

The Financial System: Towards 2010

Introduction

The stability, integrity and efficiency of the financial system are critical to the performance of the entire economy. The financial system is an essential component of the infrastructure of commerce, providing in excess of \$40 billion worth of services annually to other sectors of the economy.

The financial system has entered an era of accelerated change that is likely to continue into the next century. Change in the financial system implies the need to adapt regulations imposed on financial institutions and markets. Regulation must adapt both to facilitate greater competition and efficiency in the financial sector and to secure the integrity and stability of its operations.

The Financial System Inquiry was asked to analyse the forces driving change in the financial system and recommend ways to improve current regulatory arrangements.

The main findings and recommendations of the Inquiry are summarised in this overview. The Inquiry's detailed findings and recommendations are presented in Parts One and Two of the Report.

The Inquiry was asked to report on the results of financial deregulation flowing from the Campbell Report published in 1981. The Inquiry's report on these matters is presented in Part Three.

Outcomes Sought by the Inquiry

The efficiency of the financial system affects every business and individual in the nation. There are very large efficiency gains and cost savings which could be released from the existing system through improvement to the regulatory framework and through continuing developments in technology and innovation. Markets can only deliver these outcomes where competition is allowed to thrive and where consumers have confidence in the integrity and safety of the system.

The Inquiry has not pursued change for its own sake, but has sought an appropriate balance between achieving competitive outcomes and ensuring financial safety and market integrity. In particular, its recommendations seek to:

- create a flexible regulatory structure which will be more responsive to the forces for change operating on the financial system;
- clarify regulatory goals;
- increase the accountability of the agencies charged with meeting those goals;
- ensure that regulation of similar financial products is more consistent and promotes competition by improving comparability;
- introduce greater competitive neutrality across the financial system;
- establish more contestable, efficient, and fair financial markets resulting in reduced costs to consumers;
- provide more effective regulation for financial conglomerates which will also facilitate competition and efficiency; and
- facilitate the international competitiveness of the Australian financial system.

Precise prediction of the direction and performance of the financial system cannot be made. However, the Inquiry is confident that implementation of its recommendations will place Australia's financial institutions and markets in a strong position to adapt to change and to respond to the ever increasing competitive pressures which lie ahead.

Change in the Financial System

Rapid technological innovation and an evolving business environment together with longer-term changes in customer needs and profiles are reshaping the financial system.

The system will have a progressively greater array of participants, products and distribution channels which, in some cases, will expand beyond the traditional categories of banking, insurance and financial exchanges.

Competition is emerging from new providers of financial services and through the increasing globalisation of financial markets. This generates increasing pressure for improved efficiency and performance.

The Forces Driving Change

Customer Needs and Profiles

Changes in customer needs and profiles are gradual but powerful influences on financial sector developments. The impact of these changes is particularly strong in two areas.

First, the role of the financial system in the economy is deepening, with households increasing both their financial asset holdings and their borrowing from the financial sector. This higher demand for financial services reflects increasing wealth and changing financial needs arising from demographic and life cycle changes, including:

- the ageing of the population and increasing expectations of higher retirement incomes; and
- more diverse life cycle experiences including greater job mobility, longer periods spent in training and education, shifts in work-leisure preferences and changes in family structures and experiences.

Secondly, customer behaviour is changing in two broad ways which are together promoting a more competitive marketplace.

- Better access to information and weakening of traditional supply relationships are raising consumer awareness of product and supplier value, thereby increasing competitiveness in markets.
- Greater familiarity with the use of alternative technologies means that more households are pursuing lower cost and more convenient means of accessing financial services.

Skills and Technologies

Technological innovation has been a major force shaping financial service delivery over the past two decades and appears likely to accelerate over the next few years. Systems for processing, communicating and storing information are an essential part of the infrastructure supporting financial activities. These are all undergoing substantial and irreversible changes as a result of technological advances.

Technology has made it easier to access markets and products both domestically and internationally. Technology has also made it possible to analyse and monitor risk more effectively, to disaggregate it on a broad scale, to price it more accurately and to redistribute it more efficiently. While the pace of innovation cannot be predicted precisely, it is likely to accelerate over coming years for two main reasons.

- The costs of technology will continue to fall.
- Innovations will increase the ease and security of electronic transactions.

These factors will facilitate the conduct of financial activities through homes, workplaces and other sites physically remote from service providers, further reduce cost and lower entry barriers to new suppliers.

Changing Regulatory Framework

The regulatory framework is itself an important driver of change in the financial system. The governmental and regulatory environments profoundly influence the structure and scale of finance sector activities. Their influence is by no means confined to direct financial regulation. Also of considerable importance are:

- the increased opening of the Australian economy to the global marketplace, including the financial system;
- the introduction of compulsory superannuation;
- changes in the role of government, in particular the almost complete departure of government as an owner of financial institutions and the associated removal of explicit government guarantees of finance sector liabilities; and
- the impact of the taxation system on investment choices and the international competitiveness of the Australian financial system.

Deregulation following the Campbell Report has been a major influence. Among other important changes, this involved a lowering of barriers to entry into the banking sector and the removal of controls over interest rates and other aspects of banking business.

Deregulation stimulated change in the financial landscape in two respects. First, it focused innovation on the delivery of financial services rather than on the unproductive activity of circumventing outdated regulations. Secondly, it created a more competitive environment in financial markets. Nonetheless, the financial system remains subject to a wide array of regulations and entry restrictions and there is scope to encourage greater competition and efficiency through further regulatory reform.

The Changing Financial Landscape

Major change in the financial system is being shaped by the interaction of these different forces. Some of the more significant effects are summarised as follows.

Increasing Business Focus on Efficiency and Competition

Technological innovation has fostered innovation in products and delivery channels. Regulatory costs have also prompted innovation with products engineered to exploit gaps, inconsistencies and imperfections in the regulatory scheme. Customers are becoming increasingly sophisticated and effective in demanding value for money.

The implications of these developments are several.

- Business survival will increasingly depend on accurate costing and pricing — there will be ever-decreasing scope for cross-subsidies in banking and other financial services.
- High cost services and delivery channels will be subject to rationalisation, irrespective of change in regulatory arrangements.
- Many markets will be more competitive and contestable, with lower entry barriers allowing niche or specialist providers to exploit opportunities created by the mismatching of price and cost or by inefficiencies in production.

Increasing Globalisation of Markets

A striking feature of wholesale financial markets is the trend towards international integration as deregulation has removed many of the barriers to cross-border transactions and technology has lowered their cost.

As markets have become increasingly global, the volume of cross-border financial activity has increased. The strongest areas of growth in international financial activity in the past decade have been international bond issues and derivatives trading.

Australia has actively and irreversibly embraced globalisation. A consequence is that competition in many financial markets occurs globally, rather than at the national or regional level, presenting both opportunities and challenges for Australian financial service providers.

While globalisation of wholesale markets is already well advanced, most retail financial markets have scarcely been affected. It is clear, however, that the new technologies and techniques which will stimulate change are now

imminent. Advances in the means of achieving secure electronic transactions and the critical mass of electronic network coverage are now well within sight. Global retail electronic financial transactions are likely to emerge in the near future and will almost certainly flourish over the period to 2010 if the regulatory environment is accommodating.

Concurrent Conglomeration and Market Widening

Innovation in product design and distribution has blurred the boundaries between financial instruments and institutions. Consumers now have greater choices, offered in many cases by entities which have not previously operated in the financial system. The range of choices, and the channels through which they may be exercised, are likely to multiply further.

Competition for existing markets is likely to be intense, with new competitors emerging from outside the financial system and from overseas. Technology will make it easier for foreign markets to attract investors away from domestic markets. As globalisation increases, investors will increasingly be represented by global funds managers with scant loyalties to products or markets. They will buy shares, bonds, mortgages and other financial products wherever the price is most attractive.

These forces will widen the boundaries of financial markets and lead to heightened competitive pressures.

Many of these changes will occur within the institutions already providing financial services. To ensure that the most efficient and competitive services can be offered, these institutions will need to ensure that they do not bear greater regulatory costs than their competitors. This will often involve large financial institutions establishing conglomerate structures under holding companies, and conducting as much business as possible through subsidiaries subject to lighter regulation.

To choose among a plethora of options, consumers may rely to an increasing extent upon trusted names, resulting in brands of preferred financial system suppliers or advisers becoming very valuable. It may prove highly profitable for financial conglomerates to use their brand strength across a wide range of activities.

A Shift in the Balance from Intermediaries to Markets

The evolution of financial systems is characterised by a continuing struggle between financial intermediaries and financial markets. As imperfections in the operation of markets have receded with the development of new transactions technology and new ways of harnessing information, trade on markets has been increasingly substituted for financial intermediation.

This trend has a number of dimensions, the most important of which are:

- disintermediation in certain credit and risk management markets;
- as part of that trend, securitisation; and
- developments in household savings preferences and the means of meeting them.

Disintermediation in Credit Markets

Disintermediation in credit refers to the tendency of firms or individuals to access financial markets directly and independently of a balance sheet financial intermediary.

Large firms, especially multi-national corporations, can increasingly raise funds directly in capital markets. This partly reflects improved information technology which permits ultimate lenders to inform themselves about the characteristics of borrowers more easily and at lower cost. It is partly also the result of the sheer size and multi-national presence of the world's largest corporations, which have improved their credit ratings in international financial markets.

The response of balance sheet intermediaries to disintermediation by their larger clients has been to join the process as advisers and arrangers and to concentrate traditional lending efforts in those sectors of the market less able to take advantage of direct finance. Banks in some markets have focused more on small and medium sized firms and on personal clients. At present, such clients are mostly unable to issue bonds directly into markets because of the absence of sufficient information about their creditworthiness. They can raise funds only via an intermediary whose creditworthiness substitutes for their own.

The trend towards disintermediation in credit markets has been relatively weak in Australia to date. Banks remain strong sources of corporate credit, and there is no clear trend away from them at this time. Private corporations' use of bond markets is relatively less developed, and it is the banks themselves which are among the heaviest issuers. However, technological advances that lower information costs and extend the reach of markets have the potential to change this situation rapidly.

Securitisation

Securitisation refers to the process of issuing marketable securities against an income stream derived from a pool of otherwise illiquid assets. It involves sales of loans or other assets into specially designed trusts which then issue securities directly into the capital market.

In Australia, securitisation has become a force in home mortgage finance. It has also emerged in some other retail markets, such as credit card receivables and motor vehicle loans, although at this stage only on a small scale.

Like disintermediation, securitisation represents the substitution of trade on financial markets for functions traditionally performed via the balance sheet of financial intermediaries. By originating loans and providing recourse to an insurer in the event of default, financial institutions screen loans and enhance their creditworthiness sufficiently for the loans to be traded in open financial markets. The role of the institution is not displaced entirely by this process but it is substantially restricted in scope. In many cases, it is the institutions themselves which are using securitisation as a means of better managing their capital.

The prospects for growth of securitisation will depend on its cost effectiveness relative to balance sheet intermediation. The question also arises as to possible limits to securitisation. At present, securitisation is largely restricted to assets which have very low, even negligible, risk or which represent a homogeneous class on which risk can be statistically estimated and priced. Whether there will be a market for higher risk or less homogeneous assets is unclear. The test will come with assets like loans to small businesses (some mortgage backed lending has recently emerged in this area).

Competition for Household Savings

The trend to markets has been reinforced by changes on the household demand side. The retirement savings needs of an ageing population are steadily increasing the proportion of financial sector assets taking the form of market claims rather than products offered from the balance sheets of financial intermediaries. This is particularly evident in the relative growth of superannuation funds and products.

Despite this, products backed by balance sheets will not cease to exist in the foreseeable future. Indeed, the recent decision to allow superannuation savings to take the form of deposits through retirement savings accounts may provide some easing for a time in the trend towards market claims. There is also evidence of an increasing demand for capital certain income products for retirees and immediate annuity products offered from balance sheets are already a growing sector for life companies.

However, the broad sweep of the forces for change suggests strongly that the overall balance will continue to shift towards funds managers and markets. The evolution of financial systems has been consistently in the direction of reducing obstacles to the more efficient operation of financial markets. Developments in information technology and risk management techniques are accelerating this trend.

Possible Future Developments

Over time, the processes of disintermediation and securitisation will increasingly offer households alternatives to balance sheet contracts like deposits. For example, more accurate pricing of individual risk categories facilitates the retail packaging and offering of low-risk securities such as those backed by insured home mortgages. An implication is that deposit taking intermediation is likely to shrink in relative importance within the financial system, albeit at a pace that is difficult to predict.

Another key development is likely to be the increasing tendency for superannuation funds and other funds managers to use new technologies in order to link their funds management activities to other financial services. Already, superannuation funds have begun to offer related financial products such as housing loans, group insurance and retirement income

products. In the future, other services could be linked to managed funds, notably payments instruments. This could diminish one of the remaining key advantages of balance sheet intermediaries over funds managers.

Beyond this, developments may increasingly transcend existing institutional patterns. For example, financial claims, including loans and bonds, could bypass intermediaries to be bought and sold by electronic auction through global bulletin boards at minimal cost. Users and suppliers of financial claims may be networked together to exchange real-time data and documents. Payments systems are likely to extend beyond the present deposit-based stores of wealth to broader credit-based systems linked to the security of other forms of wealth, perhaps including illiquid assets such as real estate.

All this not only suggests that providing financial services will become very competitive but that the boundaries observed today between markets and between institutions could quickly disintegrate.

A Vision for the Future

Alternative Views

The future is necessarily uncertain, and there is worldwide debate about the nature, scale and pace of change in the financial system.

One view is that change will remain gradual and incremental. It is observed that the basic functions of the financial system are not changing, and that the impact of new technologies on the basic structure of the financial system has been relatively limited to date. If the recent pace of change is merely projected forward, this vision would suggest that the financial system in the year 2010 may not look very different from that of the present.

On another view, the financial system (and perhaps other areas of the economy) is undergoing a 'paradigm shift', a more revolutionary transformation which represents a sharp discontinuity from the trend experience of the past. Those holding this view expect that financial processes and structures will be transformed by the rapid emergence of much lower cost information technology and its equally rapid dissemination

into homes and workplaces. This shift would not only dramatically alter service delivery channels but could also redefine the character and boundaries of markets. Such discontinuities have occurred in the past in other industries, and it is argued that the financial services industry will now experience a similar shift.

Between these two extremes lie a diversity of views which perceive some truth in both positions. There is a great deal of common ground on many aspects of the debate and there is no doubt, in the Inquiry's view, that considerable change will be experienced over the medium term.

Inquiry Task

The Inquiry is unable to resolve this debate. However, it considers that it does not need to base its recommendations on firm or precise predictions about the future of the financial system. Creating the future and securing a place in it is a role for the private sector responding to customer demands. Provided processes are genuinely competitive, the private sector is best placed to determine the future shape of the financial system.

For the Inquiry, charged with considering the regulatory framework, the need is to ensure that change can be accommodated within responsive and flexible regulatory arrangements, and that regulation encourages innovation and competition so that the most efficient players and processes prevail.

There is, nonetheless, advantage in anticipating the broad nature of the likely changes which will be the focus of regulatory concern in the near term.

In forming some broad judgements about the scale and pace of change, the Inquiry considers sufficient change is underway for it to recommend modifications to financial regulation. Similar views are emerging overseas with changes to regulatory arrangements being made or considered in several countries.

This is not to say that change is so rapid or pervasive that a fundamentally new approach is required. The Inquiry has steered a course based on the changes which are already clearly emerging rather than on assumptions of radical change in the future.

Elements of the Inquiry's Vision

The key changes to the financial system likely over the next decade will not alter the rationale for financial regulation, but will shift much of its focus.

- Advances in information technology could well erode the traditional roles of financial institutions, and more niche and specialist players may enter a variety of financial markets.
- In some areas, this new entry may include participants offering services from abroad.
- Many new payment instruments and payments service providers may emerge, some divorced from traditional deposit products and many using new technologies and new delivery channels.
- The emergence of new players will be matched by the continued evolution of large financial conglomerates, using their brand and other strengths to provide a wide range of financial services. The market may come to be polarised into large and small players, with relatively fewer participants of middle size.
- Within the larger financial service corporations, there will be continuous changes in the way services are designed and bundled. The range of activities will be allocated among group entities to minimise regulatory costs, and this will be increasingly important to meet competition from niche (and perhaps foreign) players.
- A much larger share of household financial wealth will be held in the form of market claims, particularly through superannuation savings and retirement income products. The share of financial system assets taking the form of deposits is likely to continue to fall.

For some time to come, however, most of the existing institutional forms are likely to remain, including deposit taking institutions (DTIs), insurance companies, superannuation funds and public unit trusts. The relative balance will depend as much on taxation developments as other factors. In the case of the larger financial services corporations, the regulated entities may become divisions of much broader entities, while all participants will operate within broader markets encompassing close substitute products.

These trends are already evident and have provoked many ad hoc regulatory responses, such as efforts to harmonise conflicting disclosure regulations,

efforts to tighten and extend credit laws, the establishment of codes of practice providing flexible but duplicated regulatory coverage, and lead-supervisor protocols for financial conglomerates.

Given these considerations, the challenge is to design a regulatory structure that represents a more systematic and complete response to current trends. The changes which the Inquiry proposes are designed to facilitate market developments already underway. The Inquiry believes that this will provide the best chance of unlocking the potential efficiency gains that a more competitive market can bring, while at the same time maintaining necessary prudence and safety in the financial system.

A Blueprint for Reform

Establishing Priorities

The ideal regulatory scheme requires a balance between preventing market failure and allowing financial markets to perform efficiently the functions for which they were designed.

While this is a general principle, the balance required and the environment in which the judgment is made may vary over time. Consequently, it is possible that a particular structure will not meet the objectives of regulation at all times and in all circumstances. The blueprint for reform presented by the Inquiry in this Report is a measured response to the need for change — a response that maintains many of the features of current regulatory arrangements in Australia.

As previously noted, the Inquiry's recommendations are based on trends that are already evident. The Inquiry believes that a more fundamental paradigm shift, should it occur, will bring pressure for further change.

In particular, a paradigm shift is likely to lead to a world of low-cost information and many specialised providers at each point in the distribution chain. Further, these specialised providers may range across international boundaries. In such an environment, the Inquiry believes that there would be both a philosophical justification and a practical need to wind back the

more intense forms of prudential regulation and to shift the focus of regulation more to conduct by market participants and disclosure of information.

While these considerations have not been foremost in the Committee's deliberations, it has been conscious of the need to provide a regulatory framework that is flexible enough to cope with more dramatic changes in the financial landscape, should they occur.

Competition and Efficiency

A principal aim of the Inquiry is to achieve a more competitive and efficient financial system. Even a 10 per cent improvement in efficiency would translate into cost savings for the economy in excess of \$4 billion per annum.

To this end, the Inquiry has concentrated on two main objectives:

- to identify the best overall framework for the efficient delivery of regulation; and
- consistent with the Inquiry's Terms of Reference, to propose changes to the way regulation is conducted which will enhance competition and efficiency.

In designing regulatory arrangements, it is important to ensure minimum distortion of the vital roles of markets themselves in providing competitive, efficient and innovative means of meeting customer's needs.

Like the Campbell Committee before it, the Inquiry has proceeded in the knowledge that the performance of the financial system relies heavily on maintaining free and competitive markets. However, where such markets cannot alone meet performance objectives, it is essential to provide effective regulation by government. Regulation is necessary only to the extent that markets may fail, and then only where it can be demonstrated that the benefits of intervention outweigh its costs.

A more competitive and efficient financial system can be promoted in a variety of ways:

- more neutral regulatory treatment of competitors from different institutional sectors encourages those who are most efficient;
- reducing barriers to entry promotes more contestable markets;
- arrangements for regulation which are more responsive to market changes facilitates innovation and new entry;
- more cost-effective conduct and disclosure regulation lowers costs and promotes competition; and
- regulatory and taxation arrangements designed with greater regard to their effect on competition and administrative efficiency would contribute substantially to lower costs.

Conduct and Disclosure

Main Issues

Financial markets cannot function effectively unless participants act with integrity and there is adequate disclosure to facilitate informed judgements.

Regulations for these objectives are necessary across the entire economy. In considering their application to the financial system, the main issues for this Inquiry were:

- to decide where such regulation should be provided by general economy wide regulators and where specific financial sector arrangements are needed; and
- in the latter case, what the most effective structures and approaches to the provision of this regulation might be.

As a general principle, and to avoid regulatory inconsistency, economy wide regulation should not exclude the financial system. Thus:

- subject to the most consistent and efficient administration, consumer protection laws, including the prohibition on misleading or deceptive conduct, should apply to the provision of financial products and services; and
- privacy rules for the financial system should be the same as those being developed for the broader economy (subject to any special considerations that may be appropriately implemented through industry codes).

A Single Regulator for Conduct and Disclosure: Establishment of the Corporations and Financial Services Commission

While there are economy wide objectives for conduct and disclosure regulation, the complexity of financial products and the specialised nature of financial markets has led most countries to establish specialised regulatory arrangements for the financial sector.

In Australia, this has been provided through a variety of agencies, with arrangements governed by the institutional form of the service provider. The Inquiry considers such arrangements to be inconsistent with the emerging structure of markets. It considers that they have resulted in inefficiencies, inconsistencies and regulatory gaps and that they are not conducive to effective competition in financial markets.

A single market conduct and disclosure regulator for the financial sector should be established by the Commonwealth. This new body should seek to establish a consistent and comprehensive disclosure regime for the whole financial system, albeit one with flexibility to apply different rules, in response to different situations, beyond a common core. This regulator should also have responsibility for the regulation of advice and sales of retail financial products, including the licensing of financial advisers under a single regime. It should oversee industry based schemes for complaints handling and dispute resolution and establish a common means of access for consumers.

Regulation for the integrity of market conduct, consumer protection and the regulation of companies have significant synergies. These functions should therefore be combined by establishing the **Corporations and Financial Services Commission (CFSC)** comprising the existing Australian Securities Commission and that part of the Insurance and Superannuation Commission (ISC) which deals with disclosure, sales and advice. The consumer protection codes presently overseen by the Australian Payments System Council chaired by the Reserve Bank of Australia (RBA) should also be transferred to the CFSC.

Roles of the CFSC

The CFSC should be established by statute with power to administer the various conduct and disclosure laws which currently apply. The laws should be amended to ensure consistency of treatment of like products. Streamlined disclosure requirements should be introduced, including the right to sell products on the basis of succinct profile statements and shorter prospectuses.

The CFSC should also be given powers, exercisable within its jurisdiction, which mirror those provided under the consumer protection provisions of the *Trade Practices Act 1974*. Vesting administration of these powers in the CFSC for the financial system to the exclusion of the Australian Competition and Consumer Commission (ACCC) will avoid duplicate administration while retaining substantive universal coverage of the provisions. These substantive provisions will also greatly enhance the enforcement capacity of the CFSC. Existing inconsistencies within and between various laws should be removed, in particular by ensuring that specific due diligence defences have full effect. Such defences play a vital role in the efficient functioning of financial markets.

The CFSC should adopt a flexible approach to regulation. No one model of regulation should be imposed on the whole system. Where industry standards and performance suggest that the most practicable method involves self-regulation or coregulation, such methods should be preferred. In other areas, where good conduct is not so well established, a stronger statutory style should prevail. In all cases, the cost effectiveness of regulation should be subject to ongoing stringent assessment.

The Inquiry would in principle prefer that the CFSC assumed responsibility for the *Uniform Consumer Credit Code* (UCCC), but has not recommended this change because of the practical constraints that such a transfer would face. However, if after further experience and review the UCCC proves not to be efficiently and uniformly meeting its objectives, consideration should then be given to the Commonwealth assuming current State/Territory responsibilities for the regulation of credit.

Financial Safety

Case for Financial Safety Regulation

As noted previously, the case for regulation is founded in the prevention of market failure.

The sources of potential market failure in the financial system include information asymmetry and systemic risk. Where these are present, the market may not deal efficiently with financial risk. This provides the basis for financial safety regulation.

Risk is an intrinsic feature of financial products, and a major role of financial markets is to manage, allocate and price risk. The ultimate source of risk is commercial, and constitutes the inherent uncertainty facing all economic activity. This risk can never be eliminated, but it can usually be allocated through markets to those who are willing to bear it in return for appropriate reward. Thus, it is not the role of regulation to eliminate financial risk wherever it arises. To do so would destroy the vital risk-management role of financial markets with highly adverse consequences for economic activity.

It is therefore necessary to circumscribe the application of financial safety regulation. This is all the more so because financial safety regulation can induce 'moral hazard' by encouraging the risky behaviour it is seeking to deter. The Inquiry has reviewed the case for financial safety regulation and confirmed, broadly, that it should continue to be applied in the areas to which it is currently applied. At the same time, it has reviewed the form and intensity of prudential regulation and formed the following judgments.

- Since there is a spectrum of risk in financial markets which should be preserved for reasons of economic efficiency, the degree of

regulatory intervention for financial safety should be proportional to the intensity of potential market failure.

- Over time, the scope and intensity of prudential regulation should be adjusted to take account of changes in the intensity of these risks in the different parts of the financial system.
- Government should not guarantee any financial promise, just as the government does not underwrite any other product, even where its safety is intensively regulated.
- It is important for participants and consumers to understand the goals of regulation, and for the framework of regulation to promote such an understanding.

Prudential Regulatory Framework: Establishment of the Australian Prudential Regulation Commission

To maximise public certainty as to the scope of financial safety regulation, its coverage should be clearly defined by requiring licensing or other authorisation of providers. This would not extend to entities which do not offer the defined classes of regulated products, such as most collective investment schemes — the latter would be regulated only by the CFSC.

A Single Prudential Regulator

A new regulatory entity, the **Australian Prudential Regulation Commission (APRC)**, should be established to undertake prudential regulation within the financial system, combining the existing prudential regulation functions of the RBA, the Financial Institutions (FI) Scheme and the ISC.

To achieve national coverage and remove artificial and anti-competitive distinctions in the marketplace, all prudentially regulated financial corporations should be brought under Commonwealth jurisdiction. This should replace the existing State/Territory FI Scheme for the licensing and prudential regulation of building societies, credit unions, and friendly societies.

Combining prudential regulation in a single regulator will better accommodate the emergence of wide ranging financial conglomerates and

enable a more flexible approach over time to changes in the focus of prudential regulation. Such an entity will be better placed to reduce the intensity of regulation, and so lower its cost, in the likely event that new technologies or other developments facilitate a reduction in systemic risks.

The Inquiry considers that the APRC should be separate from the central bank — the RBA — for the following main reasons.

- The combination of deposit taking, insurance and superannuation regulation is unlikely to be carried out efficiently and flexibly by a central bank whose primary operational relationships are with banks alone and whose operational skills and culture have long been focused on banking.
- Separation will clarify that, while the central bank may still provide support to maintain financial stability, there is no implied or automatic guarantee of any financial institution or its promises in the event of insolvency.
- Separation will enable both the RBA and the APRC to focus clearly on their primary objectives and will clarify the lines of accountability for the regulatory task.

The APRC should be empowered under legislation to:

- establish and enforce prudential regulation of any licensed or approved financial entity (unlicensed entities generally would be prohibited from offering products of specified classes including deposits, insurance and retirement savings or income products);
- issue or revoke authorities for DTIs, including banks, building societies and credit unions, life and general insurance companies and friendly societies, and approvals for superannuation funds;
- administer and enforce retirement incomes policy requirements on superannuation products (other than excluded funds where the trustees are the only beneficiaries — these should be regulated by the Australian Taxation Office); and
- assume management control of any licensed financial entity which fails or is considered likely to fail under clearly defined provisions and procedures for early resolution.

Approach to Prudential Regulation

In exercising its powers, the APRC is to cooperate closely with the RBA and, where applicable, the CFSC. It is desirable that its operations, including its findings in relation to financial entities, be publicly disclosed to the maximum practicable extent.

Under the Inquiry's approach, licences for banks, building societies, credit unions and other licensed deposit takers will in most respects be identical. Some differences will remain in the rights to use certain names, and the APRC will have the discretion to apply different intensities of regulation according to the characteristics of the individual institution. A credit union licence will apply only to a mutual organisation using the name credit union. The use of the name 'bank' will require the approval of the APRC, and banks, as now, will be required to have a minimum capital of \$50 million and hold an exchange settlement account (ESA) with the RBA.

Similarly, the licences and associated regulatory requirements for life companies and friendly societies issuing life products will be identical (subject to suitable transitional provisions or any case-by-case variations in regulatory intensity).

Policies preventing mutual ownership of banks should be removed. The general principle of spread of ownership should be retained, particularly for DTIs. However, a more flexible approach should be adopted, allowing exceptions where there is a strong case; for example, where other activities within a corporate group are congruent with the provision of financial services. Restrictions on the number of licensed or authorised entities within a corporate group should be eased.

The Inquiry considered the option of introducing deposit insurance but, on balance, was not convinced that such a scheme would provide a substantially better form of protection than is available under existing arrangements. However, the Inquiry recommends that existing arrangements be clarified and adjusted in certain respects. Depositors with banks, building societies and credit unions should enjoy statutory preference in the event of a winding up of the institution, as bank depositors do now.

In the case of mutual entities, restrictions on the issuance of capital instruments should be removed to facilitate meeting capital and liability

requirements. In the case of small institutions, provision may be made for voluntary contingency fund arrangements to assist resolution of financial difficulty. Participation in such schemes should be recognised in setting other regulatory requirements. The existing statutory preference protection provided to policy holders by the statutory and benefit funds of life companies and friendly societies should be maintained.

Systemic Stability and Payments

Stability

Since instability can arise from a wide variety of sources and must be addressed by the monetary authorities, the systemic stability of the financial system should remain the responsibility of the central bank. The RBA should be responsible also for the payments system because of its central importance to stability.

The RBA should continue to have powers as a lender of last resort to those financial corporations operating ESAs with it. However, the RBA should cease to have explicit responsibilities for the protection of bank depositors and should act instead in the national interest only. Depositor protection functions should be transferred to the APRC, helping to make it clear that, while the RBA may intervene to maintain systemic stability, its balance sheet is not available to guarantee deposits.

The RBA should have unfettered access to financial information held by the APRC and the CFSC. It would be expected that the RBA and the other regulatory agencies would maintain close and continuous liaison.

Competition in the Payments System: Establishment of the Payments System Board

The task of ensuring systemic stability is closely linked with maintaining the integrity of the payments system. The central bank itself plays a pivotal role in the final settlement of payments.

Accordingly, it is proposed that the RBA remain the regulatory authority in charge of the Australian payments system, but with a separate subsidiary

board established to oversee this function — **the Payments System Board (PSB)**. The PSB would have some common membership with the parent board of the RBA, including the Governor and one deputy governor. It would make its decisions independently of the main board which would concentrate on monetary policy and economic stability.

The RBA should be empowered to set standards for the payments system, adopting the role of regulator. Any provision of payments clearing services to its customers in competition with the private sector should be clearly separated from the RBA's regulatory function and be subject to transparent reporting arrangements. The RBA should, however, retain its ownership and participation in those parts of the payments system where high level control and coordination is necessary to ensure maximum efficiency; for example, in the provision of the infrastructure for the high-value payments system.

The clearing systems should be subject to access rules which are transparent and subject to approval by the competition regulator. There should be no presumption that any one class of financial institution should have exclusive rights to issue particular payment instruments, with the exception that only DTIs should be able to issue cheques in their own name. Conditions of access to clearing streams will vary and especially high standards may be mandated as necessary. Entry to payments clearing streams should be determined by the PSB and not be controlled by industry organisations.

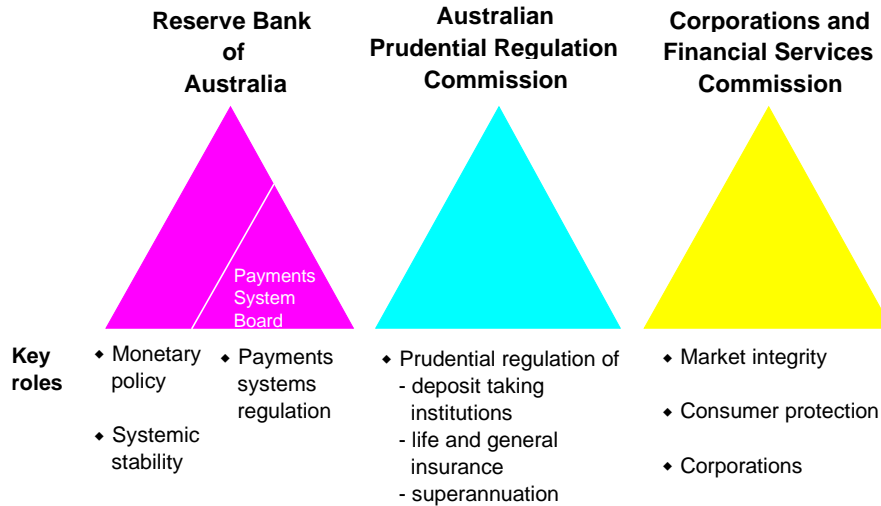
There should be no presumption that banks will be the only holders of ESAs. The right to hold an ESA should be determined by the RBA on the basis of clear and open guidelines, including the requirement that participants have extensive payments business with third parties.

Providers of open system payments instruments such as stored value cards, electronic cash or paper instruments should be required by the PSB to meet appropriate prudential, collateral or other requirements. This is needed to provide some assurance that funds outstanding in such systems are safe.

The Regulatory Framework: Summary

In summary, the Inquiry proposes that the existing regulatory framework based on four institutional regulators be replaced by three agencies established on functional lines. The new structure is illustrated below.

Figure 1: Proposed Regulatory Framework



Mergers and Acquisitions

Mergers

The Inquiry considers that the threat of takeover can be an important source of competitive pressure.

At the same time, mergers which would result in a substantial lessening of competition in markets should be regulated in the financial sector, as in any other sector. Accordingly, merger regulation in the financial system should be administered by the ACCC pursuant to the *Trade Practices Act 1974*.

There is no clear case for retaining restrictions such as the ‘six pillars’ policy which has imposed a blanket ban on mergers among the largest banks and

life companies in Australia. The Inquiry considers that the prudential aspects of mergers should be administered by the APRC and would rarely prevent their occurrence (although their funding or conduct may be affected).

In its Report, the Inquiry presents a number of findings about the nature of competition in certain financial markets. In particular, it comments on the cluster of services methodology used by the ACCC, the importance of retail transaction accounts and small business lending to competition assessment, and the pace of movement of retail banking products from the regional to the national level. However, it has refrained from commenting on any particular merger scenario.

Foreign Acquisitions

As for competition regulation, foreign investment policy should apply to the financial system in the same way as it applies to other sectors of the Australian economy, without the application of special rules or limitations.

The Inquiry considers that no part of the financial system should be immune from foreign acquisition, including major banks and life companies. However, it considers that a large scale transfer of ownership to foreign hands would reduce Australia's future policy flexibility and should be considered contrary to the national interest.

Promoting Greater Efficiency

The regulatory framework proposed by this Inquiry is founded on the premise that the financial system should be more strongly competitive and efficient.

A broad suite of regulatory issues needs to be revisited to establish whether changes can be made to promote further competition and efficiency, even in the absence of the major changes envisaged for the financial landscape.

- Where regulations or taxes distort or restrict choices, efforts should be made to find more neutral alternatives.
- In the face of globalising markets, every effort should be made to ensure that Australia's financial system is able to compete without

the impediments of outdated, inadequate or costly regulations (whether financial or otherwise) or discriminatory taxes.

- Regulators should pursue cooperative arrangements with their overseas counterparts to ensure that global trading is facilitated rather than impeded by local requirements which have no international equivalent, and that international enforcement action can be taken expeditiously.
- Moves towards more efficient pricing reducing cross-subsidies should be recognised as a necessary outcome of heightened competitive pressures. Government could contribute to efficiency and fairness in this area by expediting examination of alternative low cost means of meeting the transaction needs of social security and other recipients of government transfer payments.
- Choice should be maximised in superannuation and other steps taken to increase competitive pressures, including by simplifying regulatory arrangements.
- Impediments to the introduction of electronic commerce should be addressed as a high priority.
- Foreign investment policy should be reviewed where it discriminates between foreign owned and domestically owned life companies and managers of collective investments.
- Privacy provisions which restrict the development of data bases for credit scoring purposes should also be reviewed as they may be imposing considerable costs on consumers.

The taxation system at present does not appear fully conducive to attaining international competitiveness and other financial system goals. It will be important that in any future review of the taxation system its effects on the financial system be extensively and closely considered. For example, taxation provisions, including income tax provisions and stamp duties, inhibit structural reorganisation of corporate entities. Taxation provisions aimed at minimising tax avoidance through foreign portfolio investments also act to discriminate between foreign and domestic providers of collective investments.

Accountable and Responsive Regulation

A number of organisational improvements in financial regulation in Australia are desirable, including:

- secure funding for the regulatory agencies based on industry charges which match costs;
- maximising the operational independence of the regulatory agencies; and
- establishing boards comprised mainly of members independent of management.

It is also important to maintain a Council of Financial Regulators for information sharing and cooperation among the RBA, APRC and CFSC.

Establishment of the Financial Sector Advisory Council

Arrangements should also be established for the ongoing participation of private sector experts in the review of financial sector developments and policy. The Inquiry proposes the establishment of a **Financial Sector Advisory Council** to advise the Treasurer on developments in the financial system and their implications for regulatory arrangements and on the cost effectiveness and compliance costs of regulation. The Council should also focus on the international competitiveness of Australia's financial sector and how Australia could become a preferred location for financial activities in the region.

Concluding Comments

The Inquiry's recommendations are set out in the following listing.

If these recommendations are adopted, the existing institutional framework for regulation would be replaced by industry wide arrangements based on clearly distinguishable regulatory functions:

- regulation for market integrity and consumer protection would be provided by the CFSC;

- prudential regulation would be provided by the APRC; and
- the protection of the payments system and the broader economy from both price inflation and financial instability would remain the regulatory focus of the RBA.

This would provide much more than a restructuring and rationalisation of existing regulatory arrangements. The reconfiguration of the regulatory framework would:

- create a flexible structure better able to adjust regulation to maintain cost effectiveness in the face of changing circumstances;
- provide a more clearly focused and accountable structure that meets (and helps form) legitimate community expectations for consumer protection and financial safety;
- provide more efficient and effective regulation for financial conglomerates;
- provide more consistent regulation and greater competitive neutrality across the financial system; and
- contribute to the effective implementation of the various other reforms which the Inquiry has proposed and which aim at establishing more contestable, efficient, and fair financial markets.

The successful pursuit of these goals will require considerable ongoing effort. Over time, it will be highly desirable to align a broader array of policies, including taxation policies, towards this task.

Success also requires that the institutions charged with these responsibilities remain strong and effective, that they coordinate their work closely and that financial system participants retain a close and continuing role in the development of financial system policies.

Recommendations

The Committee's complete set of recommendations is as follows.

Conduct and Disclosure

Recommendation 1: Corporations Law, market integrity and consumer protection should be combined in a single agency.

A single agency, the Corporations and Financial Services Commission (CFSC), should be established to provide Commonwealth regulation of corporations, financial market integrity and consumer protection. It should combine the existing market integrity, corporations and consumer protection roles of the Australian Securities Commission (ASC), the Insurance and Superannuation Commission (ISC) and the Australian Payments System Council.

Recommendation 2: The CFSC should have comprehensive responsibilities.

The CFSC should be responsible for:

- financial market integrity, including:
 - regulating disclosure for securities and retail investment products;
 - regulating market conduct to promote orderly and efficient price discovery, trading and settlement;
 - determining applications for new exchanges, and overseeing the activities of existing exchanges;

- regulating investment and insurance sales and advice and financial market dealers and participants;
- regulating compliance of collective investment schemes;
- facilitating the development of new markets for debt and equity instruments;
- monitoring financial innovation and technological developments in the provision of financial products and services and determining appropriate regulatory responses;
- regulation of corporations, including incorporation, governance, insolvency and liquidation, and takeovers; and
- finance sector consumer protection regulation, including:
 - regulating the conduct of dealings with consumers and the prevention of fraud;
 - approving and overseeing industry codes of conduct, codes of conduct for new payments technologies and dispute resolution arrangements;
 - delegating accreditation and disciplinary functions to self-regulatory bodies where appropriate; and
 - setting benchmarks for and monitoring the performance of those self-regulatory bodies.

Recommendation 3: The CFSC should administer all consumer protection laws for financial services.

While the economy wide reach of the powers of the Australian Competition and Consumer Commission (ACCC) should be retained in law (subject to Recommendation 4), the CFSC should have sole responsibility for administering consumer protection regulation within its jurisdiction over the finance sector. For this purpose, consumer protection provisions comparable to those in the *Trade Practices Act 1974* should be included in the CFSC's legislation.

Recommendation 4: Due diligence defences should apply to positive disclosure requirements.

The due diligence defences associated with a positive duty to disclose such as under the *Corporations Law* and the *Superannuation Industry (Supervision) Act 1993* should have full effect, notwithstanding s. 995 of the *Corporations Law* and s. 52 of the *Trade Practices Act 1974*.

Recommendation 5: The CFSC and the ACCC should coordinate examination of financial exchange rules.

To improve the administration of the law relating to the rules of financial exchanges:

- financial exchange business and listing rules should be subject to disallowance on market integrity grounds by the CFSC rather than the Treasurer;
- the ACCC should continue to be responsible for authorising financial exchange rules and arrangements under s. 88 of the *Trade Practices Act 1974*; and
- the CFSC and ACCC should coordinate and accelerate their consideration of these rules.

Recommendation 6: States and Territories should retain and review consumer credit laws.

The States and Territories should retain responsibility for the *Uniform Consumer Credit Code* (UCCC) and related laws and focus efforts on improving its cost effectiveness and nation wide uniformity. After it has operated for two years, the UCCC should be subject to a comprehensive and independent review to consider what improvements are necessary and whether a transfer to the Commonwealth would be appropriate.

Recommendation 7: The CFSC should have powers to use a combination of regulatory approaches.

In addition to its framework legislation, the CFSC should have the power to adopt detailed codes which prescribe appropriate conduct and disclosure in particular industries or to allow the industry to develop such codes. Given these broad powers, the CFSC would have the discretion to decide the best approach to regulation to be used in particular circumstances.

The CFSC should have an explicit mandate to balance the efficiency and effectiveness of its regulatory approaches.

Recommendation 8: Disclosure requirements should be consistent and comparable.

Disclosure requirements for retail financial products (deposit accounts, payments instruments, securities, collective investments, superannuation and insurance products) should be reviewed by the CFSC to ensure they provide information that enables comparison between products. This information should:

- be comprehensible and sufficient to enable a consumer to make an informed decision relating to the financial product;
- be consistent with that for similar products regardless of which institution offers them; and
- appropriately disclose remuneration or commissions paid to advisers.

The disclosure codes of conduct applying to banking, building societies and credit unions should be made consistent wherever possible.

The effectiveness of disclosure requirements should be monitored regularly, using complaints data and user testing.

Recommendation 9: Profile statements should be introduced for more effective disclosure.

The law should be amended to require the issue of succinct profile statements about offers of retail financial products, including initial public offerings. These statements must contain:

- a brief description of the characteristics of the product;
- a clear and unambiguous statement of the risks involved;
- a clear and unambiguous statement of applicable fees, commissions and charges in a form which enables comparison with similar products; and
- such other disclosures for specific products as the regulator considers appropriate.

Beyond this, the contents of a profile statement should not be prescribed by regulation, except in cases where the CFSC believes that prescription is required to provide balanced representation of the product. The format should be developed by the CFSC in consultation with industry groups.

Recommendation 10: Shorter prospectuses should be encouraged.

The CFSC should work with industry and professional groups to promote more effective disclosure in prospectuses, including use of consumer testing to eliminate information overload. In particular, for smaller offerings the CFSC should encourage the use of shorter prospectuses and abridged due diligence procedures commensurate with the size of those offerings.

Recommendation 11: Financial institutions' financial reports should meet Corporations Law and prudential requirements.

As a general principle, financial institutions should be subject to the same financial reporting requirements as are other corporations under the *Corporations Law*. Action should be taken to develop, in conjunction with industry and the Australian Prudential Regulation Commission (see Recommendation 31), appropriate accounting standards for the deposit taking institutions and life companies to enable them to prepare one set of financial statements meeting both *Corporations Law* and prudential legislative requirements.

Recommendation 12: Accounting standards should be harmonised with international standards.

The Australian Accounting Standards Board should, where practicable, seek to harmonise Australia's accounting standards with international standards.

Recommendation 13: A single licensing regime should be introduced for financial sales, advice and dealing.

The CFSC should establish a single regime to license advisers providing investment advice and dealing in financial markets. There should be separate categories of licence for investment advice and product sales, general insurance brokers, financial market dealers, and financial market participants.

Recommendation 14: The CFSC should have power to delegate accreditation responsibilities to industry bodies.

The CFSC should have power to devolve responsibility for competency training and testing to industry bodies. It should also have the option to require that licence holders be members of codes of conduct or dispute schemes that meet minimum standards.

Recommendation 15: A single set of requirements should be introduced for financial sales and advice.

The CFSC should develop a single set of requirements for investment sales and advice including:

- minimum standards of competency and ethical behaviour;
- requirements for the disclosure of fees and adviser's capacity;
- rules on handling client property and money;
- financial resources or insurance available in cases of fraud or incompetence; and
- responsibilities for agents and employees.

Recommendation 16: Regulation of real estate agents providing financial advice should be reviewed.

The existing regulation of real estate agents should be reviewed. Real estate agents providing investment advice should be required to hold a financial advisory licence unless the review clearly establishes the adequacy of existing regulation.

Recommendation 17: Licensing of professionals providing incidental financial advice is generally not required.

Professional advisers, such as lawyers and accountants, should not be required to hold a financial advisory licence if they provide investment advice only incidentally to their other business and rebate any commissions to clients.

Recommendation 18: Additional prudential regulation of financial market licence holders is not required.

It is not necessary at this time to impose additional prudential regulation, capital or risk management requirements on financial market licence holders aimed at minimising contagion or systemic risk in the event of failure. However, this situation should be kept under review by the CFSC in conjunction with the prudential and systemic stability regulators.

Recommendation 19: Broader regulation of 'financial products' should replace current securities and futures law.

The law covering financial markets should adopt a broad definition of 'financial products' subject to generic requirements and supplemented by specific regulation for particular classes of products. This should replace existing separate *Corporations Law* regulation of securities and futures contracts. The CFSC should have the flexibility to declare certain products to be covered by, or to be exempt from, the law.

An effect of such a generic definition would be that the Australian Stock Exchange could deal in futures products and the Sydney Futures Exchange could deal in corporate securities (see Recommendation 21).

Recommendation 20: Prohibitions on retail participation in over-the-counter derivative markets should be discontinued.

The existing prohibitions on retail participation in over-the-counter (OTC) derivatives markets should be discontinued. The law should provide an additional layer of consumer protection for retail transactions compared with purely wholesale markets or transactions.

Recommendation 21: The CFSC should authorise financial exchanges under a single regime.

The CFSC should be empowered to grant authorisation to operate a financial market to any corporation meeting objective criteria aimed at ensuring that it will operate a fair and efficient market. There should be a single authorisation procedure for financial exchanges. The conditions attaching to authorisation will depend on the nature of the market authorised.

Recommendation 22: Regulation of exchanges should not be excessive compared with OTC markets.

The CFSC's charter should include a responsibility to ensure that the regulation of exchanges is not excessive compared with OTC markets. Market forces, rather than legislation, should determine whether a transaction is conducted on exchange or in an OTC market.

Recommendation 23: OTC markets may be conducted by appropriately licensed intermediaries.

The CFSC should have power to authorise a financial market dealer to operate an OTC market, subject to any conditions necessary to ensure that

the market is conducted fairly and that operational risks are contained. There should be no separate authorisation of exempt markets.

Recommendation 24: Exchange clearing houses should be appropriately authorised.

The CFSC should consider the appropriateness of proposed clearing and settlement arrangements as part of its oversight of financial exchanges and should be responsible for authorising financial exchange clearing houses.

Recommendation 25: A central gateway for dispute resolution should be established.

The CFSC should facilitate the creation of a central complaints referral service for all consumers of retail financial products and services, funded by retail financial service providers on a cost recovery basis.

Recommendation 26: Coverage of dispute resolution schemes should be broader.

The States and Territories should facilitate the creation of a nationally uniform dispute resolution scheme for finance companies.

All dispute resolution schemes should be encouraged to extend their coverage to small business on the basis that the cost of operation should be shared by each party to a dispute.

Recommendation 27: The CFSC should have broad enforcement powers.

The CFSC should be provided with adequate enforcement powers including:

- appropriate regulatory and investigative powers, including powers to obtain documents and question persons involved in the relevant conduct and to accept legally enforceable undertakings;

- provision for protection from liability for those who provide investigative assistance;
- power to impose administrative sanctions, such as banning or disqualification orders;
- power to initiate civil actions, to seek:
 - punitive court orders such as financial penalties;
 - a range of remedial court orders, including restitution orders, injunctions and corrective advertising orders; and
- power to initiate, and to refer matters to the Director of Public Prosecutions for, criminal prosecution.

The CFSC should be provided with adequate resources to meet its mission and to allow for effective regional representation so that it is readily accessible and well placed to perform its registration, inspection and investigation functions.

Recommendation 28: The CFSC should monitor new technologies.

The CFSC should ensure that industry initiatives for consumer protection in relation to new technologies develop in a coordinated way. It should also monitor the development of codes of conduct in relation to retail electronic banking and facilitate consistency across media as far as possible.

Recommendation 29: The CFSC should participate in global regulatory programs.

The CFSC should work with overseas regulatory and industry bodies to provide consumer protection for cross-border financial transactions and to avoid the potential for fraud. To this end, the CFSC should be empowered to:

- enter into bilateral and multilateral mutual assistance treaties with overseas counterparts;
- encourage the creation of international codes of conduct;
- develop mutual industry recognition or harmonisation regimes; and

- develop, with industry, education programs for consumers on cross-border dealings.

Financial Safety

Recommendation 30: Prudential regulation should be imposed on deposit taking, insurance and superannuation.

Prudential regulation should be imposed on institutions licensed to conduct the general business of deposit taking from the public, or offering capital backed life products, general insurance products or superannuation investments.

Recommendation 31: A single Commonwealth prudential regulator should be established.

A single Commonwealth agency, the Australian Prudential Regulation Commission (APRC), should be established to carry out prudential regulation in the financial system.

Recommendation 32: The APRC should be separate from, but cooperate closely with, the Reserve Bank of Australia.

The APRC and the Reserve Bank of Australia (RBA) should be separate organisations. However, strong mechanisms should be established to ensure appropriate coordination and cooperation between the two agencies.

- The RBA should have three ex officio members on the APRC Board.
- Provision should be made for full information exchange between the RBA and APRC.
- The RBA should retain responsibility for reporting under the *Financial Corporations Act 1974*.
- Provision should be made for RBA participation in APRC inspection teams.

- A bilateral operational coordination committee, chaired by an RBA deputy governor, should be established to coordinate information exchange, reporting arrangements on financial system developments, and other ongoing operational cooperation between the RBA and APRC, including cooperation in establishing clear procedures for the management of regulated entities which experience financial difficulties.
- The financial system regulators — the RBA, CFSC and APRC — should continue to pursue operational cooperation through a joint council chaired by the RBA.

Recommendation 33: The APRC should have comprehensive powers to meet its regulatory objectives.

The APRC should be empowered under legislation to:

- establish and enforce prudential regulations on any licensed or approved financial entity — unlicensed entities would be prohibited from offering financial products of specified classes, including deposits (subject to exceptions noted in Recommendation 37), insurance, retirement savings accounts, and superannuation or retirement income products; and
- consistent with prudential requirements, issue, revoke or place conditions on authorities for deposit taking institutions (DTIs), life and general insurance companies or other classes of licence, and approve public offer superannuation fund trustees.

Decisions made by the APRC on prudential grounds should not be subject to administrative or other review.

Recommendation 34: The intensity of prudential regulation needs to balance financial safety and efficiency.

The APRC's charter should emphasise the need to approach prudential regulation in a way that balances the objective of promoting financial safety with the need to minimise the adverse effects on efficiency, competition, innovation and competitive neutrality. This balance should preserve a

spectrum of market risk and return choices for retail investors, meeting their differing needs and preferences.

Recommendation 35: Prudential regulation of DTIs needs to be consistent with international requirements.

Prudential regulation of all licensed DTIs should be consistent with standards approved by the Basle Committee on Banking Supervision and should aim to ensure that the risk of loss of depositors' funds is remote. Quantitative prudential requirements such as capital adequacy, liquidity requirements and large exposure limits should apply. Regular on-site reviews of risk management systems should form an integral part of the approach to prudential regulation.

Prudential regulation should be sufficiently flexible to accommodate differences in the operation of DTIs, while pursuing the fundamental objectives of stability, efficiency and depositor protection.

Recommendation 36: A single DTI licensing regime should be introduced.

The APRC should be responsible for the licensing of all DTIs subject to prudential regulation. DTI licences should be issued such that:

- only those entities which meet minimum capital standards as prescribed by the APRC from time to time, and hold an exchange settlement account (ESA) with the RBA, should be entitled to use the name 'bank';
- only those entities which are mutually owned should be entitled to use the name 'credit union', 'credit society' or 'mutual';
- any licensed DTI should be entitled to use the name 'building society'; and
- licensed DTIs should be entitled to use any other business names provided they are not, in the view of the APRC, misleading to depositors.

Industry support organisations such as special services providers (SSPs) under the Financial Institutions Scheme should become companies under the *Corporations Law* and apply to the APRC for a licence appropriate to the role they wish to pursue.

The incorporation and general corporate regulation of building societies and credit unions should be transferred to the *Corporations Law* and the CFSC.

Recommendation 37: Deposit taking by unlicensed entities should be restricted and regulated by the CFSC.

The offer of deposits by unlicensed entities should remain subject to the fundraising provisions of the *Corporations Law*. The CFSC should be responsible for the issue of exemptions under the *Corporations Law* from the fundraising requirements for deposit products. Exemption should be granted only in exceptional circumstances, be for five years or less and be subject to revocation if conditions are not met. Conditions should include limiting the scope of any offer, as applies currently for pastoral finance companies. Any extension of the deposit taking role of these entities beyond the scope of the exemption should require licensing and regulation as a DTI by the APRC.

In the interests of competitive neutrality, the APRC should be consulted by the CFSC where exemptions from fundraising provisions of the *Corporations Law* may result in the general offer of deposit products.

Deposit products which are not regulated by the APRC should be disclosed as such in profile statements.

Recommendation 38: The APRC should regulate life companies.

The APRC should be responsible for the prudential regulation of life companies on a similar basis to that currently applied by the ISC.

However, the prudential regulation of life companies should be designed to provide, as far as is practicable, neutral treatment of life products compared with similar deposit and other investment and risk products. This should

minimise the opportunities for regulatory arbitrage between life company investment and deposit taking business.

Recommendation 39: Regulation of friendly societies should be transferred to the Commonwealth.

The future regulation of friendly societies should provide for:

- transfer of responsibility for registration and corporate governance to the CFSC;
- disclosure regulation under the *Corporations Law* and surveillance by the CFSC; and
- prudential regulation by the APRC of those societies that provide products under exemption from the *Life Insurance Act 1995*.

The recommendation to move to Commonwealth arrangements for the prudential regulation of friendly societies should not delay introduction of the new friendly societies scheme on 1 July 1997.

Recommendation 40: The APRC should regulate general insurers.

The APRC should be responsible for the prudential regulation of general insurers on a similar basis to that applied currently by the ISC.

Recommendation 41: The APRC should regulate superannuation in accordance with retirement objectives.

Regulation to ensure the compliance of superannuation funds, other than excluded funds, with retirement income requirements should be undertaken by the APRC in conjunction with prudential regulation. Disclosure regulation should be undertaken by the CFSC.

Recommendation 42: Compliance by excluded funds should be monitored by the Australian Taxation Office.

Excluded funds should not be subject to prudential regulation by the APRC. Regulation of compliance with the other requirements of the *Superannuation Industry (Supervision) Act 1993* should be transferred to the Australian Taxation Office. Measures to improve prudent behaviour should include:

- increasing responsibilities on trustees and auditors to ensure compliance by excluded funds with retirement income laws; and
- requiring all members of excluded funds to be trustees.

Recommendation 43: Other APRC regulated institutions should have the right to offer retirement savings accounts.

The right to offer retirement savings accounts (RSAs) should be extended to any institution able to offer capital backed deposit or investment products subject to prudential regulation by the APRC. Disclosure regulation of RSAs should be transferred to the CFSC.

Recommendation 44: The APRC should promote more transparent disclosure.

To promote further transparency for markets in assessing the risks posed by financial institutions' activities, prudentially regulated institutions should meet CFSC standards of public disclosure. The APRC should promote further disclosure of indicators of the risk assumed by the entities which it regulates.

Recommendation 45: The principle of spread of ownership should be retained and regulation rationalised.

The general principle of a wide spread of ownership of regulated financial entities (or holding companies where part of a conglomerate) should be retained. Existing legislation and rules should be streamlined through the introduction of a single Acquisitions Act with a common 15 per cent shareholding limit. Exemptions may be granted as follows.

- The APRC should have power to approve, subject to prudential requirements, an exemption allowing a licence holder to acquire more than 15 per cent of a licensed institution.
- Any other person may acquire more than 15 per cent of a licensed institution only if the Treasurer approves the acquisition in the national interest.

Recommendation 46: The approach to sectoral separation needs to be more flexible.

The general principle of separation of regulated financial activities from other activities should be retained, but applied with greater flexibility than at present, having regard for:

- the congruity of non-regulated activities with provision of financial services;
- relevant experience in the intended regulated financial activity; and
- whether prudential regulations will be met on a continuing basis, including any additional requirements deemed necessary.

Recommendation 47: Mutual entities should be permitted to hold all classes of licences.

Mutual ownership of all types of licence and authority holders should be accommodated, provided they can satisfy essential tests of probity and financial standing and ongoing compliance with capital requirements.

Recommendation 48: New entrants should be subject to minimum capital and other requirements.

In general, the existing entry capital requirements should be retained. However, the APRC should take a flexible and facilitative approach to allowing new DTI licences where the entities meet other prudential requirements and are assisted by industry support organisations.

Recommendation 49: Non-operating holding companies should be permitted subject to certain requirements.

Subject to a financial conglomerate meeting prudential requirements, the APRC should permit adoption of a non-operating holding company structure. The structure must satisfy the APRC in the areas of capital, management, adequacy of firewalls, reporting of intra-group activities and independent board representation on subsidiary entities.

Recommendation 50: Multiple licences and other financial activities may be permitted.

A conglomerate should not be prohibited from obtaining a number of classes of licences or conducting non-regulated financial activities. More than one licence of each class should be permitted, provided the APRC is satisfied that arrangements do not compromise prudential standards and that deposit holders and other investors are treated equitably.

Recommendation 51: The APRC should be empowered to access operations of other non-regulated entities in the group.

The APRC should have clear powers to verify intra-group exposures and otherwise be satisfied as to the adequacy of separation of the regulated financial entity from other financial operations within the group, including any holding companies and affiliates such as merchant banks and finance companies.

Recommendation 52: Fundraising by money market corporations should be subject to CFSC surveillance.

The fundraising and market conduct activities of money market corporations (merchant banks) should be subject to the *Corporations Law* and CFSC surveillance. Money market corporations should not be permitted to accept retail deposits.

The RBA should continue to register money market corporations under the *Financial Corporations Act 1974* for the purpose of collecting statistics for money and credit aggregates. Current exemptions from the *Banking Act 1959* under s. 11 in respect of banking business and s. 66 in respect of the use of the term ‘bank’ should be applied by the APRC.

Money market corporations, like other entities, should be able to hold ESAs and participate directly in high-value settlement arrangements, provided they conduct significant settlements on behalf of third parties, and meet appropriate prudential (eg liquidity, collateral, capital) and operational requirements.

Recommendation 53: Fundraising by finance companies should be subject to CFSC surveillance.

The fundraising and market conduct activities of finance companies should be subject to the *Corporations Law* and CFSC surveillance.

The RBA should continue to register finance companies under the *Financial Corporations Act 1974* for the purpose of collecting statistics on money and credit aggregates.

Recommendation 54: There should be appropriate mechanisms for resolving failure of DTIs.

The depositor preference mechanism that applies to banks should, subject to appropriate transitional arrangements, be extended to all regulated DTIs, and associated resolution arrangements transferred to the APRC and clarified by legislative amendment.

The DTI sector should consider continuing the contingency funds now operated for credit unions either by amalgamation to form a nationally based fund or by establishment of industry based funds to assist the APRC in merger or rehabilitation of member DTIs. Membership should be voluntary and extended to other entities wishing to join. Participation in the scheme should be taken into account by the APRC in determining the nature and intensity of prudential regulation applying to these institutions.

To facilitate depositor protection, restrictions on the classes of debt and equity that may be issued by DTIs, particularly by mutual institutions, should, as far as possible, be removed.

Recommendation 55: There should be appropriate mechanisms for resolving failure of insurance and superannuation.

The APRC should be empowered to replace management control (or, for superannuation funds, trustees) of regulated financial entities in the event of their failure, or in the event that the regulator reasonably forms a view that failure is likely to occur in the absence of such intervention.

Existing policy holder preferences applied to statutory funds of life companies should be retained and extended to benefit funds of friendly societies.

Where losses as a result of serious fraud are incurred by beneficiaries of superannuation funds (other than excluded funds), the Treasurer should have powers, on the advice of the APRC, to levy superannuation funds and other superannuation providers at a rate not exceeding 0.05 per cent of assets where such restitution is considered to be in the national interest. Restitution should be limited to 80 per cent of the original entitlement of beneficiaries as determined by the APRC. Consideration should be given to establishing a similar scheme for other retirement income products such as annuities.

Stability and Payments

Recommendation 56: The RBA should remain responsible for system stability.

The central bank is best placed to ensure the stability of the financial system and to manage systemic risks. The RBA should retain overall responsibility for the stability of the financial system, in consultation as necessary with the Treasurer and other financial sector regulatory authorities.

Recommendation 57: The CFSC should be responsible for regulation of financial exchanges.

The CFSC should be responsible for regulation of financial exchanges and keep the adequacy of exchanges' risk controls under review.

Financial exchanges should be included among those institutions and regulatory agencies for which there should be legislative change to remove any impediments to voluntary information sharing.

Recommendation 58: Regulatory agencies should monitor wholesale markets.

The regulatory agencies should monitor the evolution of wholesale markets for the emergence of large institutions not subject to regulation domestically or overseas by a prudential regulator. In case of an identified need, the APRC should recommend an increase in its regulatory coverage.

Recommendation 59: The RBA should promote control of domestic and international settlement risks.

The RBA should give high priority to promoting cost-effective control of domestic and international settlement risks, including by benchmarking exercises to improve systems within institutions involved in wholesale international payments, encouraging payments netting arrangements, shortening settlement times for clearing systems and extending settlement hours to allow coordinated delivery versus payment and payment versus payment arrangements.

The legislative program should expedite preparation and consideration of:

- legislative amendments for information sharing between domestic and relevant overseas regulatory agencies;
- netting legislation to cover failure to settle by participants in the payments system; and
- legislation to give legal certainty to bilateral netting of financial transactions as proposed by the Companies and Securities Advisory Committee Netting Sub-Committee — these amendments are to put beyond doubt the legal enforceability of netting contracts under the *Banking Act 1959*, the *Life Insurance Act 1995* and other legislation in the event of insolvency, liquidation, bankruptcy, receivership and voluntary administration.

Recommendation 60: Liquidity management responses should remain the responsibility of the RBA.

Instability in financial and/or asset markets may be a source of risk to the financial system and its participants. The policy responses to such developments will vary with the particular circumstances and are not amenable to pre-emptive actions. Responses may include provision of liquidity to markets generally or to particular sectors. These should remain the responsibility of the RBA (in consultation with the Treasurer), in its roles as both monetary authority and authority responsible for managing systemic risk.

Recommendation 61: A Payments System Board should be formed within the RBA.

The payments system should be regulated by the RBA under a Payments System Board (PSB). The PSB should have responsibility for implementing policies to improve payments system efficiency, including the adoption of the most efficient technology platforms, and enhancing the competitive framework, consistent with overall systemic stability. The PSB should also have general oversight of the clearing streams.

Recommendation 62: Membership of the PSB should reflect payments system efficiency objectives.

The PSB should be chaired by the Governor of the RBA and should also include one deputy governor of the RBA. Other members should be appointed by the Treasurer and drawn from payments system users and industry representatives who are knowledgeable and experienced in the operations of the payments system.

The PSB should make its decisions independently of the main RBA Board, which would concentrate on monetary policy and financial stability. In the event of a conflict between the main RBA Board and the PSB, the Governor should be given statutory authority to implement the decision of the main RBA Board.

Recommendation 63: The PSB should set performance benchmarks.

The PSB, in consultation with market participants and payments clearing houses, should establish targets for the implementation of efficiency benchmarks for each part of the payments system and report annually against these benchmarks and other aspects of payments system costs.

The PSB should also ensure that new technologies are implemented to advance the efficiency and soundness of the financial system. The PSB should have the necessary resources, focus and powers to influence, or if necessary mandate, standards.

Recommendation 64: The RBA's commercial activities should be clearly separated from regulatory responsibilities.

RBA ownership and operation of the real-time gross settlement (RTGS) system is justified on public benefit grounds. As a general principle, other commercial activities are inconsistent with its regulatory responsibilities. Where any special considerations warrant RBA participation in such activities, these should be clearly separated from regulatory responsibilities and subject to transparent reporting arrangements.

Recommendation 65: The Australian Payments System Council should be disbanded.

The Australian Payments System Council (APSC) should be disbanded, with its functions in relation to the payments system assumed by the PSB. The consumer protection responsibilities of the APSC should be transferred to the CFSC.

Recommendation 66: Rights to issue cheques should be extended.

The foreshadowed amendments to the *Cheques and Payment Orders Act 1986* should be enacted to allow building societies, credit unions and their SSPs to issue cheques in their own name. Issuers of cheques should meet objective performance benchmarks. Other financial institutions should be allowed to

issue cheques in agency arrangements with DTIs or their SSPs, subject to the approval of the APRC.

Recommendation 67: Interchange arrangements should be reviewed by the PSB and the ACCC.

The PSB should consider whether interchange pricing arrangements are appropriate for credit and debit cards. A review of arrangements by the ACCC is warranted where such arrangements are priced contrary to efficiency principles.

Recommendation 68: The ACCC should maintain a watching brief over the rules of international credit card associations.

Given the likely importance of the credit card companies in the emerging smart card business, the ACCC should maintain a watching brief over the membership arrangements and rules of the international credit card associations.

Recommendation 69: Access to clearing systems should be liberalised.

Access to clearing systems should be widened to include all institutions fulfilling objective criteria set by the regulator, the PSB.

Disputes over technical standards in clearing should be referred to the PSB for final arbitration and determination.

Recommendation 70: The APCA should continue its role in clearing arrangements with wider membership.

The Australian Payments Clearing Association (APCA) should continue to be the core regulatory body responsible for the operational and technical efficiency of the various clearing streams. However, membership of APCA should be open to any organisation approved as a payment service provider

by the PSB. The existing authorisations from the ACCC for APCA's memorandum and articles of association and the rules relating to the paper and bulk electronic clearing streams may require reassessment.

Recommendation 71: The Trade Practices Act should continue to apply to payments clearing arrangements.

Payments clearing arrangements should remain subject to the provisions of the *Trade Practices Act 1974*. The rules of any industry organisation operating a clearing system should be made subject to approval by the ACCC. If any part of the industry were to develop a monopoly in processing financial transactions, the question of third-party access to the electronic network should be considered under the access provisions of the *Trade Practices Act 1974*.

Recommendation 72: Stores of value for payment instruments should be subject to regulation.

Holders of the store of value for traveller's cheques, stored value or other smart cards, electronic cash and other payment instruments which are intended as a means of making payments to a wide range of merchants or other persons should be subject to regulation to ensure the safety and integrity of the payments system.

- For licensed DTIs and life companies, adequate regulation generally would be provided by the APRC.
- If the store of value is not held by such licensed institutions, holders should be required to hold collateral against unsettled claims or meet such other requirements as may be determined by the PSB, taking into account regulatory arrangements offshore and the issuer's ownership and capital or other backing. The PSB should facilitate the interoperability of open systems.

Where payment instruments operate only in closed systems for the purposes of a single merchant or small group of merchants, safety regulation is not required as such systems pose little systemic risk and can be adequately regulated under existing *Corporations Law* and consumer protection

legislation. However, an industry code of conduct, overseen by the CFSC, should be developed for these systems.

Recommendation 73: Access to ESAs should be liberalised subject to appropriate conditions.

The RBA should continue to determine the right to hold an ESA on the basis of clear and open guidelines determined by the PSB. There should be no presumption that banks and SSPs would be the only holders of settlement accounts.

Recommendation 74: High-value payments settlement providers should be regulated to the international standard for banks.

When the RTGS system becomes operational, application for high-value settlement facilities at the RBA should be limited to financial institutions with an appropriate business case and extensive settlement business for high-value transactions on behalf of non-associated third parties.

Given the importance of high-value payments systems to the efficiency and stability of the financial system, participants offering settlement services in the high-value payments system should be prudentially regulated to the intensity of the international standard for banks.

Successful applicants should be subject to appropriate prudential (eg capital, liquidity, collateral, separation) and operational requirements to ensure the stability and integrity of the high-value payments system.

Recommendation 75: Non-deposit takers should be able to settle directly consumer electronic and bulk electronic payments.

To be eligible for an ESA, non-deposit taking participants in the consumer electronic and bulk electronic systems should demonstrate that extensive business is undertaken on behalf of non-associated third parties. They should also meet appropriate prudential (eg capital, liquidity, collateral, separation) and operational requirements.

Recommendation 76: RTGS system benchmarks should be established.

The introduction of the RTGS system will decrease settlement and systemic risk if all high-value payments are required to be settled on a real time basis. For these reasons, all large financial cross-institutional payments should be settled with RTGS as soon as possible. In addition, a cost-benefit analysis should be undertaken for introducing to other payments, such as the bulk electronic and consumer electronic systems, some form of real-time settlement system.

Recommendation 77: The PSB should issue payments system approvals.

The PSB should provide and regulate two types of approval in the payments system. For payments clearing and final settlement, a clearing and settlement approval would be provided to all DTIs with a banking authorisation and would be available to other institutions or entities subject to their meeting appropriate prudential guidelines. A clearing approval would be available to other institutions involved in the clearing of payments instruments but not involved in final payments settlement.

Disputes over technical standards in clearing should be referred to the PSB for arbitration and determination.

Recommendation 78: The PSB and the APRC should establish close coordination arrangements.

Where entry requirements of the PSB specify that payments providers should meet prudential standards, the requirement should be administered by the APRC although consideration could also be given to collateral arrangements with the RBA in appropriate circumstances. The consultative arrangements to be developed between the RBA and the APRC should provide an appropriate forum to address a number of operational issues, including reporting arrangements between the RBA and APRC.

Mergers and Acquisitions

Recommendation 79: Section 50 of the Trade Practices Act should continue to apply to the financial system.

Section 50 of the *Trade Practices Act 1974* should continue to apply to the financial system as to other sectors — so that a merger in the financial system is prohibited where, in a substantial market, a substantial lessening of competition would be likely to result.

Recommendation 80: The ACCC should administer competition laws for the financial system.

The ACCC should continue to administer the competition laws for the financial system as for other sectors.

Recommendation 81: The prudential regulator should assess the prudential implications of relevant mergers and acquisitions.

The prudential aspects of mergers between licensed financial institutions should be determined by the prudential regulator through its regulation of the merging and merged entities. In general, prudential considerations would be unlikely to prevent mergers but regulatory, capital or other requirements might influence the methods used for giving effect to them.

Recommendation 82: The Trade Practices Act should provide the only competition regulation of financial system mergers.

Banking and insurance laws should be amended to clarify that the only competition assessment of a merger should be under the *Trade Practices Act 1974*.

In the meantime, the Government should publicly adopt a policy of accepting the competition assessment of bank and insurance company

mergers made by the ACCC (or the Australian Competition Tribunal or Courts), as applicable, under the *Trade Practices Act 1974*.

Recommendation 83: The ‘six pillars’ policy should be removed.

Mergers should be subject to assessment under the *Trade Practices Act 1974* and under banking and insurance laws, but the ‘six pillars’ policy — which separately imposes a government prohibition on mergers among the largest four banks and the largest life companies — should be removed.

Recommendation 84: Merger assessments should take account of changes occurring in the sector.

In the administration and interpretation of the merger provisions in the *Trade Practices Act 1974*, regard should be had to the substantial and rapid changes which are now occurring in the financial system, including those reported by this Inquiry, which are affecting the appropriate definition of markets and in general introducing new sources of competition.

Recommendation 85: General foreign investment policy should apply to the financial system.

The policy position prohibiting the foreign takeover of any of the four major banks should be explicitly removed and replaced with a policy which provides that all foreign acquisitions in the financial system will be assessed under the general provisions of foreign investment policy under the *Foreign Acquisitions and Takeovers Act 1975*.

The Inquiry believes that a large scale transfer of ownership of the financial system to foreign hands should be considered contrary to the national interest. However, this does not preclude some increase in foreign ownership of aspects of the Australian financial system, including its major participants.

Promoting Increased Efficiency

Recommendation 86: Foreign investment regulations for the funds management industry should be reviewed.

Foreign investment regulations requiring approval for investments made by foreign owned or controlled managers of the funds of life companies and other collective investments should be reviewed and, if possible, removed where the principal investors in these funds are Australian.

Recommendation 87: Takeover and merger provisions are needed for collective investments.

The *Corporations Law* should be amended to provide:

- the application of takeover provisions modelled on Chapter 6 of the *Corporations Law* for public unit trusts; and
- streamlined merger and reconstruction provisions for collective investment schemes.

The Australian Stock Exchange should amend Listing Rule 15.14 to permit the exercise of sanctions in trust deeds reasonably designed to provide unit holders with the protection embodied in Chapter 6 of the *Corporations Law*.

Recommendation 88: Superannuation fund members should have greater choice of fund.

Employees should be provided with choice of fund, subject to any constraints necessary to address concerns about administrative costs and fund liquidity. Where superannuation benefits vest in a member, that member should have the right to transfer the amounts to any complying fund. Where a member chooses to exercise that right, payments should be transferred to the chosen fund as soon as practicable, subject to controls necessary to maintain orderly management for the benefit of all fund members.

Transfer costs, including those incurred as a result of regulatory requirements, should be transparent and reasonable.

Recommendation 89: Regulation of collective investments and public offer superannuation should be harmonised.

The regulatory framework for public offer collective investments and superannuation should be harmonised to the greatest possible extent by:

- making both types of products subject to a single consumer protection regime (including disclosure rules) administered by the CFSC; and
- bringing the structure of collective investments into line with that for superannuation funds, by introducing a requirement for a single responsible entity.

Recommendation 90: Regulation of trustee companies should be modernised and applied on a uniform national basis.

The States and Territories should give urgent priority to establishing a modern, uniform, national regime for trustee companies.

The corporate trustee and fundraising business of trustee companies should continue to be regulated under the *Corporations Law* and *Superannuation Industry (Supervision) Act 1993* regimes.

Recommendation 91: Legislation should be amended to allow for electronic commerce.

Regulation should not differ between different technologies or delivery mechanisms such as to favour one technology over another. A large number of legislative amendments will be required to implement this recommendation. In addition, further amendments will be required to facilitate electronic commerce. These should include:

- adoption and enactment of the recommendations of the Companies and Securities Advisory Committee Netting Sub-Committee;

- review and amendment of Commonwealth, State and Territory legislation to permit digital signatures in appropriate circumstances—such legislation includes the *Uniform Consumer Credit Code*, the *Privacy Act 1988*, and the *Financial Transaction Reports Act 1988*;
- amendments to legislation and industry codes of conduct to allow electronic provision of notices and documents to improve the efficiency of financial transactions and reduce costs;
- endorsement by industry and government of the Public Key Authentication Framework developed by Standards Australia to enable a reliable system for digital recognition of individuals and entities to be developed—interim standards should be in place by the end of 1998; and
- amendments to legislation, such as Evidence Acts, by the end of 1998 to take account of electronic transactions and record keeping—a short-term objective should be the enactment of national uniform legislation covering evidentiary issues for the electronic delivery of financial services.

Recommendation 92: Australia should adopt international standards for electronic commerce.

Australia should adopt appropriate internationally recognised standards for electronic commerce, including for electronic transactions over the Internet and the recognition of electronic signatures.

Recommendation 93: International harmonisation of law enforcement and consumer protection should be pursued.

To assist in international law enforcement and consumer protection, Australian regulatory authorities should maintain close relationships with counterparts in other jurisdictions. As far as possible, Australian law should be consistent with laws in major centres of electronic commerce.

Recommendation 94: Regulators should coordinate on technology.

Financial regulatory agencies should keep abreast of technological developments as they affect the financial system and liaise with each other as well as government departments and other agencies.

The PSB, CFSC, APRC and Council of Financial Regulators (CFR) should be proactive in assessing the impact of technological developments on the efficiency, safety and equity of the financial system and should seek the views of industry.

Recommendation 95: Institutions should have freedom to set fees and charges based on costs.

Banks and other financial institutions should be free to set fees and charges for retail financial and transaction services based generally on the cost of provision of those services, without government intervention or suasion.

Recommendation 96: Governments should examine alternative means of providing low-cost transaction services.

Governments should expedite the examination of alternative means of providing low-cost transaction services for remote areas and for recipients of social security and other transfer payments.

Recommendation 97: Superannuation funds should not be required to invest in small and medium sized enterprises.

Superannuation funds should not be required to invest in a particular asset class, including small and medium sized enterprises (SMEs). Superannuation investment decisions should continue to be a matter for the trustees of the fund concerned, subject to the requirements of the *Superannuation Industry (Supervision) Act 1993* that they invest prudently in a properly diversified portfolio.

Recommendation 98: Data collection on SMEs should consider the needs of rating agencies and fund managers.

The CFSC and Australian Bureau of Statistics should take into account the specific requirements of credit rating agencies and fund managers when reviewing SME data collection.

Recommendation 99: A working party on positive credit reporting should be established.

The Attorney-General should establish a working party, comprising representatives of consumer groups, privacy advocates, the financial services industry and credit reference associations to review the existing credit provisions of the *Privacy Act 1988*. The purpose of this review should be to identify specific restrictions which prevent the adoption of world best practice techniques for credit assessment, and evaluate the economic loss associated with these restrictions against the extent to which privacy is impaired by their removal.

Recommendation 100: Information sharing among group entities should be allowed unless the customer withdraws consent.

Extension of the privacy regime and future codes of conduct should specifically allow the sharing of information among entities within a group unless the customer has taken some action to indicate refusal of consent. The opportunity to exercise a right of refusal must be easily and readily available to consumers.

Recommendation 101: The extension of the privacy regime should follow a number of principles.

The approach to privacy regulation which emerges from the current consultative process should:

- strike an appropriate balance between consumer protection, consumer choice and the effective and efficient delivery of financial services to consumers;

- be carried out in a way which enables it to adapt to the changes accruing in the market, including convergence in financial service providers and products
 - this suggests that any laws or codes of practice should apply to the function of financial service provision rather than to financial institutions;
- be administered for the financial system by the Privacy Commissioner on a national basis;
- avoid or eliminate any duplication of coverage between existing privacy protection, including credit reporting provisions of the *Privacy Act 1988* and financial sector codes of conduct, and the proposed privacy codes; and
- ensure appropriate transitional arrangements are introduced for information which was obtained prior to the introduction of the proposed privacy regime.

Recommendation 102: The Housing Loans Insurance Corporation should be privatised.

To ensure that the mortgage insurance market operates on competitively neutral terms, the Housing Loans Insurance Corporation should have its government guarantee withdrawn and be privatised, notwithstanding any increase in insurance premiums that may ensue due to the loss of privileged status.

Coordination and Accountability

Recommendation 103: Regulatory agencies should have operational autonomy.

The regulatory agencies should be established under legislation with substantial operational autonomy.

The APRC and CFSC should establish their own staffing and remuneration structures in whatever form will be most conducive to their effectiveness and efficiency.

The APRC and CFSC should locate their headquarters in the main financial capitals, rather than Canberra. Inspection staff should be located in the cities where the financial industry operates.

Recommendation 104: Regulatory agencies' charges should reflect their costs.

The regulatory agencies should collect from the financial entities which they regulate enough revenue to fund themselves, but not more. As far as practicable, the regulatory agencies should charge each financial entity for direct services provided, and levy sectors of industry to meet the general costs of their regulation.

Recommendation 105: Interest on non-callable deposits should be reviewed.

The collection of revenue by the RBA through the restriction on interest payments on non-callable deposits creates distortions in financial markets and is not consistent with the principles for funding financial regulation. It should be reviewed by the Commonwealth before building societies and credit unions are made subject to a requirement for non-callable deposits.

Recommendation 106: Regulatory agencies should set their charges, subject to approval by the Treasurer.

Fees and charges imposed to recover costs of the financial regulatory agencies should be determined by the agencies, subject to approval by the Treasurer.

Recommendation 107: Regulatory agencies should be off-budget.

From the perspective of financial regulation, it is preferable that the APRC and CFSC operate off-budget.

If they are funded through the Commonwealth Government budget, they should have their funding levels determined by reference to policies for financial system regulation rather than to targets for the overall budgetary balance.

Recommendation 108: Regulatory agencies should have boards, with majorities of independent directors.

The regulatory agencies should have boards of directors responsible for their operational and administrative policies, the fulfilment of their respective legislative mandates and their performance.

The key principles in the composition of these new boards are that there should be majorities of independent members and substantial cross-representation.

The following board compositions are illustrative and not prescriptive.

- APRC — six independent members appointed on the nomination of the Treasurer, three ex officio members from the RBA including the Governor, a deputy governor and an ex officio member of the PSB, the chief executive of the CFSC, and the chief executive of the APRC (appointed to that office on the nomination of the Treasurer).
- CFSC — six independent members appointed on the nomination of the Treasurer as part-time Commissioners, three full-time Commissioners including the chief executive (appointed to those offices on the nomination of the Treasurer), the Governor or a deputy governor of the RBA, and the chief executive of the APRC.
- PSB — five independent members appointed on the nomination of the Treasurer, the Governor of the RBA and two other RBA officers nominated by the Governor, and an officer nominated by the chief executive of the APRC.

The chairpersons of the APRC and CFSC boards and the PSB should be appointed by the Treasurer from among the independent members.

Recommendation 109: Regulatory agencies should improve their reporting.

To ensure adequate accountability and to assist the application of efficient cost-recovery arrangements, each regulatory agency should develop internal accounting systems and reporting arrangements to identify its effectiveness and efficiency, both in aggregate and in respect of each major regulatory objective.

Each agency should report annually to Parliament and should seek continuous improvement in reporting quality. Reports should include the results of internal assessments of efficiency, compliance costs and cost effectiveness. Where possible, comparisons with international best practice should be provided.

Recommendation 110: A Financial Sector Advisory Council should be created.

A body should be established, named the Financial Sector Advisory Council (FSAC), with members appointed by the Treasurer and with the functions of advising the Treasurer on:

- progress of implementation of new regulatory arrangements, and their effects on the financial sector and the economy;
- new and potential developments in the financial system and their regulatory implications;
- the cost effectiveness and relevance of the regulatory framework for the financial system;
- the compliance costs occasioned by financial regulation; and
- the international competitiveness of Australia's financial sector and how Australia could become a preferred location for financial activities in the region.

Recommendation 111: Regulatory agencies need power to exchange information.

Legislation should authorise the exchange of confidential information among the financial regulatory agencies (RBA, APRC and CFSC).

Recommendation 112: The Council of Financial Regulators should coordinate a broad range of activities.

The Council of Financial Supervisors should be renamed as the Council of Financial Regulators (CFR) and reconfigured with the aims of facilitating the cooperation of its three members (the RBA, APRC and CFSC) across the full range of regulatory functions, and the attainment of regulatory objectives with the minimum of agency and compliance costs.

In addition to implementing these aims, the CFR should give early attention to:

- considering issues of systemic stability spanning their respective jurisdictions, such as the risk characteristics of clearing and settlement arrangements, the risk control systems of futures and options exchanges and other markets, and arrangements for handling situations posing systemic problems;
- monitoring the participation in Australian wholesale markets of large institutions not subject to prudential regulation domestically or overseas;
- harmonising government agencies' data requirements from reporting financial entities, beginning with those of the financial regulatory agencies and Australian Bureau of Statistics;
- liaising with law enforcement bodies about the implications of new financial technology or regulatory practice for enforcement of other laws; and
- examining issues of competitive neutrality in financial regulation which may be suggested from time to time by industry or advisory bodies.

Managing Change

Recommendation 113: A staged approach to change is required.

A staged approach should be adopted to implementing the recommendations of this Report, commencing with announcement of the Government's position in principle on the main recommendations, and followed by establishing the new regulatory agencies and investing them with existing regulatory functions.

Recommendation 114: A panel for uniform commercial laws should be established.

A Panel for Uniform Commercial Laws in Australia (PUCL) should be established, to pursue uniform Commonwealth, State and Territory commercial laws. Agreement should be reached at the Council of Australian Governments level on the establishment of the panel and its priorities and deadlines. The PUCL should complete its task by no later than the end of 1999.

Recommendation 115: Proposed sequence for implementing the recommendations.

Implementation of the recommendations of this Report, if accepted, should proceed in the following broad sequence:

- announcement of the Government's decisions on mergers policy and ownership of financial institutions;
- development and announcement of the Government's in-principle responses to the proposals for the regulatory framework;
- establishment of the FSAC;
- implementation of the changes to promote competition in the payments system and to improve disclosure and consumer protection regulation;

- negotiation and agreement with the States and Territories on the in-principle approach to be adopted to the proposed transfer of prudential and related responsibilities to the Commonwealth, the changes to the responsibilities of the ASC, and the establishment of the PUCL;
- establishment by legislation of the new regulatory agencies and their investment with existing regulatory functions, with parallel processes of internal consultation within existing regulatory agencies;
- development and enactment of legislative reforms, and the subsequent implementation of reform proposals by the regulatory agencies; and
- implementation of the outcome of proposed review processes, for example for the *Uniform Consumer Credit Code*.