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THE CHANGING NATURE OF FINANCIAL SERVICES

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A. Introduction

My challenge is to address the theme of the conference, the changing nature of financial services. The transition of banking to financial services has taken place against the backdrop of considerable deregulation and reorganised regulation in the financial sector. The Wallis Committee of inquiry into the financial system addressed that most recently, and most comprehensively. In this presentation I will look at the factors which they considered, including demographic changes and the role of technology, before turning to the Financial Services Reform Bill. That bill is of course, the final stage of Wallis.

It is not possible to be comprehensive, and I will not try. I have chosen themes and issues, you may think, idiosyncratically at best, and self indulgently at worst; but I assure you, with the principal purpose of stimulating further thought and debate.

the recent history

The transition of banking, through deposit taking, to financial services generally, has been so pervasive in its influence on all of us, that we may tend to overlook just how profound a change it has been. Economic historians will no doubt debate what were the causes, and what were the effects, but it is easy even for those of us who lived through the last 20 to 25 years, to overlook the dramatic changes in the nature and delivery of financial services in Australia. Some of these changes are summed up in the recent book by Graham Hand[1], based on the State Bank of NSW. They include:

- the 1981 mergers of major banks, the Bank of NSW with Commercial Bank of Australia to form Westpac, and National Bank of Australasia with Commercial Banking Company of Sydney to create National Australia Bank;
- the entry of foreign banks in the mid 1980s;
- the floating of the exchange rate in December 1983, together with the lifting of controls on foreign exchange;
- the conversion of most large building societies to banks;
- the abolition of minimum and maximum terms on bank deposits in August 1984;
- the abolition of the prohibition of the payment of interest on cheque accounts in 1984, and the abolition of the prohibition on term deposits of less than 14 days at the same time;

- the creation of the cash management trust to compete with banks; and
- the restrictions placed by the Reserve Bank on the quantity of loans, creating a form of credit rationing.

It is trite to say that this massive deregulation, at the end of the 1970s and into the 1980s, must have contributed to the boom and bust among the banking sector at the end of the 1980s and in the early 1990s, which brought unstuck several State Banks, and nearly brought down Westpac[2]. Graham Hand's book also reminds us that the loss of confidence in banks dates from this period. Banks, and bankers, ceased to be pillars of the community, and became instead four of the six pillars the independent standing of which was somehow required in the national interest. Hand quotes social researcher Hugh Mackay as describing the period of bank indulgence in over-lending as the time when banks finally lost their image as "prudent, responsible, conservative organisations who carefully rationed credit...with a quasi-religious role in helping to regulate and restrain the recklessness and irresponsibility of ordinary mortals." [3]

The banks responded to the pressures they faced in the early 1990s with a determination to survive, by increasing income, including collecting fees for services traditionally regarded as part of the usual service of a bank, and by cutting costs, including limiting the number of branches and staff. Unsurprisingly, customers did not enjoy these changes, and the reputation of banks suffered accordingly. The Australian Bankers Association had the bright idea towards the end of the 1990s of not only neutralising negative comments from talkback radio operators, but positively encouraging good news. The outcome was the "cash for comment" affair, the eventual revelation of which ultimately did even more damage to the reputation of banks.

relevance to lawyers

I am sure most of you would know the bare bones of that history, and indeed it seems to be reflected in many other places around the world. You may be asking what its particular relevance is to you, as banking lawyers. Banking lawyers have to be able to advise bankers against the back drop of the business they are providing and the attitudes of the market place in which that business is operating. That alone would be sufficient reason in my view to ensure that banking lawyers are reminded from time to time of the context in which they are serving their clients. But it is more than that. Lawyers

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[1] ***Naked Among Cannibals***, Allen and Unwin, Sydney, 2001

[2] Edna Carew, ***Westpac: The Bank that Broke the Bank***, Doubleday, Sydney, 1997

[3] Graham Hand, op.cit., p17, quoting Hugh Mackay, ***Reinventing Australia***, Angus and Robertson, Sydney, 1993, p 117

may to some extent be contributing to the problem of the reputation of banks. Graham Hand quotes a standard State Bank housing loan document in these terms:

> "We can change the terms of this contract or the way it operates, or both, at any time without your consent....We can vary the annual percentage rates, the repayments and the fees and charges and can add new fees and charges without your consent."[4]

As he says:

> "Like all bank loan documents, it is remarkable that anyone signs it."[5]

Today it seems remarkable that anyone would draft such a clause and present it on behalf of their client, having regard to the history of the approach of the Common Law and Statute Law to unconscionability. I am sure it is not necessary to remind this audience of the line of authority which even I, as a non specialist in this area, can recall involving Commercial Bank of Australia v Amadio.[6] The Common Law is now preserved by section 12CA of the ASIC Act, and extended, if that were required, by section 12CB, which for relevant purposes are in the following terms:

12CA (1) A corporation must not, in trade or commerce, engage in conduct in relation to financial services if the conduct is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories.

12CB (1) A corporation must not, in trade or commerce, in connection with the supply or possible supply of financial services to a person, engage in conduct that is, in all the circumstances, unconscionable.

(2) Without limiting the matters to which the court may have regard for the purpose of determining whether a corporation has contravened subsection (1)..., the court may have regard to:

(a) the relative strengths of the bargaining positions of the corporation and consumer; and

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[4] Op.cit., p 80

[5] Ibid.

[6] (1983) 151 CLR 151

(b) whether...the consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the corporation; and

(c) whether the consumer was able to understand any documents relating to the supply or possible supply of the services; and

(d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the consumer...; and

(e) the amount for which, and the circumstances under which, the consumer could have acquired identical or equivalent services from a person other than the corporation."

I am well aware that the State Bank clause which Mr Hand has quoted would pre-date both the ASIC Law which I have quoted, and its Trade Practices Act predecessor, but the point remains the same, should the clause have been written in that way in the first place?

Although I intended that question rhetorically, I would answer it anyway by saying that it is a clause from a different era. It is from the time when banks believed their own rhetoric, and it was taken for granted that customers would not be mistreated by the capricious application of such overweening power.

B. the industry formerly known as banking

As is again well known, the industry formerly known as banking[7] has become highly profitable. A recent KPMG survey[8] has reported that the four major banks have produced combined profits of $5 billion for the first six months of the current financial year. They report that these profits have been achieved by a combination of factors:

- Strong activity and growth in corporate and consumer activity leading to increased fee levels and net interest (the increased fee **levels** is a reference to activity, not to increases in those fees).

- Favourable interest rate environment (one feels obliged to point out the KPMG comment that the banks had taken advantage "of cheaper wholesale funding rates ahead of cuts in official rates by the Reserve Bank." KPMG are not accusing the banks of having failed to pass on changes in official rates, a matter which now draws close political scrutiny whenever there is a change in rates).

- Recent acquisitions (the two prime examples being the purchase by the Commonwealth Bank of Colonial State Bank, which in turn had been significantly bolstered by its earlier purchase of the funds management businesses of Prudential and Legal & General, and the purchase by National Australia Bank of MLC, a major insurer and funds manager.)

- Cost control (more branch closures and more staff reductions?)

It is not all good news for the industry formerly known as banking. KPMG have also observed[9] four basic challenges still facing these financial power houses as they seek to broaden themselves away simply from deposit taking:

1 Culture - life insurance and banking are still different, and they suggest that some new products which bridge the gap between the two will be needed before institutions can take advantage of the synergies. I have the benefit, or burden, of being not only a former regulator in the Australian context, but also a past chairman of the international body known as the Joint Forum on Financial Conglomerates. I am able to observe that if the industry internally reflects the same cultural differences which I observed between regulators from the banking and

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[7] the title of a short brochure published by Arthur Andersen several years ago

[8] Available on www.kpmg.com.au

[9] Allfinanz/Bancassurance - the way of the future? also available on www.kpmg.com.au

insurance arenas, then this is not an insignificant challenge. They observe "selling traditional life insurance products in a bank branch using traditional life insurance sales techniques has done little to change the consumer's perceptions of life insurance." - one is tempted to add, or of banking.

2 Reducing distribution costs - again, KPMG observe that it is still easier to sell more products to each customer than to find new customers. Lawyers are also familiar with the phenomenon that cross selling is much more easily described than it is done.

3 The complexity of products - they observe that complex life products, the way they are sold and the people who sell them, alienate bank customers; I suspect that those complex life products and those people intimidate all of us.

4 Increasing sales - the usual challenge of expanding the market, especially to reach middle and lower income families.

C. The Wallis Report

The Wallis Report is now just over four years old, but remains available on the Australian Treasury website[10]. Notwithstanding the recent express or implied criticism of the report and its regulatory outcomes, I believe that it still provides a very useful basis for a discussion of these changes in financial services. I will therefore use the structure of the Wallis analysis to look at some of the forces which have driven this change in the financial services sector.

The first Wallis proposition is that the role of the financial system in Australia has deepened, with households increasing both their financial assets and their borrowings. The Regulation Impact Statement for the Financial Services Reform Bill notes that "Australia's strong and growing finance and insurance industry adds value through financial intermediation and support services, and is a significant employer in Australia. Over each of the last six years, in current price terms, the finance and insurance industry has grown more quickly than the economy as a whole [and is now bigger] than both agriculture and mining sectors."

The three major forces driving change were found by Wallis[11] to be

changing customer needs, including changing demographics and an increased willingness to adopt technology

technology driven innovation, and

significant regulatory change.

Each deserves some discussion.

demographics

The demand for financial services reflects increasing wealth in the community, and the changing needs of the community arising from demographic and lifecycle changes. In short, the community is getting older, but richer, which is either producing or being contributed to by more complex and diverse life cycles involving more job mobility, more education and training, more complex family structures, more self employment and part time work and so on.

A recent report in the Sydney Morning Herald by Ross Gittins drew my attention to some recent research which backs up one's instinctive belief that this is so[12]. To some extent, the material in the

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[10] www.treasury.gov.au. I have referred occasionally to Wallis, meaning thereby the Report, not the person.

[11] Taken from the summary in the FSRB Explanatory Memorandum, p3

report reflects the extraordinary advantage which the baby boomers have, as they have inherited or may expect to inherit their parents' houses, but were themselves the beneficiaries of the house price inflation in the 70s and 80s. As the report says, the over 55's are only 21 per cent of the population, but own 39 per cent of the wealth and have 25 per cent of the disposable income. The over 65's own half of the deposits in financial institutions, and while they are not likely to be happy with low interest rates, they will be passing those deposits to the next generation in due course.

The particular significance from a financial services perspective is marketing financial services to this well heeled group. Access Economics note that other OECD countries have seen more financial products linking income stream products to the family home, a development which has clearly started here, but apparently not yet realised its full potential.

better informed, more mobile customers

Other aspects of the changes in customer behaviour include the fact that customers are better informed as to their rights and as to the various products on offer. Intermediaries have popped up everywhere providing comparative information on fees and charges, on interest rates and earnings, rating various financial products, and so forth. Because banks have displayed less loyalty to them in recent years, customers are in turn finding more opportunities to be mobile. Perhaps not as many as they could if there were not some regulatory obstacles in their path. The 100 point identity check required to be satisfied when opening a new bank account is in itself such a pain[13], and even more difficult when physical branches are not as accessible as they once were, which provides a real disincentive for retail customers to change banks readily. This issue has been raised in connection with the proposal by Austrac that investors in cash management trusts and presumably potentially, all managed funds, should comply with the 100 point check. IFSA, the Investment and Financial Services Association, is resisting this proposal in part on the grounds that it is inappropriate, but also on the basis that it is in practice much more difficult to comply with in the current environment.

technology

It is fashionably and appropriate to say that the greater use of the new technologies permitting automatic teller machines, telephone banking and now internet banking, has produced significant changes in customer behaviour and has therefore affected the industry dramatically. At the recent

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[12] Population Aging and the Economy, Access Economics, January 2001, available on the website of the Office for Older Australians, www.health.gov.au/acc/ofoa/documents/pdf/popageing.pdf

[13] Graham Hand, op.cit., p 69

Australasian Institute of Banking and Finance Conference, Mark Lewis from IBM took a rather different perspective, and said in part:

> "Although technology is driving and enabling many of the changes that are going on, it is not about technology, but about new business ... a disproportionate number of financial institutions, products and businesses are reaching maturity. As excited as many people get about the internet, the total number of people connected globally rounds up to about zero in proportion to population. There's almost no-one connected."

While I am sure Mr Lewis is right in global terms, the extent of connection in Australia and other major developed economies is clearly significant, but it is a useful reality check. And his perspective on the institutions (which are presumably the people to whom he is marketing) is also thought provoking. I shall return to the question of technology further below.

regulation

Wallis then looked at the extent to which the changing regulatory framework itself was one of the forces driving change, and referred to the kinds of changes in regulation which I have described above. The report emphasised the significance of the following:

- the opening of the economy to foreign players;
- compulsory superannuation - as the Governor of the Reserve Bank observed recently, the risk factors with the medium size funds will be an issue for the future unless their supervision is addressed[14];
- governments ceasing to own institutions or give guarantees - the experience of State governments in particular as the owners of significant banks and insurance organisations were not happy experiences;
- tax changes.

the effects of those changes

The report focused on the efficiency and competition consequences - the fact that there was now less scope for cross-subsidies, that high cost services would inevitably be rationalised, and that there would be more competition and contestability in the financial services sector generally, producing opportunities for niche players.

As for globalisation, Wallis said it all:

> "Australia has actively and irreversibly embraced globalisation."

Globalisation is the subject of a specific discussion later in the conference, and I will limit myself here to quoting also from John McFarlane, Chief Executive of the ANZ, who said at the AIBF conference, "It is not just a concept, it's a reality." He also observed that when he took the Board of the ANZ to the West Coast of the United States recently, he took them not to visit banks, but to visit IBM, Boeing, Bill Gates, and Cisco Systems. Clearly technology has been an important part of enabling globalisation, but it is also producing its own imperatives. In the later session, I will address some interesting issues which arise from the application of the Basel principles for effective banking supervision in the Australian context, and some aspects of a recent senate committee report which has discussed Australia's position as a global financial centre.

"concurrent conglomeration and market widening"

Conglomeration is a reference not only to what was happening to the institutions, but also to the instruments. The boundaries between institutions and instruments were blurring, which was in turn producing a greater choice for consumers, and new entities operating within the financial system. The market in short, was widening, with new entrants coming both from offshore, and from outside the traditional financial sector.

Wallis identified two particular trends. First, it suggested that to ensure efficiency, large institutions would establish conglomerates with holding companies, but put as much of the business as possible in subsidiaries which would be subject to lighter regulation. I am not sure that regulators would welcome such advice, and suspect they would prefer that some kind of regulatory neutrality would emerge. Further, it suggested that consumers would be likely to go for trusted brands, a theme that re-emerges when we look more closely at the use of modern technologies.

The chief practical consequence, however, has been a new approach being taken to financial conglomerates. It was a traditional aspect of the old style bank supervision approach of the Reserve Bank, that banks would be banks, and any activities would be conducted in separate subsidiaries. Soon after its establishment, APRA issued a policy discussion paper dealing with the prudential supervision of conglomerates intended, as it said, to place a consistent and logical framework around the supervision of conglomerate groups and to emit, in certain cases, more flexibility and organisational structures. APRA then revised those proposals and settled policy which has now

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[14] Senate Economics, Finance and Public Administration committee, 11 May 2001, at 84 and 85

produced, for example, the first banking licence being issued to a mixed conglomerate, the Elders Bank Licence. A second consequence, not directly related to APRA's initiative, is the Ezy Banking joint venture between Woolworths and the Commonwealth Bank. To those who have not addressed these questions directly, the issue may seem somewhat esoteric, but it is of vital importance to regulators, who are concerned about maintaining the safety and soundness of regulated institutions. This requires measures to limit the risks which arise from the association with other entities in a conglomerate group, particularly, the risk of contagion, the possibility that financial distress might be transmitted from unregulated arms of the conglomerate to the regulated members of the group. Wallis suggested, in response to market developments of the kind, that APRA gave such priority to the development of this policy. It is therefore curious that only one application has apparently been received and dealt with in that intervening period.

The Wallis analysis then turns to the perceived shift from the importance of intermediaries, to markets. The report suggests that there will be more disintermediation in credit markets, more securitisation, more competition for household savings, and a shrinking of deposit taking in relative importance. Technology has frequently been regarded as likely to lead to disintermediation, in this case, the likelihood that major borrowers will borrow directly, but while there will be some truth in that, the probability is that intermediaries will survive so long as they continue to provide value. The challenge for them to provide that value will be increased by the access to technology.

The trend towards securitisation has clearly snowballed. The Australian Banking and Finance newsletter of April 30 this year reports that the Commonwealth Bank has recently sold US$1.1 billion of mortgage backed securities into the global bond market, at the same time as it sold some $624 million locally. In a real sense therefore, securitisation is also part of the globalisation of the finance sector, with Australian mortgage backed securities apparently being well regarded. KPMG recently suggested that securitisation may not survive the consensus ruling of the urgent issues group known as UIG28, consolidation of special purpose entities. But that ruling was issued in 1999, and the deals are still happening in 2001, from which one might conclude that this fear has not become a reality.

Was Wallis right?

Compare the above factors with the Arthur Andersen report to which I referred earlier[15]. It reported that the root causes of change in the banking industry were

technological advances - no argument.

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[15] See note 7 above

increasing product transparency - meaning the switch of power to customers, who can access information about the choices available to them more readily - again, no argument

regulatory harmonisation and the Euro - giving away the European origins of the paper! But hardly a criticism of the Wallis analysis locally

dis-intermediation - obvious at the wholesale end, if over-stated, but relevant also in the retail arena as another way of describing the conglomeration phenomenon.

break-up of the value chain - this is probably the most difficult to fit within the Wallis analysis, and yet one senses it was implicit. It is about "snatching of production of products from banks", while some new entrants (mortgage originators?) are selling products which are not their own; and about the trend to outsourcing of processing.

D. Technology

Few would quibble with the Wallis view that technological innovation had been a major force shaping financial service delivery over the past few decades. There might be more argument about its conclusion that, while the pace of technological innovation could not be predicted precisely, it was likely to accelerate over coming years for two main reasons; first that the costs of technology would continue to fall, and secondly that innovations would increase the ease and security of electronic transactions. The capital investment in technology, and the costs of transition to different times and levels of technology, do not appear to this casual user to have fallen significantly in absolute terms, even if we now get far more functionality than we did previously, or knew that we needed. Nor is it clear that there is a general acceptance that the ease and security of electronic transactions has so far increased significantly.

Consumer aspects

Some of these themes are reflected in the outcomes of ASIC's e-commerce conference held in Sydney in August last year. ASIC has reported some of the common themes raised at the conference were:

- the critical importance of trust - unless consumers are absolutely confident that the electronic system is secure, they are highly unlikely to use it;
- the role of brand - consumers will continue to be attracted by familiar brands;
- the need for industry standards to underpin e-commerce initiatives - without some commonality in standards, the market place is not likely to pay the extra cost needed to be able to link with competing systems;
- issues of identification, authentication and privacy;
- the need for a globally competitive regulatory framework;
- the implications of "advice" over the internet; and
- the importance of consumer education.

ASIC, as the consumer protector in the financial sector, is appropriately taking the lead in many of these issues. The deputy chair of ASIC, Jillian Segal, noted[16] that ASIC sees its job as building a regulatory and business environment where:

- consumers of e-commerce financial products and services can be confident that their interests are properly protected;
- industry participants can confidently plan and develop e-commerce initiative;
- ASIC continues to enhance its abilities as an effective and credible regulator in the e-commerce context; and
- regulatory outcomes will not depend on the medium used.

In order to deliver on these objectives, ASIC has continued to be active in such matters as reviewing the operation of online trading websites, its policy on internet discussion sites, and facilitating electronic applications for superannuation and life insurance products. As you would expect, I endorse ASIC's approach, which is not to drive either business or consumers into a solely electronic world, but to ensure that, with the appropriate protections, those who wish to conduct business electronically, or solely electronically, can choose to do so.

Codes of conduct

The most recent development is the launch by Ms Segal on 5 April, of the Revised Electronic Funds Transfer Code of Conduct, now covering all forms of electronic funds transfer. She said "ASIC believes that this new code is the first anywhere in the world to give such comprehensive protection to users of electronic banking. This new code protects Australian consumers regardless of how they do their banking."[17]

The revised EFT Code is reported to deliver consumer protection by setting out the following:

- the disclosure consumers must receive before they first use a new form of electronic banking;
- the information consumers must receive on receipts;
- liability for unauthorised transactions and system or equipment malfunction;

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[16] Presentation to the Corporate Law Teachers Association, available at www.asic.gov.au

[17] Also at www.asic.gov.au

- protection of a consumer's privacy;
- that, when the consumer agrees, electronic communications rather than paper ones allowed; and
- complaints investigation and dispute resolution processes.

Membership of the code is open to all organisations offering electronic funds transfer, not just financial institutions. For today's purposes, the Revised Code is important not only for its content, as described above, but also for how it fits in terms of the legislation. Section 12A(3), gives ASIC the function "of monitoring and promoting market integrity and consumer protection in relation to the payment system by promoting the adoption of approved industry standards and codes of practice, the protection of consumer interests, community awareness of payment systems issues, and sound customer banker relationships, including through monitoring the operation of industry standards and codes of practice and monitoring compliance with such standards and codes. This immediately follows the conferral of ASIC's statutory function of monitoring and promoting market integrity and consumer protection in relation to the Australian financial system generally,

Codes of conduct are intended to be dealt with rather differently in the Financial Services Reform Bill. Proposed section 1101A is in quite different terms, and provides for ASIC, on application, having the power to approve codes of conduct relating to any aspect of the activities of financial services licensees. It is only to do so if it is satisfied that the code is not inconsistent with the ASIC Act or any other law of the Commonwealth under which ASIC has regulatory responsibilities, and that it is appropriate to approve the code having regard to the ability of the applicant to ensure that persons who hold out that they comply with the code, will do so, and the desirability of codes of conduct being harmonised to the greatest extent possible. It is not clear to me that the specific paragraphs of section 12A which I quote above, are to survive. The explanatory memorandum suggests (paragraph 17.17) that new and revised codes will be developed by industry in consultation with ASIC and with consumer associations, and that existing industry codes "including those relating to practices in the areas of banking, deposit taking, and general insurance will continue to play an important role in fleshing out best practice standards for compliance with a proposed new regime. These codes will, however, need to be amended to ensure that they are in line with the requirements and obligations imposed by the Bill."

Aggregation services

It is also interesting to observe the work of ASIC with respect to a specific new issue which arises in the electronic context, namely aggregation services, under which customers of financial institutions are invited to allow either the institution or a third party to have access to all of their financial account details and to provide an overall report based on that information. Clearly, for that purpose, information such as personal identification numbers or passwords have to be made available in a way that might be contrary to the standard terms of contract. While ASIC has issued no formal policy on the subject, ASIC staff have clearly been active investigating the issue[18]. ASIC found only three account aggregation providers at this stage, but more are expected shortly.

ASIC's policy development appears to start from the premise that adequate disclosure on all matters of importance to consumers is the overriding consideration, including information on issues such as cost, security, reliability, liability, especially liability for misuse, and access to complaint resolution mechanisms. It is not necessary or appropriate to go into detail here, but the new EFT Code for electronic funds transactions does deal with the issue to some extent. The Code provides that an institution can expressly authorise particular conduct, such as subscribing to an account aggregation service which necessarily involves handing password information to the aggregator, without thereby contravening the prohibition on such disclosure.[19]

Wholesale markets

In the same way as consumer issues in technology are novel and important, so are the issues with respect to the wholesale markets. There is an industry white paper entitled *E-Business Challenges for Australia's Wholesale Financial Markets*[20] . The KPMG web page reports that the major conclusions of the white paper include:

- E-Business represents an ongoing process of rapid, unstructured, technology-enabled developments overwhelming traditional business practice in the wholesale banking industry.
- E-business offers greater speed and more automation, but will also affect the level of business risk.
- It is forcing the industry to tackle far-reaching issues - co-operating to compete, growing transparency, security and privacy, erosion of the ability to differentiate on relationship grounds, and channel conflicts between electronic delivery and traditional business.

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[18] *Consumer issues in account aggregation*, Nicola Howell,, on the ASIC web page, dated 18 April 2001

[19] The UK Financial Services Authority has also addressed this issue, with a release on 15 May providing advice for firms and consumers on the regulatory implications - see www.fsa.gov.uk

[20] a collaborative research project under the auspices of the Australian Financial Markets Association (AFMA), KPMG, and the Securities Industry Research Centre (SIRCA), January 2001

Some of the prudential issues mentioned below are reflected in the conclusions from the white paper. Another surprising (to me) conclusion was that "customers show little demand for e-enabled wholesale financial products... To many corporate customers, wholesale financial services represent an adjunct to their core business, with little apparent "upside"... corporate customers (therefore) have a more strategic focus on e-business than the banks, and use different performance measures that can undercut the banks' case to automate wholesale financial transactions.."

Prudential issues

Regulators have little choice, however, but to confront these issues. APRA has considered both the potential benefits and the potential risks of e-commerce from a prudential point of view. APRA[21] concedes the potential benefits as including:

- the ability to reduce costs;
- outsourcing of services and functions, strategic alliances with IT and T companies;
- acquiring new customers; and
- advances in data warehousing and customer relationship management.

The potential risks have been less well explored, and are worthy of some further examination. These include[22]:

- Operational risk, exacerbated by the high dependence of electronic commerce on system reliability and integrity;
- Reputational risk, because electronic commerce customers expect 24 hour access to financial services, accessible from almost anywhere, and if they can't get it, the institution will suffer the risk of damage to its reputation even when there is no other loss;
- Outsourcing risk, because while outsourcing provides considerable benefits, risk is also increased by reliance on third parties for the provision of services, products and infrastructure. Many of these technology partners are new firms with a relatively short track record, and if a large number of institutions rely upon one or a few third party providers, systemic risk increases accordingly;

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[21] *APRA Insight*, 1st Quarter 2001, p 4

[22] Op.cit.

- Strategic risk. The pace of innovation and the high costs lead to considerable strategic risks where institutions have to decide whether to be fast followers, early adopters, or merely to wait and see;

- Legal risk, which can come from a break down at any point in the electronic commerce chain but might also include the failure of existing laws and regulations to keep pace with developments, and complex cross border legal issues;

- Increased liquidity risk; and

- Narrowing of margins.

This risk list exemplifies why technology is not merely a boon to banks, but also produces its own new and expanded areas of risk. APRA has signalled therefore that it will be looking closely at these issues in the course of its on-site visits to institutions in the coming year, with particular focus on outsourcing, because it does not have jurisdiction over these third party providers at present.

APRA believes that it may have to consider licence applications for de-novo virtual banks, or cyber banks, as opposed to extensions of the operations of existing licensed institutions. APRA has not expressly indicated an attitude to these; while it says that it seeks not to stifle innovation, whether it will be in the mood for risk taking by licensing virtual banks without relevant experience, may be doubted.

E. The Financial Services Reform Bill - Regulatory Nirvana?

You probably do not need to be reminded that the new regulators established on 1 July 1998, ASIC and APRA, have until now basically administered the same laws as their predecessors. The substantive new law is embodied in the Financial Services Reform Bill, a major set of amendments to the Corporations Act intended to be enacted prior to the Financial Services Reform Bill in place of the Corporations Law. My brief today does not require me to give you a general overview of the Bill, but instead invites me to look in general terms at the extent to which the Bill delivers on the Wallis promise.

The promise was in short that there should be a single regulatory framework for all financial products, markets and intermediaries. This would include combining chapters 7 and 8 of the law dealing with securities and futures, but goes much further. The intention is to provide a single framework in which all intermediaries would be licensed, the provision of advice would be regulated, and disclosure with respect to financial products would come within a single regime. While the Bill is structured to achieve that general outcome, it may be doubted whether it was ever possible to achieve a single framework in substance across such a broad range of products, markets, intermediaries and so forth. In this section, I will look at the way in which the FSRB deals with banking, and then with disclosure, before finally concluding with some discussion of advice and licensing.

banking

There was a degree of concern in the banking community about the application of the financial sector-wide provisions of the Financial Services Reform Bill, particularly to the activities of the banks. The government has sought to allay those concerns by some specific provisions of the FSRB dealing with what are called basic deposit products. The Bill's purpose is to apply the same rules as far as possible across the full range of financial products, but there will be exceptions. For example, there are special rules "to reduce the intensity of regulation in relation to 'basic deposit products' and related non-cash payment facilities."

The stated basis is that such products are capital guaranteed and well understood by consumers[23]. The special rules include that

employees of representatives authorised to provide services in relation to such products need not themselves be authorised;

a financial services guide need not be given, but an oral statement must be;

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[23] Clause 6.33 of the Explanatory Memorandum

a statement of advice is not required, but certain information must be given instead, and

a product disclosure statement may be given after the product is issued[24].

The explanation is that these rules have been relaxed on the basis that a customer can withdraw from the basic deposit product at any time without any loss of capital, other than transaction fees, and the proposed definition section 761A defines basic deposit product accordingly.

One may be permitted to doubt whether the concern which presumably led to these exclusions was fully justified, and if it was, whether these provisions will be sufficient to remove it in any event.

- The Corporations Law liability attaches to advice, not to the mere carrying out of the ministerial or administrative action which is requested by the customer. If the actions of the bank staff do constitute giving advice, then it is hard to see as a matter of principle why the general rules with respect to advice should not apply to them. Those rules do not, for instance, require individual licensing, which has not been a feature of the Australian regulatory landscape for many years.

- As for the exclusion, it may in practice be quite limited. Basic deposit products are defined so narrowly, but not inappropriately so, with the result that the special rules do not appear at all objectionable.

The concern that I imagine most institutions will have into the future will be exactly the same as it now is - namely, just when is a staff member working at a counter giving advice anyway. Is it giving advice if, when asked for information about a particular product, a staff member provides information also or instead, about a different product? Or is it giving advice if a staff member draws the attention of the customer to the fact that a particular account has quite a high balance but is not invested in such a way as to produce the highest rate of return?

Disclosure

Disclosure is at the centre of our regulatory system. The assumption is that investors are to be protected by requiring disclosure to be made in a way that will allow them to exercise an informed choice about the appropriateness of the products which they choose, rather than some paternalistic approach being taken. Wallis recognised that, and emphasised as well the quality and usefulness of the disclosure, not its quantity. Further, Wallis was concerned with the comparability of the information provided, so that investors could make appropriate choices between products of different

[24] Ibid.

kinds and from different providers, and that all kinds of fees, commissions, including trailing commissions, and all remuneration to product suppliers or advisers should be revealed. Wallis also noted that the present rules on disclosure did not apply to all who gave advice, and specifically referred to bank staff in that context.

It is clear that the Wallis assumption was that the rules with respect to disclosure were better set by the regulator rather than by regulations. The report suggests that present "rules" should be reviewed by the market integrity and consumer protection regulator which they were recommending, the regulator now known as ASIC, and recast by the regulator to ensure that information is comprehensible and relevant, consistent and comparable. ASIC needed powers to require positive disclosure for all retail financial products, including deposit accounts. But it was also suggested that in some cases it may not do so, and it highlighted in that connection, the less onerous financial disclosure requirements which deposit-taking institutions continue to have than those for other fund raisings.

Wallis expressed broad support for the familiar test in Section 1022 of the Corporations Law, requiring investors to be given such information as they, and their professional advisors, would reasonably expect to receive, and more use being made of both profile statements and short form prospectuses. Profile statements, in particular, set out product characteristics, the relevant risks, fees, and otherwise containing material specified by ASIC. Shorter prospectuses, or none at all, have been achieved by offer information statements, the exemption for offers made to professional investors, and the ability to make private offers providing they are not accepted by more than 20 investors in any 12 month period.

Against that background, the FSRB has adopted what it describes as a mid-way approach. A product disclosure statement must address a specific list of issues, but also describe any other material known to the issuer which might reasonably be expected to influence the decision whether or not to invest. Importantly, that does not require any due diligence, and is described in the Explanatory Memorandum (14.80) as a middle ground between the full due diligence approach in the fund raising provisions of the Corporations Law, and the key features statement approach taken in relation to superannuation. This approach "seeks to balance the need for the purchaser to have sufficient information to make an informed decision and compare products against the concern that they may be provided with more information than they can comprehend."

Whether it was desirable to bring about shorter and more comprehensible material by removing the need for due diligence is open to question. One of the themes most often expressed to me over recent years has been a high degree of scepticism about who reads fund raising offers. One obvious answer is, the lawyer who you consult, after the event, to see what your rights might be. Addressing a group of banking lawyers, there are so many other documents which seem not to have been read or understood, including loan agreements and health warnings in advice letters, that some healthy scepticism on all of these subjects seems appropriate.

advice

I intend only to address what I will inevitably call, an incidental aspect of these provisions. Section 77(5) of the Corporations Law presently provides that advice given by solicitors or accountants in public practice as such is to be disregarded for the purpose of the provisions requiring the givers of advice to be licensed, if that advice is "merely incidental" to the practice of his or her profession. Just when such advice may truly be regarded as "merely incidental" has been the source of much debate and discussion over the years, and in particular was the focus of Policy Statement 119 issued by ASIC in March 1997. ASIC suggested then that a solicitor or an accountant in public practice does not need to operate under a licence when all of the following are requirements are satisfied:

(a) investment advice they give forms an integral and merely incidental part of their overall services;

(b) they charge no discrete fee for the advice; and

(c) they do not receive any commissions or other benefits from product issuers.

While the policy statement may not have resolved all of the uncertainty, I believe that it should have been helpful.

There is now in the Financial Services Reform Bill, a provision for ASIC to declare professional bodies as "declared professional bodies". The Explanatory Memorandum [25] describes this as "a mechanism for professional bodies, whose members may give financial product advice in the course of carrying on their profession, to come within the licensing regime." It could alternatively be characterised as a way of enabling them not to come within the licensing regime, but it is important to note that the Explanatory Memorandum asserts that this is not an alternative to incidental advice, as some of us had assumed. It is said that the "general refinement of the definition of financial product advice will ensure that a distinction is clearly drawn between advice that falls within the financial services reform regime and advice that falls outside"[26].

These words direct our attention to the new definition of financial product advice, which is to be found in Section 766B. That section defines financial product advice, as a recommendation intended to

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[25] At 11.38

[26] Op.cit. 11.40

influence a decision in relation to a particular financial product or class of financial products or which could reasonably regard it as being intended to have such an influence. It then asserts that there are two types of financial product advice, personal advice and general advice. For present purposes, the interesting sub-section is sub-section (5) in the following terms:

> "Advice given by a lawyer in his or her professional capacity about matters of law, legal interpretation or the application of the law to any facts is not financial product advice."

This is the nearest thing we have to an express exclusion of incidental advice, but it is important to note its limitations. First, it no longer refers at all to accountants. Second, it only relates in any event to matters of law, legal interpretation or the application of the law to facts, and will not provide any solace for lawyers assisting their clients to structure transactions even of a barely commercial kind.

Those of you who read the NSW Law Society Journal[27] may, like me, have been struck by the recent heading "Solicitors can only offer legal, not financial, advice." The article refers to the Society seeking an amendment of a section of the Family Law Act to clarify that a solicitor's certificate of independent advice refers only to the provision of legal advice. It notes that a solicitor who is not qualified to offer financial advice and who complies with the present wording of that section would breach professional conduct and practice rule 45.6.4 which requires solicitors to advise their clients that they do not profess to give financial advice. "In seeking the amendment, the Society wishes to clarify the fact that solicitors are qualified to give only legal advice (as opposed to financial advice); the only exception being solicitors who have other qualifications such as a degree in economics, commerce, business administration or accountancy or who are otherwise licensed by ASIC as financial advisers."

The practitioners who are not immediately familiar with rule 45.6.4, and who found it surprising in light of section 77(5) of the present law, may take some comfort from the fact that the rule probably does not have the general implication which the short article might suggest. The rule is about the giving of certificates by solicitors to borrowers from banks and other lending institutions, and is clearly designed to limit the liability for negligence in such situations.

licensing

Because the Financial Services Reform Bill is regarded as creating a single regime for licensing, there was, I believe, an expectation in some quarters that that meant that it was a regime for a single licence. In the case of those financial services entities who are regulated by APRA, the regime is at least a

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[27] NSW *Law Society Journal* April 2001 page 31

requirement for dual licensing, because every licensee regulated by APRA will also need to obtain an Australian Financial Services licence under the Financial Services Reform Bill provisions. There are, therefore, specific provisions designed to ensure that this apparent overlap does not provide practical difficulties. For example, ASIC is required to consult with APRA before imposing any or additional conditions, or varying conditions, of a licence where the licensee is regulated by APRA. Further, if the licensee is a deposit taking institution "and the proposed condition would have the result of significantly limiting or restricting the ADI's ability to carry on all or any of its banking business, then ASIC does not have the power to impose the condition, and the power to impose, vary or revoke such a condition are (sic) taken to be powers of the minister (Explanatory Memorandum 11.18 quoting proposed sub-section 914A(5)).

F. Conclusion

There is still so much to talk about - the social obligations of banks to provide services regardless of profitability, privacy, credit card fees, among others no doubt. But enough is enough.

The analysis in the Wallis report stands up well after more than four years, as a reasonable description of the emerging financial services sector, and as a prescription for how best to regulate it. Without wishing to be drawn on the subject, it is interesting that general insurance, an aspect of financial services now much in the news, received such short attention, a mere five paragraphs on page 331, with a recommendation as follows:

> (APRA) should be responsible for the prudential regulation of general insurers on a similar basis to that applied currently by the ISC.

The basis for the recommendation was the need for "consumer protection in the context of substantial information asymmetry and the adverse consequences for policy holders if insurance claims cannot be met. Accordingly, there is a continuing role for prudential regulation of general insurance. This is a specialist function, and the licensing and other regulatory arrangements now in place for general insurance should be retained with minimal change under the proposed (APRA) scheme."

I still believe that the report stands up well.

Secondly, the industry has continued to develop basically in the ways that were anticipated in the report. However, while there has been some consolidation among industry associations, with the formation of the Investment and Financial Services Association, there remain numerous other industry bodies, including

> the Australian Financial Markets Association,
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> the International Banks and Securities Association,
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> the Securities and Derivatives Industry Association,
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> the Insurance Council of Australia and
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> the Australian Bankers Association,[28]

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[28] Others include the associations of insurance brokers and agents, financial planners, credit unions, building societies, and friendly societies.

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but it is likely that these will continue as separate bodies so long as the respective financial institutions and intermediaries find them convenient.

Finally, the Financial Services Reform Bill does give overall effect to the Wallis vision of a single regulatory regime for financial products, markets, services and intermediaries. Those who expected a single licence, have been disappointed, but do large and complex institutions really want all their regulatory eggs in one licence basket? The challenge of describing the risks inherent in a bank deposit, without frightening the community unreasonably, far less those in general insurance products (!), have defeated the attempt at a strictly single disclosure regime. And there are more exceptions and qualifications than will make life simple for those advising those giving advice - but it should not be necessary to understand superannuation, to sell travel insurance.

Even if some of the hype about a single regime was unrealistic, the FSRB is disappointing in some respects. First, the need to make provision in specific cases to address industry concerns about the inappropriateness of the one-size-fits-all approach has produced considerable complexity. Secondly, some of the drafting principles of the earlier Simplification and Corporate Law Economic Reform Program exercises have not been carried through. For example, definitions are to be found scattered through the law rather than in one place, and some of the terminology (PDS, FSG) is not particularly attractive. We are, of course, still missing the transitional provisions as this is being written, and with such a short time projected between passage and coming into effect, these are vital. One could be forgiven for doubting whether 1 October 2001 is achievable even now, as we await both those provisions, and the uniform enactment of the new Corporations Law as what appears to be a necessary precursor to the passage of this legislation. But so much appears to be invested in the legislation by the government, the regulator and industry, that one hopes any delay, unlike this paper, will be brief.