Banking and Financial Services Law Association Conference

"Compliance in Financial Services: Are you there yet?"

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Good morning and thanks for this invite to address you on a glorious winter morning in Queenstown.

I propose to canvass a couple of areas this morning – primarily because that is what I've been asked to do, but also because I want to take this opportunity to deliver some timely reminders. We are focussing on compliance... a buzzword for the early noughties and a word that sits uncomfortably on the lips of many. Not surprisingly when the Concise Oxford Dictionary defines compliance as "yielding under applied force" and when the first hit on the internet when searching for "FSR Compliance" is a desperate ad for lawyers who specialise in this area.

Compliance however actually serves to benefit all parties:
It helps us as the regulator achieve our statutory objectives of improving the performance of the financial system and the entities within it and promoting confident and informed participation by investors and consumers in the financial system.

The benefits to industry are that you have upgraded compliance systems in place and an honest, efficient and knowledgeable staff. This builds firm credibility and sustainability in a competitive environment, attracts business and importantly increases your bottom line.

How we regulate can be shown by use of the Regulatory Pyramid.

On that note, I propose to canvas compliance with FSRA, give you some insight into our compliance approach and also talk a little about compliance with the Codes applicable to your sector.

FSRA

The FSRA seeks to provide consistent regulation of functionally similar markets and products – moving away from the piecemeal, varied and sometimes duplicative regulatory and licensing regimes in favour of a single regime. It harmonises the regulation of all financial products including managed investments, superannuation, general and life insurance, securities, futures and derivatives, foreign exchange and deposit accounts and provides a single licensing framework

for financial sales, advice and dealings for financial services.

Integral, reasonable and admirable objectives aimed at a level playing field and increased consumer protection... but will you be complying come March 11 next year? The countdown to the end of transition is coming fast. We are now only 7 months from the full implementation of the Financial Services Reform Act (FSRA).

The quickly evaporating timeframe is a potentially frightening prospect when most of the industry is yet to make the transition to the new regime. In fact only about 10% of the industry has applied for their licence to date and we estimate that up to 8,000 applicants will need an AFSL to operate or continue operating. As at mid July, we had issued approximately 675 licences out of 1050 applications, although our system shows that an additional 1500 license applications are in progress. This means there are a lot more to come through.

We have received 10 AFSL applications from entities that indicate they do banking business (of which four have been approved). All are APRA regulated, but no applications have yet been received from the "Big 4". Likewise, no conglomerate licenses have yet been approved and we estimate that there will be about 200 in total.

Of the licences issued to date, the principal industry distribution is as follows:

Industry Distribution

Financial advisers make up 30%, market dealers 19%, managed funds 16%, life insurance 14.5% and general insurance close behind on 12%. Deposit takers account for only 1.7% of the applications – 10 applications in total.

Authorizations to deal and to advise continue to dominate licence applications, with 86% seeking dealing and 80% seeking advising, possibly in combination with other authorizations. About 58% of all licence applications seek both advising and dealing authorizations in combination.

The origins of licence applications showed a relative shift away from NSW to Queensland and Victoria, currently with 44% from NSW, 27% from Victoria, 12%

from Queensland, 10% from WA, 5% from SA and about 2% from ACT, Tasmania and overseas.

There have been 2,265 authorizations applied for among 1,176 licence applications, giving an average of 1.9 authorizations per application.

Key messages

- Naturally, the later you apply, the greater the demands on our licensing resources will be. It will therefore come as no surprise that the key message from ASIC at this time is to apply soon. To remain operational beyond 10 March 2004, financial service participants must obtain their Australian financial services (AFS) licence in time. We cannot give a general extension to the FSR transition period - we can only grant an extension in exceptional individual circumstances.

- We have commenced licence verification surveillances on those licensees that have already obtained their AFSL to ensure documentation they have referred to in their application is in place. The overall results are positive with high levels of compliance but there are some common issues being identified, which include an absence of breach registers, formalized risk management procedures, documented complaint procedures and information demonstrating that all directors are informed and involved on all compliance issues. In addition, we are finding that compliance manuals are not reflecting FSR terminology.

  Notwithstanding the overall pleasing level of compliance we are taking, and will continue to take, our usual approach to deliberate non-compliance and systemic non-compliance ie we consider breaches like this as serious and will use our whole regulatory tool box to address these breaches, including enforcement and licence revocation.

  For those people who are genuinely trying to comply we will take this into account, particularly if there has been some legal uncertainty. We fully expect industry to report breaches. We expect to be notified of non-compliance and reasons why, and also of what action has been undertaken to address the breach.

- You will notice on visiting our website that we have added a time ticker to remind applicants of the time remaining to the deadline. In the last six months of the transition ASIC's priority will be to assess streamlining and composite applications that have all the required attachments, and applications for relief that address the requirements of Policy Statement 51.

  We will not be giving priority to variations to pre-FSR and AFS licences, licence applications from new industry participants that require full assessment or poor-quality relief applications.

- Lodge within the next 2 months to avail yourself of ASIC's help - after this time we will not be able to give the level of assistance we have previously because resources will be dedicated elsewhere within licensing. We are nearing the stage where industry must turn its minds to complying with FSRA, rather than pursuing exemptions.

- Going forward, we are planning targeted compliance visits that will focus on applicants that may be a compliance risk, including late lodgers. This provides another incentive for applicants to come in early.

- Read Proforma 209 and the specific licensing kits.

No extension to transition period

We are regularly asked whether the transition period might be extended. The answer is no. Many of the major players have now already transitioned or are about to, making the prospect of extension more remote than it ever has been. ASIC does not have the power to grant a general extension to the transition period. In an address mid-July the Federal Treasurer reiterated, "The Government will not be extending the deadline for transition beyond 11 March 2004", adding "The Government is committed to ensuring the long-term health of our financial services industry."

Banking Issues with FSRA

I'd also like to take this opportunity to offer comment and reminders on specific FSRA issues affecting the banking industry:

- Definition of Basic Deposit Products: The regulations have changed the definition of basic deposit products from 2 to 5 years. We are happy to follow

Treasury's consideration on this regulation but don't feel it is appropriate to bring forward implementation of the amended regulation as we believe it is likely to be the subject of Parliamentary debate.

- It is the responsibility of conglomerates to make sure their people down the line are complying with the legislation and ancillary requirements. It is also the responsibility of conglomerates to ensure the processes and rewards systems in place, such as differential fees and commissions, reflect the FSRA provisions.

- Banks should be looking at new and different compliance tools to test your level of compliance, which are consumer based. Such means as mystery shopping, hot lines may be of use.

- From a conduct and disclosure perspective, we also recommend you assess the complaints received under the EFT Code to try and establish trends. Trends may indicate small systemic issues that are easily corrected, and once corrected serve to lift overall banking practices.

- The Banks have naturally been a big player in financial services for a long period. Adopting a complaints based approach may require a change in banking culture, where more emphasis is placed on the consumer's perspective over the commercial. We all acknowledge that everyone makes mistakes – yes, even Banks - so we encourage you to give yourselves a positive advantage by using the complaints information at hand as a consumer window into your banking practice.

- Training is a continuing issue for banks. An analysis will need to be conducted of staff to determine who is providing advice and who is not, and therefore to what level your staff need to be trained. This is especially so in remote areas.

- There have been a number of changes to regulations concerning distribution through call centers, which you are probably aware of and should be following.

We believe that Australia has a very good and overall a compliant financial services market. FSRA improves that by setting high standards across the sectors whereas up until now different standards have applied to various operators.

In order for standards to be improved however the four key elements of FSRA must all be present. This is industry's key responsibility.

FSRA Key Elements

These are:

Barrier to entry

The single licensing regime creates a barrier to entry for industry participants. To obtain an AFSL licence, the applicant must have established it meets certain criteria regarding training, organisational competencies, compliance and risk management systems, resourcing and financial adequacy.

Competency requirements

The Wallis Inquiry recommended a single set of requirements should be introduced for financial sales and advice, which include minimum standards of competency and ethical behaviour. In response to this recommendation, the FSRA sets out obligations to maintain the competence of those providing the financial services and ensure that representatives are adequately trained and competent.

ASIC has issued specific policy guidance on the level of training that must be attained by all authorised representatives providing financial advice, and also the level of organisational competencies that must be met by licensees.

Appropriate advice

Whereas the disclosure requirements generally apply to retail clients, the conduct requirements are more standardised: "know your client" requires givers of personal advice to demonstrate knowledge of objectives, strategy and products appropriate for the client. "Know your product" requires a provider to have done appropriate and adequate research into the product.

These two requirements together ensure that the advice given by the financial advisor suits the particular circumstances of the consumer investor, while disclosure of commissions aims to ensure the consumer is aware of any interest the advisor may have that taints the objectivity of the recommendations made.

Disclosure of commission

FSRA aims for consistent and comparable disclosure by mandating standard disclosure requirements. Disclosure of commissions is one area that remains contentious amongst industry participants. Essentially, any instance where commission (or any other benefit) may impact product choice should result in disclosure.

ASIC's preference is for fee-for-service charging, but we appreciate that some aspects of the market won't be reached because people will not pay an upfront fee. Commission payments may be seen to successfully access these parts of the markets.

FSRA also introduces Product Disclosure Statements, for more effective disclosure by product issuers and requires that a PDS contain any information that may reasonably be expected to have a material influence on a decision (of a reasonable person) whether to acquire a product.

Both ASIC and the Government have an expectation that FSRA will lift industry standards. Some standards are not currently good enough as was recently illustrated by the results of the Financial Advisers Survey. Banks had 30% of their plans in the poor category, primarily due to frequent failure to provide an ASG. In addition, a common observation by judges across the overall survey was the adoption of a practice they characterised as "commission-driven product selling, not impartial advice".

These matters are of great concern to ASIC, especially when you consider that there is approximately $A124 billion currently invested in public unit trusts in Australia. This amount is growing at the rate of 10 – 20 % per year [1] and more than 90% of all retail managed funds are placed through financial advisers. There are approximately 16,000 financial advisers operating in Australia and financial institutions employ an increasing number of them. 60% of the top 50 adviser groups are owned by large financial institutions, 12% are part institutionally owned, 20% privately owned and 8% are listed on the ASX. Of the 16,000 advisers active in Australia nearly 56% or 8931 within the top 50 operate through groups wholly or partially owned by institutions. Nearly 12% operate through privately owned groups. Less than 9% are managed by listed entities. Nearly 34% operate through major financial institutions such as AMP, National

Australia Bank, Commonwealth Bank and AXA. Vertical integration of the industry has accelerated in the last five years. There are very few large adviser groups left which are not owned by banks, insurance companies or fund managers and this is the key reason why Banks have a responsibility to work towards the lifting of industry standards and to do it now. The industry simply can't afford another survey with similar poor results, in two years time.

Compliance

You may be aware that ASIC has an ongoing program for monitoring financial services licensees and their compliance with financial services laws. We do this to promote a culture of compliance by encouraging voluntary compliance and cooperation from market players, without invoking punitive enforcement remedies.

Our monitoring activities range from desk-based reviews of documents such as product disclosure statements, to examination of breach notifications, and ultimately to detailed on-site visits to the entities and people we regulate.

We work much of our monitoring activity into campaigns, which are in-depth projects focusing on particular issues or problems. They typically encompass surveillance, education and policy development activities.

In the year to 30 June, we conducted 800 surveillances in the financial services arena, about 200 of which were responses to breach notifications and a further 200 were detailed reviews of disclosure documents. The balance relates to a variety of compliance visits and campaigns examining various aspects of licence holders' compliance procedures and activities.

In many cases the matters that cause us concern are not particularly complex – they are straightforward, basic compliance activities that have not been attended to. Examples include unsatisfactory disclosure of commissions and product costs, non-compliance with information gathering notices from ASIC, poor training and supervision of representatives, insufficient "know your client" information, incomplete record-keeping, absence of breach registers, no formalised risk management procedures, no documented complaint procedures, compliance manuals that have not been updated for FSR terminology, and no information demonstrating that all directors are informed and involved on all compliance issues.

[1] Axiss Australia

Campaigns

We conducted 21 campaigns over the last financial year, some of which are likely to be of direct interest to your industry.

Financial Institutions Campaign

Responding to our concerns about the disclosure of commission and the quality of advice when financial advisers receive preferential remuneration for promoting "in house" products, we conducted a campaign that looked at financial institutions offering advice.

We were aware that it is difficult to obtain truly independent advice in the current market, that commission arrangements common in the Australian market have inherent conflicts and that consumer complaints about the quality of financial advice continue to increase. Our key concerns were that consumers may not be aware that some financial institutions pay favourable remuneration when their advisers recommend internal products; that advisers may recommend internal products without taking into account the consumers' needs because of the favourable remuneration; and
that consumers may not be getting the best advice where there is preferential remuneration for internal products.

We conducted an analysis of the financial institutions advice industry and conducted a nationwide review of the promotion of "in house" products by financial advisers employed by financial institutions. This involved reviewing distribution and remuneration arrangements for a number of financial institutions as well as file audits to review the disclosure of commissions and the quality of advice.

We examined vertical integration and preferential remuneration trends in the financial services industry and whether financial institutions paying preferential remuneration to advisers who recommended "in house" products told consumers about the higher rates of commissions and gave appropriate advice.

We focussed on reviewing compliance with the requirements to disclose commissions and give appropriate advice by financial institutions but also noted findings, which suggest areas for potential law reform or further industry guidance. The report and findings will be released shortly (available on our website when it is)

and highlight a number of areas where ASIC may usefully deal with Treasury and professional associations to deal with risks to consumers.

We will continue to work with industry associations to improve the quality of disclosure and advice to consumers.

Analyst independence

There has been much political, regulatory, industry and media attention focused on the issue of conflicts of interests within investment banks within the last 24 months. In part this has been driven by the high profile investigations in the US, but it is a matter in which all securities regulators have displayed interest.

We commenced a campaign in the second half of last year to examine research analyst independence and the role analysts play in promoting securities in financial markets. We specifically considered the practices and activities of research analysts in Australia, the standards of conduct and supervision of analysts and the adequacy of current regulatory requirements.

We reviewed the research practices of 8 investment banks with 4 of these entities then selected for closer examination. Corporate entities, independent research houses and investment banks without research functions were also invited to comment and their feedback has been considered as part of the project.

Again, the project report on this campaign is pending so I am unable to go into any detail on our findings, other than to say the review identified a number of issues around the independence of research analysts operating within the investment-banking environment. It also indicated potential risk areas that may benefit from additional regulatory or policy guidance.

Campaign proposals for the year ahead

Moving forward and looking to campaigns for this financial year, we will be continuing our superannuation focus and also look further at financial advice. We also plan to look into the advertising, PDS and disclosure practices of lending institutions.

Financial Industry Codes: Compliance issues

I have (also) been asked to say something about compliance issues in relation to the revised Code of Banking Practice. I will say something as well about the credit union and building society Codes and the Electronic Funds Transfer Code of Conduct.

Notwithstanding the comprehensiveness of the *FSR* reforms, the financial industry Codes remain an important part of the Australian regulatory environment, in ASIC's view. Their most important function going forward is likely to remain that of dealing with consumer protection issues not covered by the legislation. They can also play a role in elaborating or building on the legislative requirements. Under the FSR framework, however, there is no capacity to mandate participation in a financial services' industry Code.

As many of you will be aware, the Australian Bankers Association first adopted its Code of Banking Practice in 1993. This was followed by "mirror" Codes covering the credit union and building society sectors, the three Codes generally being referred to as the "payment system Codes". In August 2002, a revised Code of Banking Practice was launched by the ABA after an extensive, independent—and, I am told, highly credible—Review. This revised Code is due to come to commence in August this year and will be binding on individual banks as soon as they subscribe to it. A review of the credit unions' Code is currently underway.

The EFT Code of Conduct has been in existence for many years. The latest version, which became effective in 1 April 2002, extends the scope of the Code to virtually the full range of fund transfer transactions effected electronically. The next Review of the EFT Code is due to commence in April next year.

ASIC's Role

ASIC inherited responsibility for monitoring these Codes from the then Australian Payments Systems Council in 1998. This was one aspect of our assumption of responsibility for consumer protection in financial services.

Statutory agencies have played a role in Code-monitoring in financial services even though the Codes in question are, in essence, voluntary self-regulatory instruments that derive their force from the fact that subscribers contract with their customers

to comply with them. This is because the Codes have hitherto lacked compliance-monitoring mechanisms and Government agencies have effectively picked up the responsibility. In addition, there is no obvious industry body to establish (and fund) a Code compliance-monitoring process for the functionally-based EFT Code. This situation is about to change in the case of the Code of Banking Practice—however, I'll come back to this point a little later.

ASIC's primary means of monitoring compliance with the Codes is through an annual compliance survey and monitoring report. Monitoring is based on self-assessment by code subscribers who must complete and forward a compliance report to us. As well as providing information on compliance with the specific provisions of the Code, subscribers' reports cover their compliance assessment procedures, staff training and arrangements for external dispute resolution. In addition, they must provide us with statistics on the number and type of internal disputes they have processed during the monitoring period. ASIC publishes an annual compliance report for each Code based on this data. These Reports are available on our consumer website, FIDO.

I am pleased to report that the latest surveys indicate that, while there's been a steep increase in the number of transactions covered by the Codes, the overall incidence of complaints remains low. As far as EFT transactions were concerned, there was no overall increase in complaints; however, there was a marked change in the breakdown, with some increase in complaints about system malfunction but a pleasing decline—for the second year in a row—in complaints about unauthorised transactions. Other common complaint categories related to inaccurate fees and charges, direct debiting, and service delivery issues.

I should emphasise that, while ASIC does monitor global trends in the consumer banking area, we do not generally become involved in the resolution of individual consumer complaints. This is very much the responsibility of the internal complaints handling processes of the financial institutions themselves and, if these fail, of external dispute resolution processes, such as the Australian Banking Industry Ombudsman.

Code of Banking Practice

I might turn now to the revised Code of Banking Practice specifically. As I noted, this revised Code will commence next month and will be binding on individual

banks as soon as they subscribe to it. ASIC would certainly urge the prompt adoption of the Code by all retail banks and we will be watching the "sign on" process with considerable interest.

The new Code undoubtedly presents compliance challenges—as some of you will doubtless know better than me. One such challenge will obviously be to ensure that the significantly improved disclosure regime for loan guarantors—including, for the first time, guarantors of loans to small business customers—is fully implemented. There are also important new disclosure and other requirements relating to direct debits, the credit card chargeback system, joint borrowers and subsidiary cardholders.

ASIC particularly welcomes the commitment (and I emphasise it is a contractually-binding commitment) that Code subscribers will make to attempting to assist customers in financial difficulties before they initiate recovery proceedings. Equally welcome, is the obligation to comply with the ACCC's Guideline on debt collection practices when recovery action is initiated. I note in passing that ASIC is receiving an increasing number of complaints about the debt collection practices of lending institutions and their agents and we see this as a potential area for compliance and/or enforcement action.

Code Compliance Monitoring Committee

Earlier, I implied that the revised banking Code, unlike the current Code and other financial industry Codes, incorporates compliance-monitoring processes. Specifically, a Code Compliance Monitoring Committee is to be established, with participation by industry and consumer representatives.

We certainly welcome this development. Once established, the Committee will be able to deal with matters referred by any person, whether or not that person has suffered a loss or has a direct interest in the matter. Thus, it will be able to deal with Code compliance issues that do not fall within the province of the external dispute resolution processes, including issues raised by consumer/ community advisers and others, even government officials. If the Committee is reasonably active, as we suspect it will be, some of you (from Australia) may find you are dealing with compliance issues in relation to the Code more frequently!

Once the Code Compliance Monitoring Committee is established, ASIC will cease the monitoring role in relation to the Code of Banking Practice that I described above. However, I would not want to leave you with the impression that ASIC intends to 'abandon the field' when it comes areas covered by the Code of Banking Practice.

Far from it. Our compliance and enforcement staff are currently investigating a range of banking-type issues involving potential breaches of the *ASIC Act* prohibitions. As you will be aware, these include the misleading conduct and unconscionable conduct prohibitions, as well as a number of other more specific prohibitions (for instance, the prohibition against undue harassment in debt collection). Areas of interest to us in this context include:

- misleading advertising, particularly of home loans;
- misleading and/or unconscionable conduct in relation to margin lending for investment purposes;
- the activities of finance and mortgage brokers; and
- harassment in debt collection by employees and/or agents of lending institutions.

CONCLUSION

We acknowledge and support the work of your industry in implementing and maintaining these codes of practice as a best practice framework. The implementation of industry codes and standards as a third tier of regulation (after the principles based legislation and ASIC policy and guidance) enable both regulators and industry to benefit from a more flexible regulatory regime.

The risk, if industry did not or does not continue to maintain and comply with good standards, is that the Government will see fit to address this gap with more prescriptive legislation. This means industry loses the flexibility that the current principles based regulation affords. The legislation is designed to enable you, as financial services providers, to keep pace with international and domestic developments in the Financial Services Sector and offer a level playing field between you and your competitors.