SECOND SUBMISSION TO THE

FINANCIAL SYSTEM INQUIRY

January 1997

Bankers Trust Australia Group

This submission directs the Committee's attention to three points.

The *first* is that there are, at the end of the day, two basic types of investment products - those where the financial intermediary bears the risk and those where the investor bears the risk. Whatever the number of regulators, unless this basic distinction is reflected in the organisation of regulation and its rules, then the appropriate type of regulation will be obscured and the messages to investors will be confused.

The *second* concerns regulation of the fund management industry. Our impression is that, in the debate so far, this question has been left somewhat in the background[1]. However:

- managed funds now account for a major part of the flow of household saving;
- the move to managed funds (and within managed funds to market linked investments) is one of the strong forces for change in the finance sector; and
- there are widely acknowledged overlaps and duplication of regulations in this area.

It would be unfortunate if reform of this area were not a centrepiece of the Committee's final report.

In our first submission we suggested[2] that the overlaps and duplication of the regulation of unit trusts, superannuation accumulation funds, and market linked life products be corrected by:

- removing tax anomalies so that there is a single tax regime for market linked managed fund products;
- applying a single regulatory regime to managed fund products; and
- treating additional regulatory requirements in respect of superannuation products, as an "overlay" on the basic standard regulation.

We believe that something along these lines is necessary if the objectives identified by the Committee in Chapter 4 of its Discussion Paper - particularly those of competitive neutrality, transparency, and cost effectiveness - are to be met[3].

These first and second points are closely related. It is increasingly inappropriate for example to speak of "the insurance and superannuation industry". Both contain apples and oranges. Capital guaranteed and market linked investment products should be regulated by different and, in each case,

single regimes. Additional regulation where those products constitute superannuation provision should be via overlays.

Proposals simply to merge the ISC and the ASC miss the crucial point.

The danger is that proposals for reform at the organisational level which do not consider, at least in broad outline, the types of regulations which are appropriate will leave the most important issues unaddressed or, worse, will constrain regulatory outcomes in a dysfunctional way.

Our *third* point concerns consumer protection. It is clear from a wide range of submissions that there is a need for action to rationalise regulation of disclosure, advice, dispute resolution, etc across the board. However, we believe that there is a very real danger in locating such functions in a separate special purpose regulator.

The danger is that, over time, such a body will come to make cumulative demands on the industry without a "cost/benefit" perspective. This could occur either by interest group or political activity or by the natural drift of an institution with a single purpose mission statement. Our reading of the history of regulatory bureaucracies makes such an outcome likely.

The result would be higher costs to consumers and a less efficient financial system.

Because of this, we suggested locating these functions with a regulator which has countervailing pressures on it as well.

The issue, then, is not only one of synergies between regulating market integrity and consumer protection[4], but also the downside of a separate consumer protection regulator.

Two further points can be made in relation to the issue of consumer protection.

In regard to the Sec 52 TPA issue, the Discussion Paper recognises the arguments both ways. However one additional point struck us. Amongst the "Criteria for Good Regulation" (at para 8.34), the Discussion Paper says: ".......consumers should be aware of their rights and responsibilities." This, of course, should also apply to the providers of financial products, and that is not the case with the present dual regulation.

Finally, in regard to the regulation of financial advice which the Committee was yet to consider at the time of the Discussion Paper, we stress again the importance of disclosure statements and refer the Committee to our comments at page 32 of our first submission.

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Our initial submission proposed avoiding change where present regulation is working satisfactorily and hence focussed on the areas where we saw existing and prospective problems from confused regulatory structures. In the structure we proposed, the regulatory emphasis for institutions offering balance sheet dependent products was on capital strength and reserving policy, while for market linked products the emphasis was on disclosure including the security selection process, market risks, and risk management policies. The structure was soundly based in terms of the basic characteristics of financial products, and met the objectives for regulation which the Committee has endorsed.

No doubt the principles underlying the structure we proposed could also be embedded in *some* of the other regulatory structures which have been proposed. However it will be a telling test of other structures as to whether they deal satisfactorily with the distinctions and issues raised above and in our submission.

Appendix

Some brief comments suggested by other submissions

1. Should the authorities rely more on public information disclosure to achieve financial system regulatory objectives[5]?

   While not opposing increased disclosure, we see a strong case, even apart from systemic considerations, for prudential regulation of some (or, indeed, all) financial institutions offering capital certain products. The case is clearest for us in relation to life or disability insurance[6]. Here the consequences of default can be catastrophic for individual families and, in the absence of prudential regulation, it would plainly be *impossible* for individuals to assess the likelihood of a company's solvency in five, ten, or fifteen years no matter how much information they had.

   We also see an analogous if somewhat diluted case for prudential "protection" of bank depositors and general insurance clients.

2. Should the coverage of any "implicit government guarantee" be reduced? How could this be achieved?

   If technological advance means that payments mechanism and systemic concerns are lessening over coming years, then it makes sense to reconsider the breadth and depth of government involvement (explicit and implicit).

   However, given community expectations and the political process, action to reduce implicit government backing might not have much operational significance.

   For this reason we envisaged an evolutionary process.

   The short run effect of the proposals in our submission would be:

   a) to reduce the coverage of the implicit government guarantee by removal of market linked insurance products to the managed fund regime where it is clear that the investor bears the risk; but,
   b) to increase the coverage by inclusion of all deposit taking institutions under the supervision of the RBA.

In the longer run, there will be a continuation of the processes such as securitisation which shift both assets and liabilities off the balance sheets of financial institutions and into the managed fund "investor takes the risk" sector. On this view, capital and other prudential requirements would be set at a level to ensure the solvency of institutions making balance sheet dependent promises. If and as these costs are viewed as too high by investors, or as investors find they can achieve acceptable risk profiles via diversification and managed funds, the guaranteed sector will shrink to its "optimal" size.

Whether such an evolutionary process will be viewed as fast enough depends on views as to whether prudential regulation can be effective in modern financial markets. Our view is that it can and that fears to the contrary are overstated.

FOOTNOTES

[1] While the FSI Discussion Paper presents the range of views on this subject, there is something of this at paras 7.57 to 7.61 (Options for the Prudential Framework).

[2] BT Submission at pp 20-24.

[3] For example: "Competitive neutrality requires that the regulatory burden associated with a particular financial commitment or promise apply equally to all those who make such commitments" (Discussion Paper, para 4.53) and "regulatory functions be allocated among regulatory bodies so as to minimise overlaps, duplication and conflicts" (Discussion Paper, para 4.55).

[4] c.f. FSI Discussion Paper para 5.60.

[5] Department of the Treasury Submission to the Financial System Inquiry, page 88 et passim.

[6] c.f. FSI Discussion Paper, Chapter 8, where there is a discussion of protection of depositors only.