August 1996) "What's New in CyberTalk", on www.loma.org/cyber.htm.
[14] ibid, p. 21.
[15] Ownership of home computers increased from 40 to 46 per cent and modems from 6 to 10 per cent between February and August 1995 according to research by Keig & Co, (August 1996) *New Media & Technology Monitor*, reported in *The Australian Financial Review*.
[16] According to a Telstra survey of 1000 households in April 1996, as reported on www.Telstra.com.au, 14 June 1996.
[17] *The Bulletin*, 20 August 1996.
[18] The national survey by Frank Smithers and Associates polled 348 members of The Executive Commission.

New entrants will include direct distributors that use technology as their chief means of distribution. Most importantly, technology will enable entry by non-financial companies -- postal and utilities companies that have a broad customer base, software suppliers that already have links with financial services, telecommunications companies that have the infrastructure for future electronic commerce, and retailers who will be building broader relationships with their customers.

Overseas this is already occurring. In the UK, the retailer Marks and Spencer and Virgin Direct (originally a music distributor and airline business) are offering financial services.[19] Other examples include General Electric, the Ford Motor Company, General Motors and IBM in the Unites States. In Australia, Telstra and General Motors already have credit cards issued through arrangements with banks.

Developments in technology such as the Internet will also shape opportunities for globalisation of financial services, in the sense of being able to "export " across national boundaries and into the Australian market place. This is in contrast to much of the globalisation in the last decade which has occurred with major world-wide financial institutions establishing physical operations in a number of countries.

2.2 Conclusion and recommendations

The challenge facing policy makers will be to shape a regulatory and competition policy environment that adequately meets the needs of industry and consumers alike. At the same time, the framework will need to be sufficiently flexible so that it can continue to be relevant as technology changes the ways in which customers and financial institutions interact, and so that it is able to accommodate likely innovation. Importantly, adequate resources should be provided to ensure that Australian regulators work with other regulators internationally towards establishing global standards for electronic commerce.

[19] AMP is a joint venture partner with Virgin Direct.

3. The Regulatory Framework

Australia's regulatory authorities in the financial system are the:

- Reserve Bank of Australia (RBA);
- Insurance and Superannuation Commission (ISC);
- Australian Financial Institutions Commission (AFIC); and the
- Australian Securities Commissions (ASC).

Together these authorities form the Council of Financial Supervisors (CFS), established with the aim "to enhance the quality of financial supervision and regulation in Australia".[20] In addition the Australian Competition and Consumer Commission (ACCC) has responsibilities for the conduct of competition policy as well as responsibilities for fair trading in the financial sector, as it does in all sectors of the Australian economy.

The Inquiry's terms of reference direct it to make recommendations on future regulatory arrangements for the financial sector. Overall, Australia's regulatory system is serving the participants in the financial market well but there are ways it can be substantially improved.

Changes are required to both the system of prudential regulation and to the regulatory arrangements that protect consumers by ensuring fair trading in financial markets. The key benefits of these changes would be fewer regulators as well as the development of appropriate regulatory arrangements that minimise arbitrage, duplication, inconsistencies and gaps that are features of the current system. Rationalisation, simplification and the development of a best-practice standard of consumer protection that balances consumers' rights, benefits and industry compliance costs could achieve a more effective and less costly system.

3.1 Prudential Regulation

Prudential supervision aims to ensure the soundness of financial institutions and is, by its nature, institutionally based. Such regulation can be distinguished from other regulation, directed more towards the integrity and even handedness of financial markets and products.

There are two substantive issues for reform of prudential arrangements. These are the regulation of financial conglomerates, and the related issue of the need to address regulatory arbitrage.

[20] Council of Financial Supervisors (1995) *Annual Report*, p. 5.

3.1.1 Financial conglomerates and supervision

Financial conglomerates, largely banking or insurance groups, dominate the Australian financial system. According to the CFS, "financial conglomerates are a major feature of the financial landscape, both in Australia and overseas".[21] About 70 per cent of the total assets of the Australian financial system are controlled by the 30 largest groups, with the 10 largest accounting for about 50 per cent.

There has been a great deal of work by bank, insurance and securities regulators in Australia and overseas on the appropriate arrangements for the supervision of financial conglomerates.[22] The principal concern for the supervisors of financial conglomerates combining banking insurance and securities business is that of managing contagion risk, so that failure in one part of a conglomerate does not spread to the entire organisation.

In Australia this issue, among others, is being addressed through the operations of the CFS. The Martin Committee (1991) recognised that "the continuing trend within the financial system for the creation of financial conglomerates creates a need for closer coordination between the various supervisory organisations".[23] The CFS was established in late 1992 following the committee's recommendation.

The CFS has focused on the problem of multiple regulators for financial conglomerates, where most large conglomerates are regulated by two or more supervisors in addition to the Australian Competition and Consumer Commission. The CFS has developed principles for supervising conglomerates as well as encouraging co-operation among regulators involved with the group's separate businesses.

A gap identified by the CFS in the current arrangements is the treatment of (non-trading) financial holding company structures. There are currently no provisions for direct regulation or supervision of financial holding companies. Internationally, the trend to conglomeration has been accompanied by an increasing incidence of holding companies across these structures.

Until now most Australian conglomerates have been headed by a bank, life office or other financial institution. (The sole example of a non-financial institution holding company is Lend Lease Corporation which owns MLC and a building society).

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[21] op cit, p. 26.

[22] The Tripartite Group of Bank, Securities and Insurance Regulators, an international committee of regulators set up to look at the conglomerate issue, discussed the issue of prudential regulation for holding companies and their subsidiaries. It was particularly concerned with how to ensure adequate prudential supervision of conglomerates across the whole of their organisations.

[23] House of Representatives Standing Committee on Finance and Public Administration (1991) *A Pocket Full of Change: Banking and Deregulation* (Martin Committee) AGPS, Canberra, p. 233.

Government policy on the ownership and control of banks, has resulted in groups containing an Australian-incorporated bank acting as the holding company of the group (with main exception being the ownership of the State Bank of NSW by the Colonial Mutual Group). This policy reflects the RBA's preference to have the supervisory responsibilities over the controlling entity in any conglomerate which includes a bank.

The CFS has recently proposed to the Government a framework for the effective supervision of conglomerates headed by special purpose holding companies, including a formally nominated lead regulator. In a recent speech, Deputy Governor of the RBA Mr Graeme Thompson said this regulator would oversee and regulate the holding company; disseminate information collected from the holding company to other agencies; and co-ordinate supervisory responses to any problems involving or potentially involving more than one entity in any group.[24] These arrangements also could be suitable for other financial conglomerates, he said.

AMP would welcome the opportunity to discuss the CFS recommendations in detail during the course of this Inquiry, given that they will involve measures to assess capital adequacy across the group (including avoiding double counting), intra-group exposures and the extent of any firewalls and transparency of the group structure.

The ISC, in its submission to the Inquiry, has advocated an approach described as "specialised solo supervision plus a layer of group supervision." They propose this lead supervisor model for prudential supervisors (alongside the separation of consumer protection and prudential functions of each of the existing regulators).[25]

The ISC model envisages bringing the supervision of credit unions and building societies within the responsibilities of the RBA, subject to the agreement of state governments who currently have oversight through AFIC. There is little basis for the continued distinction between bank and non-bank deposit taking institutions.

Deposits with banks, building societies and credit unions are all perceived to be the "safest" products on the risk spectrum and are subject to similar prudential requirements. Data from the RBA shows that the average risk-weighted capital ratio for building societies and credit unions of 14 per cent is above that for banks, that is, 11.5 per cent.[26]

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[24] Thompson, G.J. "The Wallis Inquiry: Perspectives from the Reserve Bank" Address to the Economic Society of Australia (Victorian Branch) Conference, Melbourne, 5 September 1996, p.10.
[25] Insurance and Superannuation Commission (1996) Submission to the Financial System Inquiry.
[26] Reserve Bank of Australia Bulletin (July 1996)

A question for debate is whether a lead regulator approach is sufficient, or whether a single prudential regulator would bring greater benefits. AMP believes that the single regulator model provides the most appropriate means to supervise conglomerates, and particularly holding company structures of conglomerates.

In assessing the need for a single regulator, the following issues should be addressed:

- the relationship between the responsibilities of the RBA for monetary policy and supervision of banks to ensure stability of the financial system; and

- the benefits and costs of combining regulatory supervision of banking and insurance under one roof, given that the supervision of banking (deposit-taking) and insurance are quite different.[27]

There is a legitimate question as to whether the "protection" afforded all banks (and solely to banks at this stage, notwithstanding their declining deposit base) by the RBA can be justified any longer on the basis of systemic risk. An approach that combines the management of systemic risk for the major deposit taking institutions, with an insurance scheme (up to a set) limit against failures has advantages.

With a single prudential regulator approach, the costs of supervision would be transparent, and the perception that "banks can't fail" could be addressed. On this basis there should be no difficulty in having a single prudential regulator supervise capital-backed (ie, banking and insurance) products and retail products offered through funds managers.

On balance, the single prudential regulator model may also offer some administrative economies and more effective communication and hence supervision of each business within conglomerates, and across the group. A single regulator would enable, through proper transparency and coordination, the adequate assessment of the financial position of a conglomerate as a whole. In that way it would help protect against contagion within the group from occurring, and on a larger scale, protect the system against systemic risk.

[27] As is well understood, there are important differences between these products on both the liabilities side and assets side of the balance sheet of banking and insurance institutions. There are important distinctions between the type of risk to be managed and supervised. For example the credit and market risk associated with a bank balance sheet are very different from the insurance risks related to mortality and the incidences of particular events.

3.1.2 Regulatory arbitrage

Opportunities exist within the current arrangements for significant arbitrage opportunities to be used within financial conglomerates combining banking and insurance. Choices can be made to select the most favourable regulatory environment for a particular product. The consequences of the current arrangements are that there may be advantages that conglomerates combining both a bank and an insurance subsidiary can obtain. Further, there may be some risk to the overall security of the system if the arbitrage results in insufficient capital adequacy.

The arbitrage opportunities are illustrated in a technical paper prepared by Coopers & Lybrand for AMP, which looks at the effect of differing capital adequacy requirements applicable to banks and life insurers.[28] The paper highlights the existing inconsistencies and the potential for regulatory arbitrage.

Using a simple comparison of capital adequacy requirements for a capital guaranteed deposit product, the analysis shows that a bank would be subject to a lower capital requirement than a life office for a life company type portfolio, while the opposite is true for a life office which adopts a bank's asset mix. A bank would need to hold $65,800 in capital for a typical $1 million life insurance portfolio, while a life office would need capital of $116,178 for the same portfolio. This is largely due to the fact that life companies have to reserve significantly more for equities, properties and fixed interest assets but not for the credit risk on their variable rate loans.

3.1.3 Conclusion and recommendations

The rise of conglomerates in the financial system poses potential problems for regulators, including the risk of contagion occurring within the group, opportunity for regulatory arbitrage, and the risk posed to the financial system where there is inadequate assessment of the strength of the conglomerate as a whole.

AMP considers that a single prudential regulatory authority would provide the most adequate supervision for financial conglomerates, and financial holding company structures. Proper transparency within a group could be ensured through a single regulator, so that contagion is avoided and a proper assessment of the conglomerate is achieved.

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[28] Coleman, Tony, and Shuttleworth, Danny (1996) *Measurement of Capital Adequacy for Financial Product Providers,* Coopers & Lybrand, Sydney.

AMP, therefore, supports the creation of a single prudential regulator, possibly called the *Financial Institutions Commission,* which would incorporate the current prudential responsibilities of the RBA, AFIC, the ISC and the ASC.

However, it is acknowledged that the formation of the *Financial Institutions Commission* could take some time to allow implementation issues to be resolved.

3.2 Consumer Protection Regulation

The second major type of financial regulation is consumer protection, or conduct of business, regulation. Its underlying purpose should be to:

- protect consumers' interests in their dealings with financial institutions, with particular concern for the less sophisticated customer (requirements for disclosure and complaints resolution are more stringent in retail markets than for wholesale or professional markets); and

- promote competition and efficiency by improving the quality of information for market participants, and ensuring that similar product rules apply as widely as possible to similar products regardless of which financial institution offers them.

Consumer protection should be focused most strongly on retail markets, and centre on the conduct of business of market participants in the key areas of: information provided to customers, including product disclosure; the distribution of products; and the mechanisms for resolving complaints.

Like prudential regulation, consumer regulation of financial products is segmented along historical institutional lines. Also, consumer regulation has been developed in response to consumer dissatisfaction with the level of protection of their interests. The result today is that similar products are subject to a range of regulators backed by varying legislation. In each area of customer regulation, problems of duplication and inconsistency are evident. Examples of the varying legislation and their application are shown in Appendix 7.

Securities are regulated by a specific legislative framework, administered and interpreted by the ASC. Life policies are regulated by some legislation governing insurance contracts and agents and brokers but are subject to a significant number of "voluntary" circular developed by the ISC, outside of their legislative powers.

Bank products have no specific legislative framework and the RBA has not entered the field, leaving consumer regulation to the general provisions of the Trade Practices Act. Further, bank products have no prescribed pre-sale documentation to inform consumers, in part because of an assumption that these transactions are relatively simple and straightforward.

3.2.1 Customer information

The first area of consumer regulation is customer information. The aim of regulation should be to ensure customers are provided with comprehensive and accurate information about the terms and conditions attaching to financial services.

However varying disclosure rules mean that customers are being presented with divergent levels and type of information for different products. Life offices and fund managers, governed by the ISC's "voluntary circulars" and ASC's regulations, often provide lengthy disclosure documents and prospectuses. However, this "longer is better" approach is defensive, complex, and ineffective in assisting consumers make a quality decision. It is also costly for institutions, and ultimately, consumers.

3.2.2 Distribution

The second area of consumer regulation is the distribution of financial services. Regulation should promote integrity of market participants as this is in the best interests of customers and the industry. Where the distribution involves an intermediary such as a financial adviser, the customer should have enough information to decide whether the person is objective, ably qualified and supervised.

Current regulatory approaches, however, have created a dual system of regulation of advisers governed by the ASC and the ISC, leading to many inconsistencies and duplication. For instance, there is a distinction between agents, brokers, and advisers due to different licensing systems.[29] There are also different disclosure rules about advisers' duties.[30] This system creates confusion for consumers, involves excessive cost, and introduces a market bias against agents offering more than one type of product.

The market has developed inconsistent directions because life insurance brokers are prohibited from certain relationships with life offices which are allowed between licensed dealers and fund managers provided that they are disclosed to consumers.

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[29] Under the Life (Agents and Brokers) Act, advisers selling life products must be categorised as life agents or brokers, according to whom they represent, the company, or the consumer. For advisers selling securities, the licensing provisions of the Corporations Law apply.

[30] Life advisers must state whether they act primarily for the customer or the company, reflecting the distinction between life agent and life broker. In practice, many life agents also hold a dealers licence or a proper authority from a dealer.

There are gaps in the coverage of the present regulations.

- The regulatory framework is not yet geared for the new channels of distributing financial services that are emerging through the development of information technology, and the wider use of direct marketing. Improved telephony and the Internet (as discussed in Section 2) could see greater use of technology as well as advisers in transactions for financial products, including both transactions that straightforward and complex.

- There are questions as to what is an effective means of regulation for trading across national borders, that will be possible including via the Internet

- Bank staff advising on banking products are not subject to any specific regulatory requirements, and there is no regulation of bank staff giving advice to customers regarding bank life subsidiary products and services.

3.2.3 Disputes resolution

The third area of regulation is the means for addressing complaints and resolving disputes between financial institutions and their customers. Complaints mechanisms are aligned both to product types and to intermediaries.

There is now an array of five major industry consumer tribunals, plus the Banking Industry Ombudsman, which increases the complexity of the system for customers seeking redress.

3.2.4 Perceptions of banks

A related consumer issue is the question of perceptions about the security of all financial services, particularly products provided through subsidiaries of banks. This is important as it goes to the confidence that customers can have in the financial system and the services institutions offer.

There can be a misconception about the prudential status of subsidiaries of banking-based conglomerates. AMP's market research has shown for some time that customers commonly believe that the products of life subsidiaries of banks carry the prudential support of the bank, and the lender of last resort protection that that implies.

AMP commissioned Newspoll to conduct a survey on this issue. The findings, provided in Appendix 8, back up earlier research. The survey found that less than 15 per cent of respondents understood that the bank life insurance subsidiary was not afforded "bank" protection. Around two-thirds who were aware they had bought their product from a subsidiary believed it was fully or partially backed by the reserves and capital of the bank.

The fact that consumers are purchasing products on a mistaken view of “protection” is conferring some competitive advantage on bank products across the spectrum.

3.2.5 Conclusion and recommendations

The current regulatory framework does not reflect the market structure in relation to distribution, has generated significant overlaps and inconsistencies in financial advice, product disclosure and complaints handling, due to the existence of several sets of regulation. Also, there are gaps including the omission of regulation in the banking sector.

Ensuring that all the requirements for different products are met means there is an unnecessarily high cost of compliance, particularly for an institution such as AMP.

AMP recommends that all financial system consumer protection regulation be consolidated in one legislative framework administered by one regulatory authority, possibly called the *Retail Financial Services Commission.* This legislation should govern the conduct of business, including more effective and consistent disclosure rules, and a new single complaints tribunal system.

A potential approach is shown in Appendix 9.

AMP supports a separate regulator for financial services, rather than integration into the general consumer protection jurisdiction of the Trade Practices Act, because more than any other industry the financial services industry depends on market credibility, which is enhanced by direct and specialist supervision. A specialist regulator could be paid for by the fees paid by participants in the industry, and should therefore be able to take a more pro-active approach than the ACCC can afford.

So far as possible, the legislation governing the marketing and sale of all financial products should be simplified and set out the principles necessary to ensure market integrity. It should be based on the principle that customers are entitled to choose the product or service they wish, provided that the choice is an informed one, based on all relevant information. AMP recommends that a Simplification Task Force be appointed immediately to commence the process of shaping the new consumer protection legislation. A model for this Task Force is the membership and approach adopted by the Corporations Law Simplification Task Force.

An issue that the legislation would need to address is the inconsistency in the licensing and registration of advisers. The current distinctions between agents, brokers, and advisers as applied by the ASC and the ISC need to be removed, and changes made that reflect the reality of the operation of the financial services industry.

The preferred model would be to move towards the Corporations Law approach, where the ASC licenses principals, and the principals in turn register proper authority holders. This would introduce common registration for advisers, regardless of whether they were a broker, financial planner or life insurance adviser.

To address the problems of different perceptions of the quality or security of the same products offered by different institutions, one approach would be to require the public disclosure of a claims paying rating by all prudentially regulated institutions.

The distribution of financial services (product and advice) via electronic commerce would also need to be considered to ensure that the standards of advice and information matched the level required where an intermediary is involved. For instance, product information on World Wide Web pages provided by Australian companies would potentially need to be subject to the same disclosure rules as information provided in brochures and other documents to consumers.

However this raises the question of foreign companies not based in Australia selling products via the Internet. It may be difficult to subject these companies to Australian regulations. As noted in the Monash University Centre for Electronic Commerce research paper, Australia would be wise to work with regulators globally to pursue international standards in this area. AMP recommends that regulators be given adequate resources to enable them to pursue this important work.

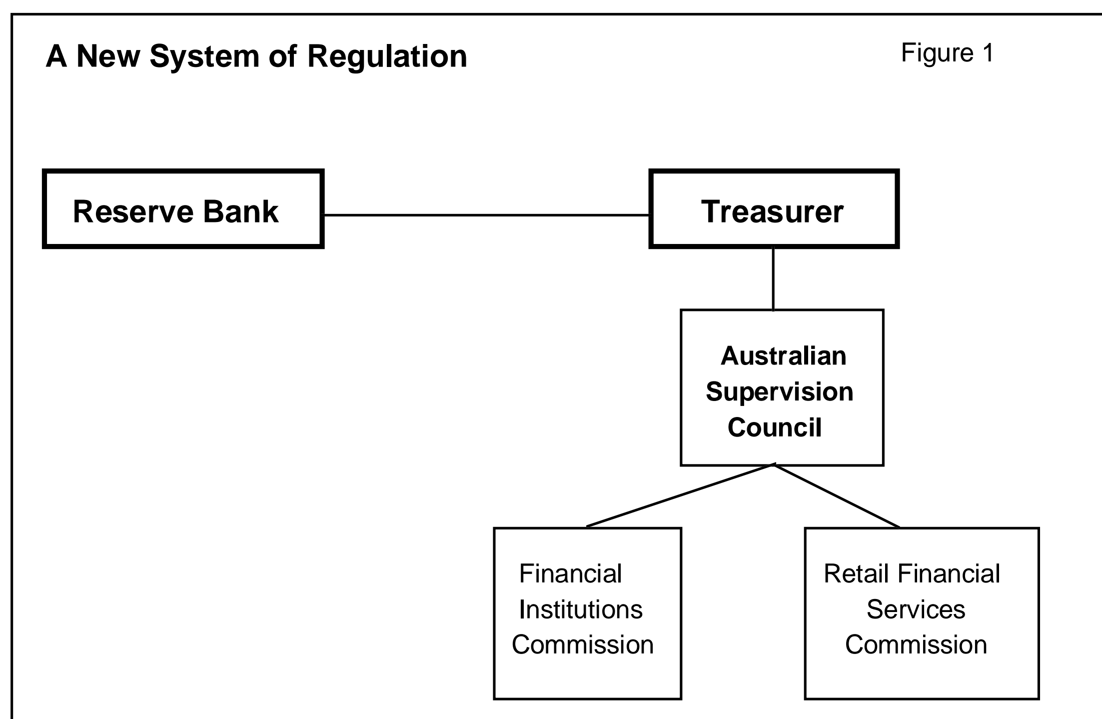
3.3 The new regulatory framework

The changes that AMP has proposed in this submission to the Inquiry are a measured approach to re-shaping Australia's current regulatory framework. It will be the work of coming months to refine these proposals and to quantify the potential benefits of the new system and to estimate the costs of transition.

These changes do not need to be made overnight, yet they are worthwhile objectives within a given time frame. The CFS is already in place to assist with the transition and is a ready made forum in which the regulators could assist with the implementation of the new system.

With the appointment of a Simplification Taskforce, work can begin immediately on reconciling the different approaches to consumer protection. The *Retail Financial Services Commission* could be established relatively quickly whereas the creation of the *Financial Institutions Commission* could be expected to take more time, with say a target of two years from the date of announcement. This would allow the resolution of a number of important issues, as discussed in this submission.

A model of the proposed framework is represented in Figure 1.



The question remains of the co-ordination of the responsibilities of the two *Commissions.* Clearly consumer protection and prudential responsibilities are linked, notwithstanding the specific functions and different methodologies. Put another way, effective consumer protection rules regarding disclosure and distribution rely on a detailed understanding of the prudential backing of a product, for instance the capital backing, solvency reserving and assets and liability matching that applies.

Following the establishment of both *Commissions,* an *Australian Supervision Council* could be set up with a charter to co-ordinate the activities of both Commissions and to maintain strong links with the RBA, given its continued responsibility for monetary policy and for the stability of the financial system.

It would be appropriate for the Chair of the new Council to be the Treasurer or the Secretary of the Treasury. Additional members could include industry and consumer representatives with a defined tenure.

4. Competition in financial markets

The terms of reference direct the Inquiry to review "the efficiency of the financial system including its international and domestic competitiveness." Further, the Inquiry is to "identify the factors likely to drive further change including ... international competition and integration of financial markets; and domestic competition in all its forms ..."

In recent years, competition has intensified in Australia's financial markets. This has occurred under the influence of advances in technology, deregulation and globalisation referred to earlier in the submission.

In the retail area this has resulted in a reduction in costs and a greater diversity of products. There is evidence to suggest that margins on all retail products are falling.

- Recent research by the Reserve Bank of Australia shows that bank lending margins peaked at around 5.5 per cent in 1988, and have since declined to current levels of 3 per cent to 4 per cent.[31] (One factor that has recently contributed to this has been the securitisation of home loans, resulting in mortgage originators substantially increasing their market share.)

- Fees and charges in superannuation and premiums in life business have also been declining across the industry.

In the wholesale market, margins have fallen for funds managers also. According to Dr Peter Jonson, wholesale rates for management of balanced funds have fallen from around 1 per cent in the early 1980s to an equivalent rate today of 0.6 per cent. Fees on larger sums now attract fees of between 0.4 per cent and 0.5 per cent, and further falls appear inevitable[32].

AMP has over $80 billion of assets under management, of which just over half are Australian funds under management. Like its international competitors, AMP is focused on its competitiveness both at home and internationally in each of the markets in which it operates. Importantly, in our view, opportunities for growth in scale and scope (product and service coverage) could operate to improve AMP's capacity to compete in world markets.

4.1 Competition policy

The ACCC has responsibility for the regulation of competition and mergers in all Australian markets, including the financial sector. It administers Section 50 of the Trade Practices Act through informal guidelines.

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[31] Jonson, Dr Peter, "Financial Deregulation - the Scorecard" Address to the Committee for Economic Development of Australia, Melbourne, 18 July 1996.
[32] ibid.

The financial sector is subject not only to the rules under the Trade Practices Act, but since 1990, a specific government policy has ruled out mergers of the four major banks and of the two major life offices, the so-called “six pillars” policy.

There is scope to remove this restriction, with possible subsequent mergers among Australia’s six major financial institutions, without a reduction in competition. The principles already applied by the ACCC to all other markets would be sufficient to safeguard competitiveness in the financial sector.

4.1.1 Policy on mergers of the “six”

The restriction on mergers was announced by the Government in 1990 at the time of its rejection of the proposed merger between ANZ and National Mutual. Then Treasurer Paul Keating said: “At the present level of competition, it would be preferable for the six or seven largest institutions in these industries to remain separate”.[33] This position was confirmed in the Government’s banking policy statement in 1993, that “... mergers between any of the four major banks (or a major life insurance company) will not be permitted”.[34]

The Government’s view in 1993 was that a merger between any two of the major players would be “likely to detract more from effective competition than was in the national interest”.[35] Further, it was argued that if mergers were allowed a single dominant player could be the result, to the detriment of competition.

In today’s financial market these concerns are not well founded, as the market shares held by major financial institutions across market sectors suggest the creation of a single dominant financial institution is not readily achievable. There can be little justification for imposing this arbitrary rule to the financial sector alone.

The unforeseen impact of the policy has been the sale of one of the six institutions to a foreign buyer, at the same time as the acquisition of the four major banks by a foreign buyer was prohibited.

Bank rationalisation could bring substantial benefits. As the Governor of the Reserve Bank observed recently, “banks have recorded generally good profits in recent years, but they remain relatively high cost, high margin providers of retail financial services.”[36]

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[33] Keating, Paul, Press Release, 23 May 1990.
[34] Dawkins, John, “Banking Policy Statement” Statement by the Treasurer to Federal Parliament, 18 June 1993.
[35] ibid.
[36] Fraser, Bernie, “Financial Regulation and the Financial System Inquiry” Address to Advance Bank luncheon, Canberra, 5 July 1996.

The current policy is restricting bank rationalisation and limiting the reductions that would follow in costs and margins. These are efficiencies that Australian-owed institutions may well need to compete effectively against international and new low-cost specialist competitors.

4.1.2 The merger test

There are two aspects of the current tests that need review:

- the definition of a market in the financial sector; and
- the return to the dominance test, rather than the "lessening of competition test".

A broader definition of geographical market may be warranted because of the added contestability of these regional markets given the advances in technology that support a greater variety of distribution channels to customers.

Examples include:
- cash withdrawals from supermarkets, beyond geographic boundaries;
- the use of telecentres and processing centres for retail lending, operating nationally (Westpac and ANZ); and
- the growth in independent financial advisers for retail products, ensuring geographic coverage.

Further, any application of competition tests should assess product substitution across the financial markets rather than looking at institutions solely.

The Industry Commission noted in its June report, "the move from a dominance to a competition test for evaluating mergers has brought with it additional administrative difficulties. The dominance test was simpler to administer than the competition test, since analysis of the competitive effects of mergers largely requires a subjective evaluation of many factors affecting the future conduct of firms".[37]

The use of the dominance test for mergers would allow the industry to have greater certainty of the acceptability of any particular merger proposal. However, an alternative position that would assist industry, would be for the ACCC to produce a detailed list of criteria, including the approach to substitutable products, on which it will base its assessments of substantial lessening of competition.

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[37] Industry Commission (June 1996) *Merger Regulation: A review of the draft merger guidelines administered by the Australian Competition and Consumer Commission,* Information Paper, Canberra..

AMP is continuing to work with Coopers & Lybrand in assessing in detail the impact that the differing competition tests are likely to have in the financial services sector. This work will be made available to the Inquiry.

4.2 Conclusion and recommendations

Sufficient safeguards exist within the tests on mergers to protect competition in the financial sector. Anecdotal evidence suggests that there could be improvement in competition from the removal of the “six pillars” policy.

5. Conclusion

The Inquiry is an opportunity to improve the regulatory and competition policy framework, with real benefits to the Australian community.

In this submission we have argued that there is scope to:

- put in place arrangements that ensure the most effective supervision of financial conglomerates, including supervisory arrangements for financial holding companies;

- address the problems of arbitrage between bankers and insurers within financial conglomerates;

- bring non-bank and bank intermediaries under the same supervision;

- address the problems of multiple regulators with responsibility for consumer protection; and

- permit mergers that will bring benefits through reductions in costs and margins, and increased competitiveness of Australia's financial institutions.

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