# SUBMISSION TO THE

# FINANCIAL SYSTEM INQUIRY

**September 1996**

Bankers Trust Australia Group

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## INTRODUCTION

A conclusive assessment of the balance of costs and benefits of the deregulation of Australian financial system since the early 1980's is difficult because:

- In the pre-deregulation period there was credit rationing, the costs of which are difficult to quantify.
- The post deregulation experience has included an asset price boom and subsequent recession. These were in part attributable to adjustment to the deregulated world. However, the boom and recession were also a global phenomenon.
- Finally, it is not clear what the outcome would have been if Australia had not deregulated in a world where developments in finance were moving rapidly in other countries.

Our approach is to say that deregulation was desirable, and in any case was inevitable, that it was done, that a considerable part of the adjustment to the deregulated environment has been made, and then to assess where the financial system stands today.

At a broad level, we can say that Australia has ***a modern financial mechanism comparable with those of other"Western" nations. It is working and there are no fundamental structural deficiencies as there were twenty years ago.***
However, if we look below such very general assessments, we see that there are tensions and the process of adjustment has not been completed.

The banking system has recovered from the losses of the early 1990's and has now re-capitalised, but is struggling with inefficient cost structures (including mis-pricing and cross-subsidies) - problems which are hangovers from the regulated era and which might have been addressed over the last decade but for the well documented distractions. Now that the source of funds for the cross-subsidies (the mortgage business) is under threat, this process will speed up.

For life <u>insurance companies</u>, an increasing proportion of their business has been fund management products offered in the tax and regulatory framework evolved for life risk insurance, and sold by commission agents some of whose conduct has come under increasing scrutiny.

In <u>superannuation</u>, assets are rising as compulsory contributions are stepped up, and the industry is shifting from defined benefit to defined contribution funds. However, there are problems with the structure of the system (emphasis on lump sums and opportunities for double dipping) and with small balances and complex rules so that further reform is inevitable.

<u>Managed funds</u> have grown rapidly but have had to fit into a legal framework designed for other purposes. The regulatory framework for collective investments has been under review.

The <u>financial markets</u> (for equities, bonds, currencies, and derivatives) are well evolved. However, the legislation is complex, and in some areas dated, as witness use of regulation by the ASC to "get around" awkward areas of the Law. There is also diminution in some markets in favour of Singapore partly because of the more conducive regulatory and tax environment there.

The <u>consumer</u> (saver or investor) faces a reasonably wide and expanding range of investment alternatives. There are however inconsistencies in the information disclosure regimes for different products, prospectuses offer a lot of "boilerplate" legal detail but less effective information for unsophisticated investors, and regulation of financial advisers is uneven.

All this is against a background of continuing macro-economic imbalances and a tax system badly in need of reform and simplification.

In summary, the Australian financial system has been through a period of great change and, at the broadest level, the deregulation of the 1980's has given us a modern functioning financial mechanism. However, ***there remain important tensions in the system, not least in the regulatory framework***, which are yet to be resolved.

There is no doubt that change in the financial sector will continue to be rapid. But how will change affect achievement of government objectives for the financial system? This is addressed in Part 1.

Part 2 looks at the organisation of regulation and the means employed to achieve the objectives of regulation. The main problems that we have identified are not in the regulation of banking or the regulation of markets, but in the regulation of managed funds, disclosure and advice.

## PART 1

### What does a financial system do?

A financial system performs an important economic function. It stands between the ultimate savers in the community and the ultimate users of funds and acts as a conduit and a transformer.

It transforms the scale, term, liquidity and risk of savings and investment flows and provides a means of payment.

This is not the place for an exposition of the different preferences of financial surplus and financial deficit units and the way that a financial system allows both a better choice set than they would face in the absence of a financial system.

However, we do want to emphasise the following points:

- The transformations of scale, term, liquidity and risk are ***economic functions***. They contribute to the efficiency of the overall economic process and to the "well-offness" of both borrowers and lenders.
- To the extent that these economic functions can be delivered at a lower cost - in simple conceptual terms measured by the margin between what the end-user pays and what the saver receives - the greater is the economic welfare of the community.
- There is a tendency to speak of the transformation process in terms of financial intermediation or, more narrowly, of banking. However, this underplays the roles of markets. Stock markets have for centuries provided a mechanism for transforming scale, risk and liquidity of investment flows and, since the 1970's, the rapid development of fixed interest, foreign exchange, derivatives and swaps markets have added to the range of transformations and reduced the cost of the financial function.

- A focus on intermediation also underplays the role of managed funds.
- The "products" supplied to both surplus and deficit economic units from each of these three broad classes of transforming mechanisms have different
  and developing characteristics and different and developing costs. Each will play a role in the financial transformation process according to the preferences of particular borrowers and lenders.
- The interests of the "consumer" of financial services feature in the Committee's terms of reference. However, because the financial system stands between savers and users of funds, there is a "consumer" of the services of the financial system at both ends of the transformation. The small investor who deposits amounts in a bank or invests in a unit trust is a consumer, and the corporate fund raiser is also a consumer.

Finally, ***the finance sector is pivotal in that it serves to allocate finance and hence resources across all sectors of the economy. It is especially necessary that the finance sector be competitive and efficient as this will affect Australia's development and rate of growth***.

## The significance of the rise of managed funds

The managed funds industry has expanded rapidly both in Australia and in some other countries. In Australia, it now accounts for around a third of total financial system assets and is set for further expansion as compulsory contributions to superannuation escalate.

| Assets of Managed Funds | June 1995<br>$ billion |
|---|---|
| Life offices | 119* |
| Superannuation Funds | 133 |

| | |
|---|---|
| Cash Management Trusts | 6 |
| Common Funds | 4 |
| Friendly Societies | 9 |
| Public Unit Trusts | 41 |
| | ----- |
| Total | 312 |
| | === |
| Total Assets All Financial Institutions | 887 |
| | === |

Source: RBA Australian Economic Statistics 1949-50 to 1994-95, p120

* Includes risk and capital guaranteed as well as market linked funds.

In contrast to the traditional bank deposit where the value of the deposit and often the amount of interest were fixed in nominal terms, investments in managed funds are generally market linked - their value rises or falls in line with the market values of the underlying assets.

Because of this, the rise of managed funds is a watershed development in the evolution of financial systems. ***It is converting savers into investors.*** More specifically:

- Managed funds provide an alternative mechanism for aggregating savings and pooling investment risks.
- Investors, now face a wide range of investments with differing return/risk profiles depending on the type and mix of assets each fund invests in according to its charter.
- This is an important improvement on the situation where investors could invest only in bank deposits, less secure deposits or debentures, or directly into bonds or individual equities.
- The difference is pronounced for small and medium investors who do not have sufficient resources individually to reduce risk by diversification.
- In economic terms, investors can now choose points along a well-filled-out return/risk spectrum where risk is dimensioned not only by volatility of returns (or probability of loss), but also by area of investment e.g. property, Australian equities, overseas equities, Australian bonds, etc.
- Finally, decisions about the investment of funds are being passed to investment professionals which should improve the efficiency of the allocation process.

As the population bulge moves into saving age and as compulsory contributions to superannuation are stepped up the amount invested via managed funds will rise.

***An important issue for the Committee is what is the appropriate taxation and regulatory framework for managed funds in Australia***. The history to this point is a classic case of a new product being force-fitted into existing regulatory frameworks. There has been an extensive review of the regulatory issues in the Law Reform Commission's Collective Investments Review - the conclusions of which we endorse - and this Inquiry provides the opportunity to take a wider view of the issue. The various taxation issues which are outside the Inquiry's terms of reference will have to be dealt with in parallel.

## Some forces driving change

At a basic level, the most important driver of change in the financial system is profit. The discovery or development of better (i.e. cheaper) ways to perform the basic economic functions which the financial system performs will result in profits for the innovator. In time however, if competition is sufficient, there will be a diminution of profits and at that stage the transformation process will be cheaper and there is a benefit to the community as a whole.

We give just two examples:

- In the wholesale markets, corporations used to borrow from the banking sector. When borrowing direct from markets was introduced (in the mid 1980's) market access was limited and liquidity was poor. Now there are over 100 borrowers with outstandings close to $15 billion, spreads are fine and market liquidity is high.
- In the retail markets, the securitisation of mortgages is bringing down the spread between rates charged to housing borrowers and the cost of funds.

At a more proximate level, rapid advances in technology are bringing great change to the financial system at almost every point:

- the means of client interface;
- client servicing;
- product design, new products, customising;
- credit analysis and monitoring;
- risk management;
- the structure of financial organisations;
- the types of financial markets and means of dealing;
- processing;
- clearing and settlement systems; and
- regulation.

An extra dimension to most of these is that technology will increasingly allow access to information and dealing across national boundaries.

In each of these areas events are moving quickly and it is impossible to be confident about outcomes even a few years hence.

In considering the implications of changes in all these areas for the way the financial system is regulated, we look first at the implications for government objectives for intervention in the financial system, and then at some basic questions that the Inquiry will have to address.

**Technological advance and objectives of government intervention in financial markets**

As with any rationale which has evolved over long periods, descriptions of government objectives vary. However, we consider the following which are often cited in the Australian context:

- to ensure that there is an efficient payments mechanism;
- to minimise the danger of systemic risk;
- to protect investors;
- to ensure the pooling and transformation functions are provided efficiently;
- to ensure investors and borrowers have fair and accurate information about the products they are considering.

***i) The payments mechanism***

A well-functioning payments mechanism is fundamental as it is a pre-requisite for efficient trade and commerce. This is one area where information and communications technologies are bringing marked changes.

It can reasonably be expected that advances in technology will allow:

- the float period (i.e. the period between receipt of a cheque and clearance of funds) to go to zero as real time transfers take place[1];
- prior verification of the adequacy of balances (which will be an advance on arrangements to date which do not protect against bad cheques)[2]; and
- instantaneous settlement and transfer of financial assets.

***Such developments will remove many of the causes for concern about the payments system and focus attention more on systems integrity and criteria for membership of the clearing system.***

### *ii) Systemic risk*

The term "systemic risk" is often used loosely. We take it initially to refer to situations where "trouble" at one financial institution gives rise to "trouble" at other financial institutions and, if sufficiently widespread, affects saving and investment flows and significantly impacts the level of economic activity.

Views differ as to the impact of technological advance on systemic risk.

Those seeing growing risks point to:

- the large rise in transactions and gross exposures between financial institutions over the past decade; and
- the fact that the interdependencies extend beyond the banking system to securities and derivatives firms, and across national boundaries into jurisdictions where regulation may be less effective.

However we see several developments pointing strongly in the other direction:

- Current moves towards legally certain national and international netting of positions will have a marked scale effect on the potential for knock-on problems.
- Real time settlements and prior verification of funds and assets holdings will eliminate risks in those areas.
- Risk management techniques in individual organisations are coming of age. The Barings experience clearly shows that there is some way to go - but that should not mask the spread of risk management applications.
- Central bank monitoring of capital ratios, risk management systems and exposures of banks lessens the likelihood of lead off problems.

***Overall, while the advent of derivatives led to higher gross interbank positions and no doubt at first increased the potential for systemic problems, our view is that developments are now running strongly in the other direction.***

Reinforcing this, the present policy stance in Australia and elsewhere involving steady monetary and fiscal policies is a further factor tending to reduce the likelihood of systemic problems because trouble at banks is most often the result of bad credit decisions made during boom times.

A further question is whether systemic risks are confined to banks or also are of concern in relation to non-bank financial institutions and managed funds?

Systemic risks will be greater where there is gearing, where funds may be withdrawn at call, and where there are large exposures to other similar institutions. These conditions do not appear to apply to Life Insurance products.

With managed funds, the case has been raised in the US where, say, a bond fund experiences redemptions when bond prices fall, liquidates assets (i.e. sells bonds) to meet redemptions and thereby exacerbates the fall in bond prices. While such scenarios can be postulated, we believe they are overstated. The implications would appear to be more for volatility of prices rather than solvency of institutions, but in any case:

- Managed fund holdings have not been volatile.
- Would the effect be less if the bonds were held directly?
- Where there is no gearing, and assets are "market to market" there is less of an element of get out quick or miss out.

- The situation is different if unit trusts are invested in illiquid assets, but in Australia, funds generally have discretion to defer redemption for 30 days or longer.

Our view is that, at the moment technological advance is working to reduce, not increase, systemic risk. However that is not to say that it can be disregarded. ***While ever the basic transformations of risk and liquidity are achieved by highly leveraged bank balance sheets, there is a case for a conservative stance towards prudential regulation***.

There remain difficult questions of judgment such as when a run on a particular institution constitutes a broader threat, and when a lack of action by the central bank in such circumstances makes the threat of repercussions greater. It is
partly because of the mix of information and judgment required when such issues arise that we suggest below that the central bank should be the prudential regulator for banks.

***iii) Protection of investors***

"Protection" has two aspects - requirements for information disclosure (discussed separately below) and prudential regulation of certain financial institutions designed to ensure they remain solvent. This distinction will be fundamental in the Committee's deliberations and it is discussed below.

In terms of the impact on prudential regulation, technological development in the form of derivative financial instruments has been seen in some quarters as increasing the riskiness of financial institutions which deal in them. ***However the real issue is not the "means" by which financial institutions take on or hedge risk, but how well they identify and manage risk.***

While development of information and risk management systems may have lagged initially, such development is now well advanced. In addition the authorities are actively monitoring financial institutions' internal capital allocations, operational risk management and market risk management systems and exposures[3]. Our impression is that in the regulation of banking, where our experience lies, the present degree and means of regulation is appropriate and adequate.

### *iv) Efficiency*

Technological advance is affecting the efficiency of the financial system in various ways.

It is promoting competition by allowing competition across national boundaries, although the impact has been uneven over the range of financial activities.

For instance:

- Some financial markets (e.g. forex) are now basically global, while some (e.g. Australian bond and equity markets) experience significant overseas participation (and, indeed, competition from markets overseas).
- Corporate banking is increasingly global reflecting the increasing globalisation of the corporations it serves. Home base banks still have some advantages, but increasingly, corporations which are active internationally seek advice with a global perspective, and international fund raising and dealing facilities.
- Fund management is now largely global on the investment side (but with percentages held "abroad" in portfolios around the world still rising), and global "sourcing" of funds is now rising significantly.
- Financial innovations spread from economy to economy with securitisation of mortgages a good example.

- We discuss retail banking separately in Part 2 below.

Within financial organisations, technology is increasingly allowing functions, services and risks that have been bundled together in traditional financial products to be unbundled, priced, out-sourced and subjected to competition separately. In this respect the competitive environment is critical. ***Where there is strong competition, technological advance which reduces costs will result in higher returns for investors, or lower costs for borrowers, or both. Where competition is inadequate lower cost structures will result in higher profits.***

Finally efficiency of markets per se is an objective of government and technology is bringing great changes:

- electronic markets and principal to principal dealing may become the norm (where they aren't already);
- there may be a proliferation of markets;
- secure systems will develop for prior verification and real time settlement; and
- the transactor will have a choice of markets in Australia or overseas.

An issue for regulators will be to ensure that present institutional and regulatory structures which have evolved to deal with issues such as counterparty risk do not hinder the emergence of better ways of dealing with such issues.

### *v) Provision of fair and accurate information*

In this area technology is a small positive. It affects mainly the delivery mechanism but, in time, through easy access to rating agency reports, access to data on alternative products, etc., it will improve the breadth of information.

In the longer term, with increasing financial literacy, more voluntary provision of information, more independent commentaries and ratings, there may be less need for intervention in this area. However, we judge we are well away from that point.

***Technological advance will also allow the investor to access information and deal overseas, i.e. beyond the reach of the Australian regulators***. This will require a rethinking of the objectives of regulation. At a minimum, the objective being sought will have to be narrowed to protecting investors when they invest within the jurisdiction.

Some key elements of regulation of the information flow to investors are discussed in Part 2 below.

The main conclusions from this brief survey are that:

- technology will generally enhance efficiency, security and competition;
- regulatory adaptation will be necessary where information flows to investors through different channels or where structures based on the previous need to manage counterparty risks are no longer relevant;
- individuals will be able to access information about financial products and deal beyond the reach of the Australian authorities; and
- while derivative products may initially have increased the danger of systemic risks, systemic risk is now on the decline.

This last point is not well recognised in popular discussions.

## Some determining issues

In considering the implications of the various forces driving change in the financial system for the regulation of the system, the Committee will address crucial questions such as:

- ***how to define the area of the financial system within which "caveat emptor" should apply and how to define the area where additional intervention is justified to "protect" investors;***
- what exactly does "protection" mean; and,
- are banks special (so that they require special regulation including lender of last resort consideration).

In our discussion of managed funds above we drew attention to the fact that they were generally "market linked". We now suggest that the distinction between financial products which are market linked and those which are "balance sheet dependent" defines the dividing line between the areas where caveat emptor should apply and where additional regulation may be required.

Where the investor is prepared to accept risk by investing directly in equities or bonds or in pooled market linked products, what he needs is sound information on the nature of the investment and, in the case of market linked pooling products, the parameters affecting the value of his investment, and confidence that the manager will stay within the parameters.

Where the investor purchases a balance sheet dependent product, his concern is that the institution he invests with will continue to have sufficient assets to meet its liabilities - including its liabilities to him!

In other words:

- ***where an investment is market linked, a disclosure based regulatory
regime is appropriate[4];***

- ***where an investment is balance sheet dependent, a prudential regulatory regime is appropriate[5].***

***This distinction thus provides a key to the appropriate regulatory regime. However it also is basic to the objective of the investor having the information he needs to understand the investment choices he faces and to choose sensibly. Because of the fundamental difference in who bears the risks of the underlying investment, no blurring should be allowed on this issue***.

In relation to institutions offering balance sheet dependent products, what should the objective of prudential regulation be?

In addressing this question, banks have traditionally been seen as the clearest case. Banks, it has been argued, are special in two ways:

- they take deposits from, and hence provide a savings vehicle to, members of society who want security for their savings and who are not in a position to evaluate the soundness of a bank's financial position; and
- they invest funds in small and medium businesses, whose debt cannot be priced by capital markets, and who therefore rely on banks for their financing.

These functions have been seen as socially and economically valuable. Because they imply a mis-match in bank balance sheets, and hence a vulnerability to runs, a degree of government banking has been seen as justified and that in turn is the justification for prudential regulation.

In Australia this has been reflected in the Banking Act imposing the duty on the Reserve Bank of "protection of the depositors of the several banks[6]" (although officials sometimes draw a distinction between "protecting" and "guaranteeing").

In assessing the continued applicability of such views to the current situation in Australia, we note that the range of banks' activities in Australia is wider than just these functions. However, while we have inherited "broad banking", these basic functions continue to be significant and there does not appear to be a strong case for radical change at this point.

Looking further ahead, more speculatively, one scenario might see securitisation replacing more of banks' lending than is presently generally expected, and diversification resulting in a large shift away from bank deposits. The result could be that what is left on the asset side of bank balance sheets would be the more obscure and higher risk loans while what is left on the deposit side are the more security-conscious depositors.

Such an increasing mis-match would raise questions such as:

- alternative ways to provide secure deposits;
- the advisability of the central bank standing behind balance sheets moving in this direction; and
- what happens to borrowers in the residual category if changes are made to the "protection" of banks?

However it is too early to base action on such possible scenarios.

Another area where government intervenes to secure balance sheet-dependent financial undertakings is insurance. In this area, insurance plays a valuable social function, returns may be long in the future, individuals have little expertise in assessing the financial status of insurance companies and we see a continuing role for balance sheet based regulation. (We draw a distinction with regulation of Life products which are market linked).

Similar considerations apply for institutions offering annuities and other long lived capital guaranteed products.

In summary, we see a continuing case for prudential regulation of banks and institutions offering long lived balance sheet dependent products and, as a practical judgment, we also see a need for prudential supervision of other deposit taking institutions and institutions offering shorter term capital guaranteed products.

We return to these issues in our consideration of the organisation and means of regulation in Part 2 which follows.

## Part 2: The Regulatory Framework

### Overview

First we refer to some problems in the present regulatory framework.

Then we consider options for reorganisation in the light of the conclusions of Part 1.

Whichever organisational structure is adopted, there are issues about the appropriate legislative approach, the style or approach of regulation, and handling of financial sector issues at government level.

Then we look more closely at issues relating to:

- regulation of the information flow to investors;
- regulation of banks; and
- regulation of managed funds.

### Problems with the existing regulatory framework

The major problems we see with the present framework are in the areas of:

- separate regulation of similar investment products by the ISC (Insurance and Superannuation Commission) and the ASC (Australian Securities Commission);
- disclosure requirements; and
- regulation of financial advisers.

As between the ISC and the ASC the regulation in each case seeks to achieve very similar objectives. However, because there are different laws, and different regulations and regulators, unnecessary differences arise.

The Council of Financial Supervisors has been established to co-ordinate and harmonise regulation and it may be untimely to assess the likely success of harmonisation before their work has been carried through. However the advent of the Inquiry means that we have to assess the system as it stands and make judgments about the prospects for harmonisation and alternative organisational arrangements.

In practice, while the objectives of the two regimes are similar, the codes are quite different. For example:

- The disclosure requirements vary between a unit trust, a public offer superannuation fund, and a market linked insurance product.
- There are different licensing procedures for advisers, different codes of conduct, locations of responsibility, types of offences, obligations, etc, etc.
- Even at the governance level there are differences:- SIS (Superannuation Industry Supervision Scheme) has adopted the single responsible entity fully; CIR (Collective Investments Review) while basically accepting the principle, proposes a separate custodian.

With such differences, a reconsideration of the regulatory framework may be superior to harmonisation which, we suspect, will involve compromise.

We have separately considered the question as to why it is common for regulators to view industry complaints about overlapping and complexity of regulation as overdone when, in spite of the fact that regulators these days do pay attention to the burdens of regulation, and in spite of progress on harmonisation, the industry view persists. The reconciliation seems to lie in the cumulation of various types of regulation and taxation requirements. Appendix I sets out the ways regulatory duplication and complexity impacts on our fund management business.

How costly is regulatory duplication?

Our interface with regulators is a mixture of appropriate regulation, duplication, taxation compliance, and complications from other areas of the law. In practice, it is difficult even to make a broad judgment about the relative contributions to costs.

However, as an indication, in our fund management business alone:

- we have 25 people including 13 lawyers and 8 other professionals working on legal, tax and compliance issues;
- other tasks, such as information generation, account preparation, lodging of returns, training for staff and advisers are also inflated by the current dual regime;

- our spending on outside legal advice on such matters is of the order of
  $1 million per annum; and
- at a guess, we would say one third to one half of this effort could be avoided by a more consistent framework between regulators and between States.

In economic terms, such costs represent a significant barrier to entry as well as, ultimately, a significant imposition on consumers.

**Organisation of Regulation**

In considering alternative arrangements for regulation we have been influenced by the view that regulation of banks by the RBA and regulation of markets by the ASC do not appear to require radical change. In both cases there is a need for on-going adaptation, but in terms of approach to the task, the means employed and effectiveness, there is not a strong case for upheaval[7].

Accordingly, we have focussed on what appears to us to be the problem area - consistency of regulation in the life, superannuation, and managed fund sectors.

We have also been influenced by our views about regulation of product disclosure and financial advisers. These are discussed at greater length below, but in summary are:

- we believe there are benefits both to product producers and to potential investors from having disclosure requirements decided by a regulator who has a close understanding of the products and the industry, and this is more likely if the prudential regulator is responsible for product disclosure;
- there does appear to be a good case for a single regime for financial advisers.

**Our proposal**

Conceptually, regulatory overlap is likely to be a problem when different regulators regulate products which are essentially the same type. Overlap is avoided by having a single regulator for all products "of a type". In Part 1 we suggest that investments fall into two basic types according to whether the investor or a financial institution bears the risk. We concluded that where an investment is direct or market linked, a disclosure based regulatory regime is appropriate, while a prudential regulatory regime is appropriate where investments are balance sheet dependent. Our proposal is based on this distinction.

In summary, the proposal is:

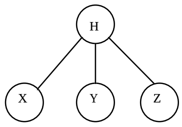
- The ASC would have responsibility for:
  - Governance regulation of market linked products, companies and markets.
  - Disclosure requirements for market linked products, and company fund raising.
  - Regulation of financial advisers across the whole range of financial investments.
- The RBA would regulate the banks and, possibly, other deposit taking institutions.
- There would be a separate regulator based on the ISC for all other institutions offering balance sheet dependent products.

This proposal to us represents the best balance between addressing current problems, getting the fundamental structure correct so that the revised organisation will endure, and minimising unnecessary change and disruption (the costs of which are easily under estimated).

In the following sections we discuss various aspects of this proposal.

***i) Conglomerates***

We see regulation in relation to an individual financial group working along the following lines:




- H is the holding company.
- X, Y, Z are subsidiaries which offer distinct types of financial products and ***each attracts the regulation appropriate to type***.
- There are strict controls on the shifting of capital and assets between the subsidiaries but these do not preclude normal business dealings.
- There is also some supervision of H and the group overall by a lead regulator in relation to the effectiveness of firewalls and to prevent double use of capital.

The questions are: can distinct types of financial products be defined, and should there be a single regulator?

As above, we believe that there is a fundamental distinction between market linked and balance sheet dependent financial products so that the distinction can and should be made.

Our proposal for separate regulators for each basic type of product draws upon the expertise in existing regulatory institutions, helps make the distinction in product types clearer, and fits with having product disclosure determined by the prudential or governance regulator.

Regulation is product based where that is appropriate (market linked products) and institution based where that is appropriate.

Arrangements for who is to be the lead regulator for a particular group would be worked out between the two prudential regulators.

We expect that conglomerate financial groups will offer investors bundled products i.e. products which embody products from more than one subsidiary, but the nature of the bundled product must be transparent to the investor. In particular, there would have to be clear disclosure that none of the subsidiaries guaranteed the products of the other subsidiaries and for example, if one of the subsidiaries is a bank, the bank name would not be allowed to attach to products of other subsidiaries.

### *ii) Prudential regulation*

The argument in favour of a single regulator for prudential regulation of all institutions offering balance sheet dependent products is that it promotes consistency and avoids overlap. However we see several arguments to the contrary as follows.

Banks still have a special place in the financial system (as discussed in Part 1) and hence require a special regulatory focus. This task is currently being performed by the RBA and there appears to be no need for change in this area. Moreover, it would be undesirable to extend that some degree of certainty to the liabilities of all institutions offering balance sheet dependent products as would occur if the RBA became the single regulator in this area. There are also clear distinctions between regulation of banks with its emphasis on gearing and credit assessments and regulation of life risk insurance, annuities and long lived capital guaranteed products with its emphasis on actuarial and market risks. Finally, two regulators allows some differentiation in the extent of "protection" afforded to the two sub-sectors - for example the power to raise an industry levy is differentiable from lender of last resort.

Having said that, we recognise that with two regulators for balance sheet dependent products there would be "border issues" in the areas of non-bank deposit taking institutions and shorter-term capital guaranteed products.

Whether there are one or two prudential regulators, the task is to design a regime which would harmonise regulation for a similar product offered by different institutions. This task would take account of the nature of the assets held as well as the nature of the liability. In our proposal, this would have to be worked out between the two regulators - but that would be the price of the other benefits outlined above. In practice, building societies and credit unions would fall to the RBA and friendly societies would fall to the other regulator.

### *iii) Superannuation and life insurance*

The flow of new funds into superannuation is increasingly into defined contribution schemes and away from defined benefit schemes. ***The implications of this change are profound but are neither widely appreciated or discussed. In fact this is another mechanism which is turning savers into investors.*** With defined benefit schemes, the benefit was fixed in the sense that it was related to salary. With defined contribution schemes, the benefit depends on investment performance.

Defined contribution schemes are essentially managed funds. Currently the ISC and the ASC have similar objectives in their regulation of managed funds but different rules in practice. In our proposal, all managed funds would receive the same basic regulation. If the superannuation authority required certain additional items for "complying fund" status for taxation purposes (as it does in the form of rules about sole purpose, equal representation, investment restrictions, etc) these would be communicated to the ASC and administered by the ASC.

Hence the basic regulation would be in line with the nature of the product or institution, and additional superannuation requirements would be an overlay. A corresponding overlay arrangement would apply for RSA's with banks where the basic bank regulation would be by the RBA but additional conditions (e.g. on withdrawal) would be determined by the ISC but administered by the RBA.

There is a transition issue as a large number of superannuation funds are currently regulated under SIS. As below, we see the new regulatory regime for managed funds drawing on both SIS and CIR with a view to minimising transition costs.

The superannuation authority will also continue to regulate defined benefit schemes. The regulation of these schemes includes an actuarial element so there is a "fit" with regulation of insurance products and we see this function remaining with the ISC.

Life insurance products currently include life risk, capital guaranteed and market linked products, and various mixes. In the proposed regime, an institution offering such products would deal with two regulators - one for balance sheet dependent products and one for market linked products. This would be the case for any financial institution offering different product types. However, for the reasons outlined above, overlap should be minimised. Our proposition is that the two types of products should have different regulation, and the consumer should be clear about the difference.

We have assumed that the result of the current reviews of the taxation of finance and of life insurance in particular will remove the existing opportunities
for tax arbitrage so that there will be no tax reason to prefer a life insurance vehicle for financial products. ***We regard such reform of the tax system as a pre-condition for regulatory reform of the type we envisage.***

With life companies however there would be important transition issues. Would application of a single tax regime to all managed funds be sufficient to shift such products into the managed fund regulatory framework? Would the new framework only apply to new funds invested or would existing products be converted? If the latter were the case, CGT and stamp duty relief would be required. We believe these problems are manageable. They would arise in any case with a single regulator if our basic view about the dividing line for regulation and disclosure is accepted.

### iv) *A single prudential/governance regulator?*

The Committee will receive submissions in favour of a "Twin Peaks" model of organisational regulation[8], so we contrast our proposal with such a model. Placing responsibility for all prudential and governance regulation with one organisation does not automatically solve the problems that exist. Decisions would still have to be made about where lines will be drawn and what rules will apply. We prefer the model we have proposed because:

- it involves less organisation reshuffle and does not disturb areas which do not appear to require change;

- it focuses on the key product distinction; and
- it does not involve problems with extension of the government guarantee.

### *v) A single consumer protection regulator?*

"Consumer Protection" is really a wrong name for the function usually envisaged by this proposal. While it is true that ensuring that the investor is well informed and well advised does, in a sense, offer him some protection, it does not (and should not) offer him protection in the full sense of that word.
Hence use of the word "protection" could tend to inflate expectations and is
misleading. If such a regulator were to be proposed a more descriptive name would be "Investment Disclosure Commission".

Proposals for a single consumer protection regulator usually see that regulator's tasks including disclosure in respect of investment products. As above, we believe that ***there are benefits to both investors and product producers from having product disclosure determined by the regulator at the prudential/governance level.***

There is some danger that a consumer protection regulator would come to make cumulative disclosure demands on product producers.

The issue of capture - either by the regulated industry or by consumers - is an important one for any reorganisation of the regulatory framework.

***We see our proposed structure as less vulnerable to capture from either consumer or industry because the expanded ASC would have responsibilities to both investors and to markets and fund raisers and this would provide a balance of pressures.***

### *vi) Other alternative proposals*

Here we mention just two of the many possible alternative proposals.

First, a line could be drawn between deposit taking institutions and all other financial institutions. However, to our mind this has the disadvantage that with both balance sheet dependent and market linked products regulated within the one body, there may not be the same drive to insist on the basic distinction between these two types of product.

Second, the main present overlap could be addressed by simply moving responsibility for regulation of unit trust investment vehicles from the ASC to the ISC. This has the advantages that it is a minimal change and it is directed at the main source of concern. If this alternative were pursued we would argue that the product disclosure requirements should also transfer to the ISC. This proposal is however subject to the criticism noted above. Whatever the organisation shape, the fundamental changes will have to be made, so why not have them reflected in the organisational structure.

In summary, ***our proposal takes account of the costs of change, and focuses on areas where action is required, and proposes a basic distinction which clarifies issues for regulators and for investors.***

We turn now to consider other aspects of regulation.

## Qualities of Regulators

In many ways the quality of regulators is as important as how demarcation lines are drawn.

At the highest level - government and its advisers - there may be a need for a change of mindset towards the financial sector. In the past, the attitude has at times been one of disinterest or one focussed on the need for restraint. While the industry needs strong police for cases of abuse, there are grounds for a more positive attitude:

- In the managed fund industry, the vast majority are fulfilling their fiduciary duties to their clients and are complying with regulation.
- Financial innovation is reducing the spread between what investors receive and what end-users pay.
- With the aging population, the industry will play a large role in investing the savings of the community.
- The industry is modern, hi-tech, generating employment, competing internationally and earning overseas.

The Treasurer's comments at the time of the establishment of the present Inquiry, and the consolidation of ministerial responsibility for regulation of finance in the Treasury portfolio are both positive and encouraging signs.

The test will come not only in the response to the Inquiry's recommendations but also in the Treasury's willingness and ability to impose a view on other regulatory agencies and the States to overcome problems, including taxation problems, such as those identified in Appendix I.

In regard to legislation, it is clear that change in the financial system will be rapid and regulation will have to adapt. In such circumstances it is more important than ever that ***legislation should contain clear and simple statements of the objectives it is seeking to achieve (both overall and section by section), establish powers for the regulator to pursue them and, to the extent possible, leave it to the regulator to decide the best way to achieve the objective.***

The action in this direction in recent legislation and in the Corporation's Law Simplification exercise are positives in this regard and the simplification project should be given adequate resources and priority.

Legislation by Press Release should be avoided in all but extreme circumstances.

With regard to regulators, the ideal is easy: one who understands the objectives of intervention in the financial sector, who seeks to promote the ends which underlie those objectives, who understands the industry, who is effective in bringing transgressors to justice, but who is facilitating rather than restraining when there is no matter of principle at stake. We draw the distinction with a regulator whose main focus is the letter of the law as it stands.

All our experience suggests that, ***wherever possible, the approach to regulation of the financial sector should be supervisory rather than prescriptive***.

In this regard both the approach of the regulatory head and the culture of the organisation are important. We would see the following as likely to promote the right culture in financial sector regulators:

- location of the head office in Sydney, i.e. in the financial capital rather than being physically isolated in Canberra or elsewhere;
- a budget which enables staff to be attracted from the private sector;
- interchange of staff with the industry; and

- an economi******************************************************************

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**********************************the market for home loans, it would clearly be a matter of concern.

It is also worth noting:

- To be efficient, financial markets require depth and liquidity[12]. The major banks are among the major participants in the markets in Australia and, while most markets now have considerable international participation, mergers between them would reduce depth and liquidity with resulting deterioration in pricing for end-users.
- Mergers would have implications for prudential regulation. It seems likely that systemic risk increases with concentration in the banking sector. With the central bank concerned to avoid such risks, banks can become "too big to fail" when there are not many of them. The present problems with Credit Lyonnais in France come to mind. Also, if the number of major banks were further reduced, options for orchestrating take-outs if a bank were to get into trouble would be limited.
- Finally in such a key sector as finance, which makes decisions which can influence all areas of the community, there may be concern about further concentration of decision-making and political power. For example if mergers took place and then one bank changed its policy toward lending to the small business sector, that sector would have fewer alternative sources for funds.

Judgments about the balance of all these factors may differ, but competition is the first hurdle. If adequate competition emerges in the areas of concern, then mergers amongst the major four banks may not present problems. If, however, competition
is insufficient, the benefits from mergers will flow into the remaining banks' profits, not to consumers, and the increased concentration may have on-going adverse consequences as discussed above.

Our conclusion is that any decision regarding mergers between the major four banks should not be based on assumptions about competition in the key areas we have identified, and that the continuing importance of the sector to the economy as a whole suggests that some more stringent tests than those applied by the ACCC to other sectors may be appropriate.

**Regulation of Managed Funds**

We have pointed above to:

- the significance of the emergence of managed funds;
- the way they have been force-fitted into prior existing regulatory frameworks (life insurance and prescribed interests); and
- the duplication and inefficiencies which result from the three different regimes (life insurance regulation, superannuation regulation, and unit trust regulation).

Clearly this Inquiry is the opportunity to achieve a single coherent regime.

We are proposing that there be a single regulator for all market linked investment products and that all such products be regulated by the same rules (with overlays for superannuation funds as necessary).

This would achieve regulatory neutrality - i.e. remove the present possibilities for regulatory arbitrage. However there is still the question of what rules should apply.

This question has been reviewed extensively in recent years and this process has given rise to the Collective Investments Report (and draft legislation), and to corresponding provisions in the SIS legislation.

The main difference between these regimes and the current Corporations Law regime is that they embody the concept of Single Responsible Entity to replace the confused roles of manager and trustee under existing law.

***We endorse this new framework. It makes clear where responsibility lies and it streamlines and makes more effective control and authorisation processes.***

If a proposal like ours for reorganising regulators were adopted, the legislative framework for market linked investment products could draw on both SIS and CIR with a view to minimising transition problems.

## CONCLUSION

Change resulting from technological advance, globalisation and financial innovation will be persuasive in the finance sector in the years ahead. However some things don't change - the fundamental functions of the sector such as provision of savings vehicles, pooling, investment, and risk management, will still be performed albeit in different ways, and it will always be relevant to ask "who bears the risk?"

In considering changes to the regulatory framework we have tried to take account of the costs of change as well as the desirability of consistency. Our view is that regulation of banks and of financial markets are not in need of radical reform.

In considering reform to the problem area where there is clear overlap between regulators, we have drawn attention to the basic distinction between market linked and balance sheet dependent financial products. This distinction is fundamental to the type of regulation which is appropriate and to the investor's understanding of what he is buying. It should not be subject to blurring.

Basing a new regulatory framework on this concept has strong attractions, although there would be transitional issues which would require careful management.

In terms of disclosure regulation, we see dangers with a separate consumer protection regulator - both the investor and financial institutions are likely to be better served by our proposal.

In regulation of financial advice, we endorse the proposal for a single, consistent and comprehensive framework.

**Why does the finance industry think that regulation is complex, duplicative and inconsistent?**

It is common for regulators to suspect that industry complaints about complex and overlapping regulation are over done.

However, in spite of the fact that regulators in most cases these days take into account the burden of regulations they are considering, and in spite of the fact that there has been a progress on harmonisation under the auspices of COFS and otherwise, the view from industry persists.

In this section we try to show by reference to our own experience why the view is held.

* As indicated in the text, the clearest cases of overlap arise because two regulators (the ISC and the ASC) regulate fund management products which apart from their tax treatment and regulatory environment are virtually identical.

  - The disclosure requirements on the fund manager differ as to whether the product is a unit trust (prospectus) or an insurance or superannuation product.

  - There are different licensing procedures, codes of conduct, locations of responsibility (with the adviser or with the insurance company), types of offences (civil versus criminal), obligations (positive versus negative), etc etc.

* There are differences between the two organisations as well at the prudential level - for example SIS and CIR take different views of the appropriate responsible entity/custodian structure.

* In regard to complaints processes, the options for aggrieved parties might include the ASC, the ISC, the ACCC, Consumer Affairs and Credit Offices in the various States, the Banking Ombudsman, the Superannuation Complaints Tribunal and the Life Insurance Complaints Tribunal.
* In regard to disclosure more generally, there are two legislative frameworks: The Corporations Law at Sec 995 et seq establishes a framework designed to promote the provision of information in prospectuses. It prohibits misleading or deceptive conduct but provides for some due diligence defences. The Trade Practices Act at Sec 52 prohibits misleading or deceptive conduct but does not provide any defences for civil offences.

* The problems for fund managers from overlap are illustrated by the experience where an officer of the ACCC raised the question as to whether a prospectus was misleading or deceptive by virtue of the type size, when in fact the type size is specified in The Corporations Law.

* There are many examples of inconsistencies in the tax environment.

* We have referred above to different taxation treatment of virtually identical products offered via life insurance or unit trust vehicles.

* There are several inconsistencies in the stamp duty area:
  - Stamp duty is payable on the purchase of life policies but is not payable on the purchase of a unit trust.
  - There are, in effect, different definitions of change of interest in the stamp duty legislation in the various States. When units in a unit trust are redeemed, some States impose duty on the underlying value of assets held in those states. This requires a very substantial record keeping task.

- When SIS was introduced, most super funds transferred assets to a new responsible entity and changed the terms on which those assets were held. NSW stamp duty administrators were more accommodating towards these changes than those in other States. This also applies to the on-going rationalisation of super funds.

* The record keeping and compliance requirements for BAD, FID and FIF are heavy. In the case of fund managers for instance, the burden for FIF is such that managers will normally organise their affairs so that they fall below the threshold on balance date. With FID, each State has different catchment provisions which are very technical.

* There are other problems with differences between States - for example not all States have yet adopted the "prudent man" basis for "authorised investments" by trustee companies and this has implications for the construction of compliance apparatus and a fund manager's ability to deal in bulk.

* Legal uncertainties such as those which arose with the question of whether options were securities or futures give rise to effort, expense, and uncertainty.

  There have been some infamous examples of legislation by Press Release which have left market participants unsure of their legal obligations for months, or in one case, more than a year.

* Because we are foreign owned, our investment vehicles are caught in FIRB reporting and approval procedures in spite of the fact that we are investing funds in a fiduciary capacity on behalf of unit holders in unit trusts or superannuation fund members who are predominantly Australian. Similar problems arise in respect of media and casino legislation and special purpose vehicle legislation. Individual authorities with their limited fields of vision have been slow to look through legal ownership to beneficial ownership.

* Finally, there has been wide-ranging and on-going reform of the regulation of finance in recent years. This has included reforms by RBA, ISC, ASC, COFS, SFE and ASX.

  Most of this represents necessary adaptation. But in each case, resources have to be devoted to have an input, and that all adds to the view of "spending more time on regulation".

  The issue of derivatives provides an example. There have been review process by the RBA, ASC, CASAC, ISC and ORR.

In setting down these points we do not want to suggest that harmonisation is not producing positive results, that the cumulation of problems is overwhelming, or that a perfect system exists which does not involve any overlaps.

Rather we simply want to give an impression of why there tend to be different views of the burden of regulation between regulators who tend to see only the impact of the regulations of their own institution, and the industry which bears the cumulation, including the effects of tax and other legislation.

| International Bank Income Comparisons 1994 (% of Av. balance sheet total) | | | | | |
|---|---|---|---|---|---|
| | Net Int Income | Non Int Income | Operating Expense | Provisions | Profit Before Tax |
| Australia (RANK) | 2.57 (7) | 1.81 (3) | 2.77 (4) | 0.31 | 1.31 (4) |
| Austria | 1.90 | 0.77 | 1.74 | 0.51 | 0.42 |
| Belgium | 1.33 | 0.42 | 1.24 | 0.15 | 0.36 |
| Canada | 2.79 | 2.28 | 2.71 | 0.51 | 1.85 |
| Denmark | 3.83 | -0.55 | 2.38 | 0.90 | 0.00 |
| Finland | 1.64 | 1.44 | 4.31 | -0.03 | -1.19 |
| France | 1.27 | 0.71 | 1.46 | 0.50 | 0.02 |
| Germany | 2.18 | 0.53 | 1.64 | 0.54 | 0.53 |
| Italy | 2.63 | 0.82 | 2.24 | 0.80 | 0.41 |
| Japan | 1.33 | -0.04 | 0.98 | 0.19 | 0.11 |
| Netherlands | 1.89 | 0.77 | 1.78 | 0.28 | 0.61 |
| Norway | 3.44 | 0.75 | 2.66 | 0.21 | 1.33 |
| Spain | 3.00 | 0.83 | 2.29 | 0.77 | 0.77 |
| Sweden | 2.56 | 1.48 | 3.28 | -0.21 | 0.98 |
| Switzerland | 1.41 | 1.70 | 1.70 | 0.85 | 0.56 |
| United Kingdom | 2.34 | 1.78 | 2.64 | 0.33 | 1.15 |
| United States | 3.79 | 1.98 | 3.75 | 0.28 | 1.74 |
| AVERAGE FOR 17 | 2.35 | 1.03 | 2.32 | 0.41 | 0.64 |

Source: Bank Profitability, OECD, 1996. Each component is expressed as a percentage of the average of asset and liabilities in 1994. Portugal, Turkey and Greece excluded on the grounds of being less developed financial systems. The figures refer to all commercial banks for the country in question.

Notes: Cyclical swings clearly affect the data for some of the countries in the table. However the data shows that Australia has a relatively high cost banking system but that this has not adversely affected bank profitability.

## FOOTNOTES

[1] The introduction of the RTGS system in 1997 will be an important step in this direction.

[2] Austraclear and RITS already embody such processes.

[3] See, for example: "Derivatives - Bank Activities and Supervisory Responses", Reserve Bank Bulletin, May 1995.

[4] "Disclosure based regulation" here includes appropriate governance rules. For example, a unit trust has to provide a prospectus to raise money from the public (disclosure). But also has to be registered, and have a trust deed which sets out its objectives, operating rules, etc., (governance).

[5] Prudential regulation refers to regulation designed to ensure (or improve the likelihood of) solvency.

[6] Banking Act, 1959, Section 12.

[7] We refer below to the Corporations Law Simplification Project.

[8] This model has a single prudential/governance regulator and a single consumer protection regulator.

[9] Growth Platforms for a Competitive Australia, McKinsey & Company Australia, 1995.

[10] See, for example, OECD Financial Conglomerates, OECD Publications, Paris, 1994.

[11] See also Appendix II.

[12] See, for example, Australia's Capital Markets, The Allen Consulting Group, June, 1996.