Norwich Union Financial Services Group

Submission to the Wallis Inquiry into the Australian Financial System

9 September 1996

Norwich Union Financial Services Group is part of the international Norwich Union Group which has operations in 14 countries and worldwide funds under management of more than A$74 billion. With a history dating back to 1797, Norwich Union is one of the world's oldest insurance and investment organisations.

Norwich Union in Australia comprises a number of companies in the financial services industry. Our core businesses are investment management, retail investment, risk and personal savings and small business superannuation. The Group currently manage funds in Australia in excess of A$4 billion for more than 300,000 customers.

Key Points

The Wallis Inquiry has the opportunity to secure significant improvements in the Australian financial system - to lift its international competitiveness, efficiency and consumer orientation. International best practice should be everybody's aim.

The facilitation of Australian business and trade on a global scale requires an outward looking, flexible and secure domestic financial system.

- In some areas **radical change** in the current system is called for - notably in our approach to **consumer protection**.
- In other areas **evolution** rather than revolution is the wisest approach, eg the role of the Reserve Bank, and **prudential supervision** of financial institutions generally.

- **Technology** is likely to totally change the "climate" for financial services. Major resources will be put into this area by individual companies; the challenge will be for the regulators to keep up.

- Economic policy should place **much greater weight** on raising national saving. The national savings gap is perhaps five percent of GNP.

Developments since Campbell

It would be easy to overlook the gains made since Campbell.

Leaving aside the six pillar "freeze", there has been substantial movement from single focus institutions to broader financial service conglomerates. In several instances this has involved the participation of foreign companies, while Australian companies have successfully extended their operations outside Australia. Consequently, corporates and consumers have a greater degree of choice in both range of products and type of institution they deal with.

The successful float of major government entities and commercial listings has resulted in a much wider group of Australians being introduced to the securities and the investment markets. The extension of superannuation across the workforce and the pending widening of member choice is extending consumer interest in, and need for greater knowledge of, investment markets.

Throughout the financial services industry there is a keener awareness of consumer and client needs. A culture of compliance and quality control is slowly developing in major financial institutions.

Codes of conduct or practice have been introduced with industry support in several areas. New impartial avenues for consumer redress have been established. There is a determined drive to lift the standards of professional financial advice across the industry.

There is considerable downward pressure on profit margins in financial services and a concerted drive to raise service standards, both developments which will provide major benefits to customers.

The attached paper "*Financial Deregulation - the Scorecard*" (Appendix 1) summarises effects of the first wave of financial reform. The main points:

- *The major effect of financial deregulation was to expose and emphasise the endemic weaknesses in our economy. Although the sequence of deregulation was not ideal, Australia is now at a point* *where the next steps on the road to an efficient and fully competitive economy are clear.*

- *The weaknesses in our economic system will be overcome by creating a freer labour market, by increasing national saving, by reforming our social welfare system and by continuing the process of microeconomic reform generally. Raising national saving is a major task which requires efforts by government, both to reduce its own demands on capital markets and to improve incentives for private saving. Our financial institutions and industry groups must help by publicising the benefits of higher savings programmes and by devising more cost effective products.*

- *There are some major challenges within the financial system to reform consumer disclosure, to simplify and harmonise prudential supervision and to help our major financial institutions to be internationally competitive. This second wave of financial deregulation will be an important part of making Australia one of the economic success stories of the twenty-first century.*

System Impediments

Significant impedients to efficiency and effectiveness remain. They have been well canvassed in recent weeks in the public domain and include:

- For consumers of financial services, information overload, a paper nightmare and costly compliance resulting from hamfisted attempts to protect consumers, to provide improved product information and to develop a more trustworthy advisory system.

- An uneasy stand-off about the issue of merger and takeover activity.

- A private savings record continuing to fall well below levels achieved in other countries.

- The compartmentalisation of regulators falling too far out of line with industry reality and structure.

- The sharing of some responsibilities between Commonwealth and State governments which adds an unnecessary element of cost, overlap and confusion.

- The uneven setting of capital and other prudential requirements - based more on historical origins of institution than on product delivered.

- The potential for technological change to get ahead of the system's ability to provide regulation that encourages its potential whilst maintaining suitable safeguards.

- An untidy, confusing blurring of roles, responsibilities and accountabilities between product provider and financial adviser.

- Hampering of the ability of product providers to move quickly and flexibly in developing new products and moving into new markets by the need to meet onerous black letter law.

- An overly complex advisory system - for consumers and advisers - with inconsistent licensing and competency requirements with, dependent on type of product recommended, advisers having responsibility to **clients** on the one hand or **product providers** on the other.

- Unwieldy avenues for consumer redress, partly product-based, partly institution focussed; some statutory, some non-statutory; and without a consistent performance standard governing their operations.

- Legislation surrounding the industry which is sometimes conflicting and too often overly prescriptive and restricting.

Overall these impediments result in a system of regulation and compliance that is too rigid, too prescriptive, too paper-driven, too costly and too consumer unfriendly. (The Industry Commission's recent report on regulation is instructive here - finding an average of 4800 pages of legislation enacted in 1990-94! As a significant participant in the industry, Norwich Union has to comply with well over 100 Acts in administering its range of businesses. Sadly the final impact of this compliance burden falls directly or indirectly on the customer.)

Principles Governing Change

In seeking to improve the current financial system, key principles which should govern solutions include:

- Strong user/customer focus

- Simplicity in all aspects

- Regulators with clear performance objectives.

- Clear, brief disclosure geared **primarily** at helping consumers to take greater responsibility for their decisions;

- Unified licensing of financial advisers - responsible to **clients**, not product providers.

- Easy-to-access (minimal number of) effective consumer redress channels.

- Overall, regulation with minimal prescription which sets fundamental requirements and leaves institutions or advisers to fulfil them in a commercial context, but facing stiff penalties for proven mis-behaviour.

Specific Recommendations

Against this background, we consider the most important changes required include:

Prudential Supervision

1. Retention of responsibility of Reserve Bank for managing systemic risk - requiring strong input into prudential supervision of major deposit takers. The reasons for this are summarised on Page 9 of the attached July 1996 paper.

2. Consolidation of prudential supervision of major and minor deposit-takers with consequent transfer to the Commonwealth of some State responsibilities.

3. A clearer framework of capital and other prudential requirements for various product providers to achieve a practical level of competitive neutrality.

4. Subject to the above, establishment of a new Financial Services Regulator - based in Melbourne or Sydney - to take major responsibility for prudential supervision of all financial services business. (Overlaps with respect to major deposit taking institutions is, however, a key issue.)

5. The attached structural summary, taken from the joint AIMA/IFA/LISA submission (Appendix 2), is a sensible model for the new regulatory framework.

6. The Reserve Bank and the Financial Services Regulator both to report to Boards of Management, with some degree of overlapping membership to facilitate consistency and common understanding of key issues and developments. The Board of the new Financial Services Regulator to include representatives of producers, advisers, government/public service but also **consumers**.

Consumer Protection

7. Consolidation of all product disclosure, adviser licensing, and consumer protection responsibilities within the Financial Services Regulator. Accordingly, the ASC and ACCC to lose some finance sector responsibilities.

8. The governing principles for the new Financial Services Regulator to be the provision of helpful guidance and targeted monitoring, not heavy-handed prescription. The experience of the UK Personal Investment authority (PIA) is of relevance here - after only two years of operation it has established "Project Evolution" to review whether its rules are too detailed and to what extent they can be replaced with principles, and guidance and how it "can shift the focus of regulation on to the end result, rather than the process".

9. Legislation governing the industry to be reviewed to maximise consistency and wherever possible consolidated.

10. A much clearer distinction to be made between accountability for **product quality** and **advice quality**. This will require the abolition of the Agents and Brokers Act and consolidation of the regulation of all financial advice into a new Financial Services Act.

11. In this area, the submission by the Financial Planning Association (FPA) has much to commend it. We support their recommendation for a universal system of regulation of financial advice to eliminate duplication of advice on life insurance products and securities and to capture other forms of advice, such as property investment advice, presently unregulated.

12. Under this approach principal license holders - whether a stand alone advisory firm or a part of a product provider - would accept total responsibility for monitoring their representatives' conduct and determine what data was captured from customers and where it was held. This would also lead to an overhaul of the current onerous, time consuming and privacy invading requirement for fact finders, needs analyses and customer advice records being collected and shuffled around the system at considerable cost. As with other advisory professions (law, medicine, tax) the onus will be on licensees, as a condition of continuing grant of licence, to ensure advice is appropriate to client needs.

13. A much more consistent, succinct product disclosure regime to be established across the whole financial services industry - with agreed standards for electronic and paper distribution of company and product data, aimed **primarily** at facilitating product comparison by advisers and consumers. (The driving force at present behind many long-winded prospectuses and product brochures is to protect product providers' backs - to satisfy the **regulator** - rather than satisfy the **customer**.)

14. We endorse here the comment of the UK PIA in its July 1996 Regulatory Plan - "our objective is usually described as investor protection,

perhaps a more realistic description of our main job is to **enable investors to make informed decisions**".

15. The Financial Services Regulator to report to Parliament annually on the effectiveness of consumer redress mechanisms each of which would be licensed. There may be an evolution over time to a consolidation of some redress channels. We are attracted to the Consumer Panel concept created by the UK PIA which provides general feedback and commissions tracking studies to monitor consumer confidence in the industry and its regulation.

16. There should be no requirement in law implied or otherwise that products cannot be sold without advice although, as part of the assistance provided to consumers, a system of health/risk warnings on all products should be instituted to help consumers decide when advice is necessary.

Savings

17. Consistency in the superannuation regime to be maintained to the maximum extent possible to avoid investor discontent. The Government also to make it clear that compulsory superannuation will not provide adequate retirement incomes for many Australians.

18. The Government to be encouraged to pursue the objective of significant tax reform. One major objective of this should be the provision of significant incentives for voluntary savings by households.

19. Savings will also be encouraged by achievement of effective price stability in Australia.

Technology

20. A Technology Advisory Group to be established as a standing forum of experts to assist regulators and the industry keep abreast of developments, to ensure regulation supports best use of technology so the buying/advising process is easier and most cost-effective.

Background

Australia cannot stand apart from major global forces. A number of powerful trends have dominated post-war economic development.

- Deregulation of goods markets - which began with the development of the European economic community in the 1950s, joined by Australia when import quotas were abolished in 1960, accelerated when tariffs were cut in 1973 and more systematically from 1985.

- Rapid growth of "emerging economies" - Japan, South Korea, Taiwan, the South East Asian Tigers, China, India, some Latin American countries. These countries generally have high saving rates, ungenerous social welfare systems and unregulated labour markets, making them formidable competitors for the older, richer economies.

- Dramatic advances in communications, information processing technology, travel and transport, all of which contribute strongly to the emerging "global village".

Dismantling war-time financial regulations proceeded at different speeds in different countries. Among the leading OECD countries, major mileposts included:

- convertibility of Sterling (and satellite currencies) in 1958.

- progressive elimination of controls over volumes and prices of lending by banks throughout the 1950s and 1960s.

- reduction in or elimination of most controls over international capital flows among major countries in the 1960s.

- floating of the $US in 1971.

- progressive moves to using open market operations to control monetary policy in the 1950s (US), 1960s (UK) and in the 1970s (Europe generally).

Those trends were fully embraced in Australia only with the government's acceptance of the findings of the Campbell Committee in 1983. At about the same time the $A was floated and remaining exchange controls were abolished. Australia entered the modern world of free financial markets later than most, and more abruptly.

Expectations

Those of us who were involved in the process of financial deregulation had varying attitudes to it:

- Most saw it as inevitable, part of Australia's maturing, unavoidable if we wished to participate fully in global economic development.

- Some of us saw it as another crucial step on the road to economic reform, another wedge into an ossified economy.

- Others emphasised the libertarian view that deregulation would produce a fairer, more democratic (and therefore more efficient) financial system - credit would be available to all, not just the relatively established, relatively risk averse, borrowers.

As to the risks:

- Some were concerned that the **sequencing** of deregulation was wrong. Driving a financial wedge into an economy with endemic budget deficits and a highly regulated labour market some saw as a recipe for potential disaster. The reformers pushed on - expecting the financial wedge to discipline both governments and Australia's entrenched industrial relations club.

- Few realised just what a volatile outcome would be produced by a mix of ready access to credit, over-enthusiastic bankers, inexperienced risk assessors and a tax system which, under conditions of inflation, encouraged excessive borrowing and lending.

Outcomes

One can attempt to assess the outcome of a major change such as financial deregulation in a variety of ways. Sorting out cause and effect is difficult, probably impossible, since one is examining a unique historical process in which everything is interacting and changing.

I will examine two sorts of evidence. The first is the macro-economic evidence - what have been the big changes in economic outcomes, and how can these be related to financial deregulation? The second is micro-economic - what has happened in the financial system itself. Then I shall discuss some important issues still to be resolved.

I have circulated a set of charts which summarise available evidence on both macro and micro issues.

Macroeconomic Outcomes

- Growth of real GDP was lower in the 1970s, 1980s and so far in the 1990s than it was in the 1950s and 1960s. While many other things were different, clearly financial deregulation did **not** unleash a growth surge, nor did it prevent a serious recession in the early 1990s.

- There is, however, significant evidence of improved productivity growth in the past few years. This may be one consequence of financial deregulation, although tariff cuts, lower inflation and better economic management generally also vie for recognition.

- Inflation was somewhat lower in the 1980s than in the 1970s, although still much higher than in the 1950s and 1960s. Inflation has been distinctly lower so far in the 1990s, although as yet there is no guarantee that this will remain the case. Inflation was controlled in the regulated era, and is again under reasonable control using market related control methods. The process of deregulation for a time somewhat confused the control process, but our central bankers should feel much more confident in the deregulated environment.

- Australia's international debt grew strongly during the period of financial deregulation, both absolutely and in relation to GDP. There was in fact a general increase in various financial aggregates relative to GDP. Clearly financial deregulation encouraged those trends. The optimists see this as a useful "gearing up" of Australia's balance sheet while the pessimists - including I - emphasise the constraints this imposes on our freedom to act. (The reasons for this are well known. Relatively high international debt limits our ability to spend government money to alleviate poverty and offset business cycle downturns. International market participants watch closely economic and political events and are quick to punish behaviour of which they disapprove. Lower currency values and higher interest rates are the immediate response to perceived failings.)

- Australia's overall saving has been insufficient to prevent rapid growth of international debt. In the early 1970s Australia had a current account surplus. By 1982 the current account deficit was almost 6% of GDP, and this crisis level (when interest rates had to be raised and government spending curtailed) has subsequently been reached on three separate occasions. Australia's saving rate began to fall well **before** financial deregulation gathered pace, and indeed the big deterioration was in 1974/75. The reasons for the continued decline in saving are complex - high inflation in the 1970s and 1980s, a tax regime hostile to saving, a welfare system which provides little incentive for "self insurance" and (I suspect) somewhat mysterious tides in national culture.

- Australia's rate of unemployment has risen strongly, in fits and starts, throughout the post-war period. Successive peaks were 3% in 1961, 6% in 1974, 10% in 1983 and 11% in 1992. Obviously the trend to higher unemployment began well before financial deregulation, but the trend was reinforced by deregulating goods and financial markets while maintaining a relatively strongly regulated labour market.

- The most important point, closely related to increased productivity growth, is that in many activities and markets Australia seems far more competitive than it was. Cuts in bank lending margins, falls in insurance premiums, cuts in costs of telephone calls, cheaper air travel, improvements in customer service levels generally are all signs of a more dynamic economy. This is very difficult to measure or to analyse, but I strongly believe that the general process of deregulation (including financial deregulation) has been important. It is important to note, however, that Australia is not yet decisively competitive in the international market place. There is undoubted improvement compared with our past performance, but others are improving faster.

My overall conclusions about the **macroeconomic** evidence include the following:

- Financial deregulation, so far at least, has had at best a minor positive effect on growth, although it has helped to increase productivity growth.

- Financial deregulation complicated for a time economic management, and may have delayed achievement of a relatively low rate of inflation.

- However, financial deregulation has linked us closely to international financial markets, and participants in these markets provide unforgiving dispassionate evaluation of domestic economic policy - thus "keeping the policy makers honest".

- With a relatively highly regulated labour market, financial and goods market deregulation added to the upward pressure on the rate of unemployment that was firmly established before deregulation.

Effects on the Financial System

The major steps on the road to financial deregulation are covered in the attached timelines. Removal of ceilings on interest rates, abolition of banks' lending limits, floating the Australian dollar, abolishing exchange controls, licensing 16 foreign-owned banks and conducting monetary policy through open market operations were the significant steps.

Many of the effects of these changes are hidden within the aggregates usually calculated. For example, money market corporations, finance companies and building societies all flourished while banks were restricted, and these trends have subsequently been reversed. Fortunes were made (and some were lost!) in the unregulated sector before financial deregulation and then there was a slow erosion of value.

Such trends are entirely predictable. Bottling up pressure in one direction intensifies pressure in other directions. There are many examples in our financial history.

- Bond rates were heavily controlled in 1974 but bill rates exceeded 20%.

- The currency was controlled (through the so called "crawling peg") in early 1983 but $3b flowed out of Australia in the week before the Federal election, only to return once the currency was devalued by 10%.

More generally, restricting the ability to compete of one set of institutions, such as the banks, creates opportunities for other groups. In the same way, restricting the opportunities for Australian financial institutions to achieve world's best practice will create opportunities for overseas owned institutions, both in our markets and in the regional and global markets.

Shareholders of Australian banks of course lost a lot of money when they coped badly with their new found freedom in the late 1980s. Recouping these losses kept lending margins high for a time, but competition from non-bank institutions is now making its presence felt.

According to a recent report (Weekend Australian, 22-23/6/96) recent RBA research shows that bank lending margins peaked at around 5.5% in 1988, and have since declined to current levels of 3% to 4%. Both recent attacks on home lending margins within Australia, and international experience generally, suggests that further substantial falls in lending margins are coming.

Margins have fallen sharply in other financial services. Premium rates for insuring the life of a 35 year old male in good health, for example, are now up to 40% below rates charged in 1992.

The pressure is on the fund managers also. In the early 1980s, the standard "wholesale" rate for a balanced fund was of the order of 1%. Now the leading managers are battling to hold their equivalent rate at 0.6%, while larger sums attract fees of 0.4 and 0.5% and further falls are inevitable.

Numbers employed in the financial sector are one indication of the overall effect. Employment was around 265,000 in 1984. It rose to a peak of around 366,000 in 1990 and subsequently fell to around 314,000 in 1995. Closing bank branches, rationalisation in banking, insurance and funds management will all provide further downward pressure. Productivity is poorly measured in service industries but I venture the judgement that when the dust settles Australia's financial services will be much more productive than they were a decade ago.

What remains to be done?

There are four major issues currently impacting on the future of Australia's financial system. Those concern regulation, especially as it relates to consumer disclosure, prudential supervision, the competitive framework and Australia's inadequate savings rate.

Removing Regulatory Overload

While there has been a lot of "top down" financial deregulation, in many ways the regulatory burden has increased. This is especially true of the rules for dealing with consumer disclosure which in many cases are complex and time consuming. Certainly they impact with different weight on different products.

It may be best simply to list the requirements for different types of financial instruments:

- Anyone can make a bank or building society deposit, or withdraw funds, without requiring any justification - no complicated "needs analysis" here. Anyone opening a new account needs to prove their identify, new depositors will be asked if they wish to provide their tax file number and loans are subject to the credit laws.

- Buying or selling shares is also simple. One talks to a licensed sharebroker, he gives advice (not generally recorded or audited) and the deal is done. If one is buying newly issued shares, one will be provided with a lengthy prospectus, but I suspect few of these are read in any detail except by the institutional analysts.

- Someone seeking to purchase risk insurance is required to complete a detailed proposal form, provide medical information and possibly undergo medical testing to enable the insurance company to accurately assess the risk. Regulation requires that, if advice is given by an agent (as is usually the case), the customer should be asked in most cases to provide a full range of information for a fact finder. The agent is required to produce a customer advice record, which explains according to the client's stated needs the rationale for the choices made. More generally, he must abide by the industry "code of practice" which specifies strict guidelines as to how the agent must conduct himself.

- An employer arranging superannuation for his or her staff, which complies with the compulsory SGC levy, has to calculate the correct payment, be aware of any award obligations and complete the appropriate application form. The fund needs to be a complying superannuation fund and abide by all the requirements of the Superannuation Industry (Supervision) Act. These requirements specify the behaviour of trustees in protecting the interests of fund members. Trustees must provide annual statements and reports, and ensure that there are "appropriate" investment strategies and risk management procedures.

- Personal (top up) superannuation requires completion of an application form in a current brochure. The investor must confirm that they are eligible to contribute (based on a complex array of rules and transitional rules). If they are rolling over an eligible termination payment (ETP) they must also provide the appropriate tax office form. Regulations require the selling institution to ensure the funds are an ETP. Tax may need to be deducted. If the superannuation fund invests in life office products, needs analysis and Customer Advice Records are also required.

- Someone seeking to invest in an insurance bond, rollover fund (deferred annuity) or immediate annuity has to complete the appropriate application form contained in a current Customer Information Brochure. Also if advice is given (and it usually is) they will be asked to provide a full range of information for a fact finder. The agent or financial planner will then be required to provide a customer advice record, similar to that required for risk products, but usually more information must be provided.

- Someone attempting to buy a unit trust must complete the application form in a current prospectus. Also if advice is given (and it usually is) they will be asked to provide a full range of information for a fact finder. The proper authority holder must provide "unbiased advice" which suits the customer's needs and circumstances. In this case there is no formal requirement for a customer advice record but the financial planner would be wise to keep records which prove that he has given appropriate advice.

I have deliberately presented these examples from the perspective of the consumer although it is also clear that the financial adviser or life agent (and the companies the agent is representing) have significant responsibilities to ensure that "due process" is followed. It is clear that very different levels of regulation are applied to different financial products but it is less clear that these differences can be justified.

At this point I am happy to acknowledge two points, both of which are raised in a recent speech, "Adjusting Regulatory Structures to Market Needs" by R G Glading, Deputy Commissioner, Life Insurance, Insurance and Superannuation Commission (ISC). The first point is that decisions about some long term pension products in many cases involve large amounts of money relative to the client's net worth or income, and sometimes decisions are made in "an atmosphere of confusion and anxiety". Some element of explicit consumer protection is clearly warranted in such cases.

This challenging speech also acknowledges that the ISC and the Australian Securities Commission (ASC) are actively engaged in the task of regulatory harmonisation, although I must say that I would encourage simplification as well as harmonisation. But it is also interesting that Glading invites life company Boards and CEOs to convey their views more clearly to their staff if they favour a "less prescriptive, more commonsense approach to compliance".

My general point, however, is simple. Philosophically we need to sort out when to apply the principle of "caveat emptor" and when to be paternalistic. I believe that most people are pretty good judges of their own welfare and mostly need **simple clear reliable "health warnings"** on financial products. Those who are in favour of complicated disclosure at the point of sale seem to forget that useable information is usually brief and to the point. Overall, our current system is far too complicated and paternalistic.

We should be able to devise a simpler, fairer and above all more efficient system of consumer disclosure. It is a major task for someone.

Efficient Prudential Supervision

Prudential supervision is currently conducted by several institutions - the Reserve Bank of Australia (RBA), the ISC, the ASC and various other regulators under the umbrella of the Australian Financial Institutions Commission (AFIC).

There is an overarching Council of Financial Supervisors, which is chaired by the Governor of the RBA.

The approach of each regulator is somewhat different. All rely on regular reporting of the financial situation of each institution in its bailiwick.

The RBA has a duty to protect bank depositors (though <u>not</u>, contrary to popular belief, to guarantee this) and as part of this duty oversees the prudential management of the banks. The RBA arranged a forced marriage for the troubled Bank of Adelaide in 1979, an action that decisively protected the interests of depositors, whilst leaving the shareholders unhappy.

The RBA monitors ownership and control, minimum capital requirements, liquidity management, large credit exposures, impaired assets, associations with non-banking financial institutions, funds management and securitisation guidelines and external audit arrangements.

The ISC monitors life insurance offices and superannuation funds, requiring adequate risk management policies and other internal controls. Life insurance companies are required both by the ISC and their appointed actuaries to put aside reserve assets in a defined and conservative manner.

The ISC also controls the disclosure and competency standards for the sale of products. Requirements include detailed and prescriptive guidelines for sales documents and sales practices and a code of practice.

The ASC administers the Corporation Law and regulates the securities markets (including shares and unit trusts).

It does this through the licensing of groups of dealers and advisers, the registering of auditors and liquidators, and by requiring regular reports from financial institutions which sell shares and unit trusts.

AFIC is the national supervisor for building societies and credit unions (which are State regulated). Friendly societies, which are also State regulated, do not yet come under the auspices of AFIC.

State authorities have day to day responsibility for supervision while AFIC plays a role in establishing the prudential standards and minimum operating standards, which are broadly based on those applying to banks.

Of course, in addition to the above, we also have the Australian Competition and Consumer Commission and a series of State based regulators to look after consumer protection.

The current system of regulation is based on institutions and products, and can fairly be described as ad hoc, or indeed "jerry built". Most regulators have a consumer protection component to their mandate although for bank deposits and shares - products at opposite ends of the spectrum of risk and reward - the principle of "caveat emptor" is applied most thoroughly. For other products the regulations about disclosure are paternalistic, as I have said.

When we come to prudential supervision the current system can also be described as paternalistic. What seems to be forgotten by our regulators is that managements and shareholders have a great interest in protecting the financial viability of their firms. In finance, as in business generally, there is nothing so helpful as a sound reputation, just as there is nothing so damning as a poor one. Resort to extensive official monitoring also ignores the role of the private rating agencies, which will develop and grow as the financial system evolves.

I am one of those who would like to see less, not more, regulation of our financial institutions. Self regulation is likely to be more effective, not less effective. Customers have to accept responsibility for their actions, and all pervading regulatory frameworks reduce the incentive for appropriate due diligence by individuals.

However, I accept that there is a case for some official supervision. My main proposal for reform is that we develop a system in which most effort is put into monitoring the performance of the weaker institutions. There are a number of indications of strength or weakness but in practice an excellent overall measure is the level of capital in relation to relevant benchmarks.

I would like to see minimal official scrutiny of strong, well capitalised institutions, with the efforts of the prudential regulators put mainly into the weaker, poorly capitalised institutions. This approach follows that used since 1992 by the US banking regulators. Capital adequacy levels should be laid down by the regulators, who should insist that levels achieved by various institutions be published, following the approach of international banking regulators generally under the so-called Basle convention.

In deciding who should carry out this work, I would note that the central bankers have developed the best overall system, both within Australia and internationally. If only for this reason I would suggest that the RBA's current coordinating role be maintained and strengthened.

There is, however, an even stronger reason for retaining a strong supervisory role for the RBA. This is because in a situation of financial crisis the central bank will need to move quickly and effectively. With a clear role as supervisor of major deposit taking institutions, as well as its intimate knowledge of financial markets, a central bank is uniquely placed. As US Federal Reserve Chairman, Alan Greenspan recently concluded: "*Removing the Federal Reserve from supervision and regulation would greatly reduce our ability to forestall financial crises and to manage a crisis once it occurs.*" (Testimony before US Senate Committee on Banking, Housing and Urban Affairs, March 2, 1994.)

I emphasise that my recommendation that the RBA exercise strong leadership in prudential supervision does **not** extend to consumer disclosure, where a separate agency should be responsible to develop and implement a fair, efficient system. The unifying thread, however, is disclosure. A great US law maker, Justice Louis Brandeis, once said: "*sunlight is the best disinfectant*".

There is also a powerful moral case to reduce the burden of regulation. (Here I repeat the conclusions of P D Jonson & Elizabeth Prior Jonson, "Financial Regulation and Moral Suasion", Quadrant, July/August 1994.)

"*The existence of an extensive explicit regulatory apparatus gives some the idea that they have done enough ethically so long as they have kept to the letter of the law. This is a powerful reason to slow down, and in some cases to reverse, the rush to regulate.*

Increasingly the question will be not whether to regulate, but rather what form that regulation should take. We strongly advocate that much greater attention be given to the use of incentives and the graduated response in devising regulations which are least costly and least intrusive. The example we give of the former is the US legislation for a capital-based policy of prompt corrective action. Our example of the latter is a lower tax rate for companies which conform to higher standards of disclosure.

Other "softer" forms of regulation - including supervision by private or official agencies - need to be encouraged. At best such agencies reinforce ethical standards. In contrast, too much black-letter law can encourage the erosion of ethical standards.

We also recommend that official regulatory agencies get back to basics. Specifically we believe that much more attention should be given to the provision of information in easily digestible form; to using the cleansing properties of sunlight."

Effective Competition Framework

It has been widely observed that there are strong forces making for the blurring of distinctions among financial institutions, and increasing globalisation in the financial services industry. This is a natural and predictable consequence of financial deregulation and is associated with greater competition, lower profit margins for producers and better deals for consumers. Major current trends include:

- Banks for many years have been involved in the provision of insurance services, and pressure on margins in their core banking businesses will intensify this tendency.

- Life insurance companies are selling mortgages, thereby helping to erode profit margins in banking.

- Both banks and life insurers are placing more emphasis on investment management. Together with the specialist fund managers, they compete fiercely to manage the retirement savings of Australians.

- New players, with the technological skills but without a long history of money management, are capable of capturing significant market share.

There are many consequences of these trends, including for the regulation of the financial system. For the present, I would focus on the question of competition policy.

I wish to emphasise one simple point. Under the previous government, competition policy was mainly concerned with the safeguarding of consumers in a narrow, industry-specific nationalistic framework. The most common test for mergers, for example, seemed to involve how it would affect market share in Australia, and indeed in the much smaller geographic units which are the individual States.

In my view, future competition policy should focus much more strongly on the provision of entities that are able to compete on the regional, or even on the global stage. Consumers will best be served if there is world's best practice in as many activities as possible, and this may well require fewer, more effective entities.

Capitalising on the uncertainties surrounding the future of Hong Kong should also be a key objective for our financial strategists. Sydney has a lot of natural advantages as a regional financial centre. I hope that someone in government is thinking about how best to build on these advantages.

Australia's Inadequate Savings Rate

Many people believe that Australia's national saving is deficient. But most people disagree on how to boost savings. In this respect Australia in recent years has come to resemble an ocean liner into which water is quietly pouring, yet we cannot agree on how to work the pump.

Propositions that are widely accepted include the following:

- As a nation we need to invest more if growth is to be maximised and if rewarding jobs are to be available to all Australians.

- Even with current, deficient levels of national investment, national saving is too low to balance the books - so we have a chronic current account deficit and rising levels of international debt.

- Our population is ageing but people are not saving enough to provide themselves with decent incomes in retirement. This will put enormous and growing pressure on the tax and welfare systems.

- Ageing will also put a tremendous strain on financing health and long term care expenditure for the elderly. The magnitude of this problem is similar to that of providing adequate retirement incomes.

The previous government's system of compulsory superannuation for most workers is widely believed to provide a good solution for retirement incomes. At best it will be a good solution for our children's children, since the amount collected will not be substantial until the full 9% levy has been invested for 20 to 30 years. The big danger in the current system is that people will save less outside the compulsory system. Many Australians of this generation will reach retirement with totally inadequate overall savings. Unless there is a major change in savings behaviour the saving shortage will be chronic, both for this generation and succeeding generations.

This government's determination to balance its budget as soon as possible is welcome, as are the parallel efforts of State and local governments throughout Australia. Research by the Life, Investment and Superannuation Association (LISA), however, shows clearly that the combination of budgetary balance and compulsory superannuation is an inadequate response to the problem of deficient national saving.

The obvious conclusion is that there need to be greatly improved incentives for voluntary savings, and reduction or removal of existing disincentives. There are several points to be made about the current system of collecting tax and its effects on national saving.

- Taxing the income from savings involves taxing income twice. Savings should be encouraged, not discouraged, by our taxation system. It must be said again and again. A tax system should not only collect taxes efficiently and fairly. In addition it should so collect them that it does not retard the creation of those incomes from which taxes ultimately come.

- I accept, of course, that there are budgetary costs of increasing incentives for voluntary savings, and that a lot of hard thinking is needed on the best ways of implementing this necessary reform.

- I believe that the best overall solution is a phased move to reduce the burden of income taxes, and I believe that this can be done in ways which will maintain - and indeed increase - the efficiency and the fairness of Australia's tax system.

- Reducing the burden of income taxation does <u>not</u> demand the introduction of a GST - indeed this is probably not the best way. Alternatives include reducing spending by government, switching from progressive income taxes to progressive expenditure taxes or simply reducing rates of tax on saving, following the precedent set for share investments with dividend imputation.

- A workable solution may be to set ourselves the target of reducing tax rates on all savings vehicles to that on superannuation savings over the next five years.

The main objection to cutting taxes on saving is that this will help people on high incomes a lot more than it helps people on low incomes. The harsh reality of course is that most saving is done by the relatively well to do members of society, and if we wish to raise national saving we must accept this reality.

But there is one major indirect way that increased saving will help those on low incomes, and that is by reducing interest rates. The high saving countries are the low interest rate countries and, by saving more, we can reduce Australia's interest rates decisively.

I would add that there are other ways to help those on low incomes - cutting income taxes generally as well as reforming the welfare system to reduce the current very high marginal tax rates commonly incurred on additional earnings by welfare recipients.

Finally, I believe strongly, even passionately, that the question of deficient saving is not all about budgets, incentives, disincentives and systems of compulsory saving. There is an important cultural aspect that no-one fully understands. This is partly because major financial institutions have lost touch with their customers. Partly it is because of the creeping socialism of the post-war period, which has discouraged, some would say destroyed, the ethic of self sufficiency across a broad front.

A major reason for our poor saving performance is inflation. The major burst of inflation in the 1970s and 1980s was in my view the most important destroyer of Australia's traditional culture of thrift. It will take many years of stable prices to rebuild a savings culture in Australia - but we must never forget the desirability, indeed the urgent necessity, of doing so. One of the surest ways to rebuild a savings culture is to provide the guarantee of effective price stability in Australia.

Concluding Comments

The major effect of financial deregulation was to expose and emphasise the endemic weaknesses in our economy. Although the **sequence** of deregulation was not ideal, Australia is now at a point where the next steps on the road to an efficient and fully competitive economy are clear.

The weaknesses in our economic system will be overcome by creating a freer labour market, by increasing national saving, by reforming our social welfare system and by continuing the process of microeconomic reform generally. Raising national saving is a major task which requires efforts by government, both to reduce its own demands on capital markets and to improve incentives for private saving. Our financial institutions and industry groups must help by publicising the benefits of higher savings programmes and by devising more cost effective products.

There are some major challenges within the financial system to reform consumer disclosure, to simplify and harmonise prudential supervision and to help our major financial institutions to be internationally competitive. This second wave of financial deregulation will be an important part of making Australia one of the economic success stories of the twenty-first century.