WALLIS INQUIRY — COMMERCIAL IMPLICATIONS FOR FINANCIAL SERVICE PROVIDERS

Financial System Inquiry

DR JEFFREY CARMICHAEL AO

Commissioner, Commonwealth Financial System Inquiry
Director, Queensland Treasury Corporation

INTRODUCTION

I am very pleased to have this opportunity, thanks to the Banking Law Association, to present an outline of the Financial System Inquiry Report.

The initial reactions to our Report from the Commonwealth Government, the finance industry and the media have been encouraging. I hope people can now take some time to think carefully about what their considered reactions will be, before the Government responds more formally later in the year.

The Report and its 115 recommendations are the result of nine months of challenging and stimulating effort by the five member Committee, supported by a very capable Secretariat based in Canberra. It was a very tight timetable, but I believe we have produced a balanced and sensible set of recommendations to guide our financial system into the next century, with benefits for all Australians.

Today I will talk about the proposed regulatory structure and also about consumer protection. But let me start with some general comments about the Report.

- First, the Report is about *competition and efficiency*.
- Unlike Campbell, it is *not primarily deregulatory*.
- Some deregulation, but the focus is on *realigning and streamlining* regulation to make it more efficient and conducive to competition, rather than on removing regulations per se.

COST

- In terms of efficiency, we built our case around our assessment of current costs and how we stood relative to international best practice:
  - Estimate cost to consumers of Australia's financial system is about $41 billion.

- Banks about 50% of this cost, ins 7b, MMCs 3½ b, funds 2 1/1 b, NBFI 1.4b.

- By international comparison, we are competitive in some segments, but overall in the middle to upper range on cost.
- System-wide savings of 10% would be some *$4 billion each year.*
- Need these savings to be internationally competitive.

FORCES FOR CHANGE

- We categorised forces for change under three main headings: *consumer needs, technology*, and *regulation itself.*
- Consumers:
  - On the consumer side, the biggest changes have been demographic. Ageing — ratio of those in the workforce, to those not, diminishing — Retirement income and spending patterns changing.
  - Net effect — consumers are becoming more reliant on the financial system and are taking on greater exposures to *market related* investments than in the past.
- Technology:
  - The costs of handling data are declining, the security of communications is improving, and new modes of distributing services to users are evolving rapidly.
  - As the cost of information management decreases, new players find it easier to enter the market. Importantly, many of the prospective new players in the electronic information world are coming from outside the finance industry (telecommunications and software firms).
- Outcomes:
  - Globalisation of financial markets. As markets have globalised, the focus of attention has shifted from national markets to international markets — the very concept of a "market" has changed.
  - Likely to shift from wholesale to retail.

VISION

- Important to have vision but not to lock in to a single scenario.
- Two: *minimalist or incremental* view with the other extreme of a *paradigm shift.*
- The incrementalist view second-order changes only.
- The paradigm shift view is that we are on the brink of a major revolution in the way finance is conducted and who will conduct it.
  - Deal without human contact.
  - Cash will be drawn down electronically to PCs and mobile phones.

  - All wealth will be held in liquid mutual fund type investments.

  - Participants will dichotomise into supermarkets and boutiques.

- There is no doubt that all this is possible — the technology already exists. Whether the world is ready to accept it yet is another matter.

  - We had a two-stage view.

- Challenge for the Committee — respond to the here and now — but flexible enough to cope with future.

PHILOSOPHY

- The Committee devoted considerable time and effort to arrive at a firm basis and philosophy on which to build this regulatory approach.

- Our philosophy about regulation in the financial system was mainstream. We accepted the need for government intervention in four areas of market failure:

  1. Anti-competitive behaviour.

  2. Market misconduct.

  3. Information asymmetry.

  4. Systemic instability.

  But no regulation just for regulation's sake — regulation must be cost effective.

- So, the first issue was whether or not to deregulate further — we looked at NZ and decided against.

- In our view, the future does not point, at this time, to the need for further deregulation, so much as to the need for *better focused and more cost-effective* regulation.

- One further aspect of our philosophy on regulation is that we have recommended building into the regulatory framework greater accountability for the regulatory agencies, more on-going tests of the cost-efficiency of regulation, and more assessment of how regulation affects our international competitiveness.

REGULATORY STRUCTURE

- The main themes of our recommendations are about:

  - contestability,

  - safety and stability, and

  - reducing costs and improving efficiency for consumers and other users.

- The Inquiry has proposed a substantial re-orientation and streamlining of regulatory arrangements.

- It proposes that regulation be organised according to broad regulatory functions, instead of along institutional lines.
  - *Competition regulation* to stay with the ACCC but without a role for government on merger policy;
  - *Consumer protection and market integrity* be brought together in a single agency to be known as the Corporations and Financial Services Commission;
  - *Prudential regulation*, aimed at the safety of financial institutions and superannuation funds, be brought together in a single agency to be known as the Australian Prudential Regulation Commission; and
  - The Reserve Bank to retain and strengthen its overall roles with respect to *financial system stability and the payments system.*

THE APRC

- The area that has generated the most interest is the prudential regulator, the APRC, so let me focus on that one first.
- APRC will take on parts of: RBA, ISC and AFIC.
- Why the need to amalgamate?
  - Banks and NBFIs were universal on grounds of regulatory neutrality.
  - Insurance on grounds of blurring of boundaries (RSAs bank-like deposits etc) and conglomeration.
  - Super was tougher government promise and tax benefits.
- Amalgamated regulator is best placed to:

  5. Oversee conglomerates.
  6. Handle blurring.
  7. Avoid gaps and overlaps.
  8. Adapt to the change demands on prudential regulation over time.

- Weaknesses are in bureaucracy but offsets in career structure, charter and accountability.
- Tiers are important.
- Why not RBA?

  9. Range of responsibilities (bank).
  10. Distraction from monetary policy.
  11. Need over time to remove guarantee.

THE CFSC

- The second big change in the regulatory structure is the **CFSC** (corporations and financial services commission).
  - This agency would oversee a greatly simplified and streamlined consumer protection regime.
- As mentioned earlier, regulation in this area is motived by two main problems:
  - unfair or fraudulent conduct by market participants; and
  - inadequate disclosure.
- Financial regulation for these purposes usually takes two broad forms:
  1. Market integrity regulation to ensure that:
     - markets are sound, orderly and transparent;
     - users are treated fairly;
     - the price formation process is reliable; and
     - markets are free from misleading, manipulative or abusive conduct.
  2. Consumer protection, which aims to ensure that retail customers:
     - have adequate information;
     - are treated fairly; and
     - have adequate avenues for redress.
- In many areas there is no clear dividing line between market integrity and consumer protection.
- Both involve the same regulatory tools, namely disclosure and conduct rules (hence our recommendation to amalgamate both functions under the one regulator).

Current arrangements are deficient

- Multiplicity of agents, overlapping, though attempts to harmonise approaches.
- Agencies include: ASC, ISC, ACCC and APSC.
- Credit is the responsibility of the States and Territories, under UCCC.

Inquiry addressed four key questions

1. Should we amalgamate Commonwealth CP?
2. If so, should agency be stand-alone or with market integrity, securities and corporations?
3. How to reconcile dual coverage with ACCC?
4. Should we transfer UCCC to the Commonwealth?

Key features of preferred model

- Amalgamate all CP (currently fragmented);
- Combine CP with market integrity, corporations, and consumer protection regulation under a single body — the CFSC;
- Retain TPA but remove inconsistencies and have sole administration; and
- For the moment, leave UCCC with the States.

BENEFITS OF AMALGAMATION

- Amalgamation removes current distortions of:
  - differing disclosure requirements for similar investment vehicles; and
  - inconsistent approaches to sales and advice for different industries.
- Amalgamated regulator also more flexible in coping with change in system.
- Market integrity and consumer protection are closely linked:
  - both enhance investor confidence, eg licensing of securities dealers protects consumers from fraud and ensures that securities markets operate efficiently;
  - wholesale different to retail but often hard to pick dividing line — combined is easier and avoids players being subjected to two regulators if operating in two markets;
  - the tasks of consumer protection, market integrity and corporations regulation are more complementary than conflicting;
  - going beyond CP also ensures balance in pursuing regulatory objectives.

AVOIDING OVERLAP BETWEEN SPECIFIC AND ECONOMY WIDE REGULATION

- At present, the ACCC oversees s 52 (false and misleading) of TPA on economy-wide basis.
- We accepted that s 52 should apply (with due diligence qualifier).
- Best course is to vest CFSC with equivalent provisions (and others relevant to financial system) in expectation that it would, in all cases, be the agency to take action.
- Do not withdraw ACCC's jurisdiction to avoid gaps.
- ACCC and CFSC should enter operating agreement to eliminate duplication of enforcement.

PROSPECTUSES AND OTHER DOCUMENTS

- Section 1022 of Corporations Law requires offerer of securities to issue prospectus.
- False and misleading statements are prohibited.

- Recovery provisions apply but no liability if reasonable precautions were taken and due diligence exercised to check that all material information is included in prospectus.
- Takeover provisions of the CL likewise require disclosure and have due diligence defence.
- SIS does likewise for trustees of super funds.
- Section 52 of TPA is general protection against false and misleading, s 82 provides a right of action, but there is no due diligence defence.
- At present, s 995 of CL copies s 52 and is unclear on due diligence defence.
- Net effect is ambiguity and overly-detailed prospectuses.
- TPA not constructed in the context of positive disclosure.
- Unlike consumption goods, financial services explicitly involve risk — s 52 is too tough.
- Due diligence defence is used in US, UK, Canada and NZ.
- On balance, due diligence should apply where there is a positive requirement to disclose.

STATE AND TERRITORY CREDIT REGULATION

- UCCC introduced in most States and Territories on 1 November 1996.
- Governs precontractual disclosure requirements and contains sanctions.

WEAKNESSES OF THE UCCC SCHEME

- Most credit providers operate nationally.
- Not entirely uniform (courts versus tribunals, maximum interest rates, and licensing).
- Penalties still steep.
- Prescriptive disclosure has led to massive documentation.
- Contract reopening provisions lead to uncertainty.
- Some advantages in administering with other State CP laws (fair trading laws):
  - four States have established specialist tribunals to hear disputes;
  - credit transactions often linked to goods (which are State covered);
  - States and Territories have developed considerable expertise in credit matters.
- There is a process for monitoring — Uniform Consumer Credit Code Management Committee.
- There are problems and costs but too early to say that it cannot work.

CFSC'S APPROACH TO REGULATION

- Want to reduce cost and improve effectiveness.
- Main options for approach to market integrity and CP are:
  - a statutory approach;
  - a coregulatory approach — where "framework legislation" sets out general principles but specific regulation is through industry codes of conduct; and
  - a self-regulatory approach — no legislative backing.
- Statutory approach enables greater consistency across industry sectors, but inflexible.
- Coregulation best where well established industry association, and broad coverage.
- But coregulation susceptible to regulatory capture and more disjointed (bad for conglomerates).
- Coregulation already exists to varying degrees (ASX and SFE and Codes).
- Retail markets less well suited than wholesale.
- Self-regulation is likely to be appropriate in very limited circumstances (if at all).
- Inquiry considered best way is a combination:
  - vesting CFSC with broad framework legislation;
  - give it power to prescribe detailed codes;
  - or to leave it to industry to develop such codes.

CONCLUDING COMMENTS

The Australian financial system has performed reasonably well in the deregulated post-Campbell era but it is clear that it could be performing better. Our regulatory system is also coping, though there are signs that it is getting further out of line with evolving trends in the marketplace. Now is the time to set the scene for the next decade or so.

There is a real opportunity to achieve major reforms in Australia's financial system. For most industries in Australia the status quo is not an option in a rapidly changing environment — the financial system equally must respond to the competitive winds of change and deliver, on a continuing basis, substantial benefits to its clients and to the economy as a whole.

In summary, implementation of our recommendations will:

- place Australia's financial institutions and markets in a good position to meet the challenges ahead;
- lower the cost of financial services to end users; and
- preserve and enhance the security of the financial system.