



Investment and Financial Services Association

**strength** through advocacy

## IFSA – Towards Better Regulation

Policy on future regulation of  
Financial Services in Australia

**February 2006**

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## 1. INTRODUCTION

This document is the Headland Statement (2006 – 2008) for the IFSA Regulatory Affairs Board Committee. What is a Headland Statement? Very simply, it is a statement that:

- acknowledges our past – where we have come from;
- looks critically at where we are now; and
- looks forward - describing our mission, where we want to be and how we propose to get there.

The IFSA Regulatory Affairs Board Committee (**'Committee'**) has the broadest mandate of the 6 IFSA Policy Board Committees<sup>1</sup>. The Committee is responsible for developing IFSA's strategies and policies in relation to existing and proposed regulatory issues affecting the financial services industry<sup>2</sup>.

The primary aim of the Committee is to engage the Government and the regulators to better improve financial services regulation in Australia for the benefit of the investing public and assisting in the efficient operation of the financial services industry. Our primary method to achieve this is "effective communication".

As at 1 January 2006, IFSA members manage approximately \$920 billion worth of assets representing the growing investments and savings of over 9 million Australians. Our members are tasked with maximising the returns to customers, and are judged on their ability to deliver on those returns in a highly competitive market. Minimising costs and maximising returns for the benefit of customers' remains at the heart of what our members do.

Our concern, which is shared by Government, is that the increasing volume of rules and black letter law has come at a great financial cost to industry and our customers<sup>3</sup>. There needs to be a shift in regulatory design and process. IFSA recommends that a three pronged approach to regulation be pursued. This approach will involve:

- (a) greater reliance on the development of industry codes of practice and self enforcement;
- (b) the introduction of a formal consultative process for proposed regulatory changes and reform proposals; and
- (c) greater emphasis and reliance being placed on the analysis of costs and benefits of regulatory proposals.

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<sup>1</sup> Regulatory Affairs Board Committee, Economic Savings and Tax Board Committee, Marketing and Distribution Board Committee, Investments Board Committee, Life and Risk Management Board Committee, Infrastructure (Operations and Technology) Board Committee.

<sup>2</sup> The mandate and operations of each Board Committee are provided separately in IFSA Guidelines.

<sup>3</sup> See current tasks of Financial Sector Advisory Council (**FSAC**) – 1998 and the newly established Taskforce on Reducing the Regulatory Burden on Business – 2005

## 2. OUR PAST AND THE PRESENT

What we now call “Financial Services Regulation” in Australia has come a long way in the last 50 years. It is a story of innovation and changing regulation<sup>4</sup>.

Our existing regulatory structure has its genesis in the recommendations of the Financial System Inquiry<sup>5</sup> (FSI). It would be true to say that in 2006, we are still working towards the regulatory regime recommended by the FSI in March 1997.

The *Financial Services Reform Act 2001* (FSRA) replaced a piecemeal legal framework that had developed over time. From 11 March 2001, a harmonised regulatory regime for consumer protection and market integrity was introduced into the law. FSRA was broadly supported by our industry and was the culmination of more than four years' work with Government.

The policy aim of the FSRA reforms was to:

- deliver an effective and responsive regulatory regime that would deliver maximum benefits to industry, consumers and the economy as a whole;
- provide greater competitive neutrality across the financial services industry; and
- remove inefficiencies created by overlaps and gaps in fragmented regulation.

The stated policy aim of FSRA serves as a benchmark for the Regulatory Affairs Board Committee against which it can evaluate proposed changes to the law and practice.

## 3. INDUSTRY ISSUES

### 3.1 Current Issues

Our industry is both dynamic and evolving. Current significant legislative issues for the financial services industry include:

- continuing financial services reforms;
- product rationalisation as legacy and sub-scale financial products give rise to additional costs and risks;
- proposed anti-money laundering legislation; and
- adoption and application of International Financial Reporting Standards.

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<sup>4</sup> Fifty Years of Managed Funds in Australia, Preliminary Research Report by Bernard T Mees, Monica S Wehner, Pamela F Hanrahan, Centre for Corporate Law and Securities Regulation, University of Melbourne, September 2005

<sup>5</sup> The Treasurer announced on 30 May 1996 the establishment of an Inquiry into the Australian financial system, to report to him by 31 March 1997.

*The Inquiry is directed to provide a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. The Inquiry will make recommendations on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.*

Each of these items constitutes a separate topic for discussion and each is indicative of the type of major reform issue that has arisen in the past and will continue to arise in the future

It is important that the legislative and regulatory solutions do not result in over regulation imposing significant cost and technical burdens on industry. **Style** and the **cost of regulation** are a fundamental consideration in being able to achieve focussed and efficient regulatory measures.

### 3.2 Style of Regulation

FSI was clearly in favour of a principle based regulatory regime or, at least, a regime which comprised a large proportion of high level principle based regulation. Recent legislation, in particular the FSRA has evolved away from the principles based approach envisaged by the FSI, towards a far more rules based model. Notwithstanding ongoing references by regulators and Government to FSRA as 'principle based', industry's view is that FSRA has finished up as rules based regulation.

The reason for the trend towards rules based regulation may have simply been that industry was not prepared to accept the responsibility that went with a principle based approach, although it is more likely that it was simply a style that has developed within Government drafters and regulators. Whatever the causes of the trend, the result is both costly and inefficient for industry and has not provided commensurate benefits to the investing community. Contrary to its objective, the rules based approach to regulation creates uncertainty in market participants encouraging them to become risk averse at the expense of their customers. Market participants under a rules based regime will continuously seek external reassurance and 'guidance' before acting.

The rules based approach is problematic in a world where products and services continue to be largely technology driven. Such an approach can be a dead hand on technology and product innovation. In the highly competitive domestic and global of financial services environment, regulation must be flexible enough to meet constant changes.

If Australia is to continue to reap the benefits of innovation it must have a regulatory regime that is supportive. An Australian principle based regulatory regime will be able to more readily adapt to changes in delivery of products and services through technological advances than will prescriptive rules based regulation.

### 3.3 Cost of Regulation

The cost of regulation is an issue which indirectly affects our customers. While product and service providers have and will continue to absorb some costs, the reality is that a significant portion will be passed onto customers. Unnecessary costs erode future savings. FSI considered that Australia's regulatory costs in 1997 were high, with only the US having higher compliance costs. The report estimated total compliance costs in Australia as exceeding \$720 million, equivalent to 7.6 basis points of assets.

Since 1997 there have been a series of major legislative reforms commencing with the *Managed Investments Act 1998* through to the *Financial Services Reform Act 2001*<sup>6</sup> and finishing with the *Superannuation Safety*<sup>7</sup>, *Superannuation Choice*<sup>8</sup> and *CLERP 9*<sup>9</sup> Acts. Each

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<sup>6</sup> The Financial Services Education Agency Australia (FSEAA) reported by Media Release dated 13 December 2005 that just to get a complaint under FSR has cost Australia's licensed Financial Services providers more than \$224 million. The survey was undertaken by Victoria University, funded by the Taxpayers Research Foundation Ltd, and supported by FSEAA.

<sup>7</sup> Superannuation Legislation Amendment (Superannuation Safety and Other Measures) Act 2005

<sup>8</sup> Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004

<sup>9</sup> Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004

Act had a major impact on industry structures and involved a significant additional compliance element.

The IFSA Key Industry Statistics Surveys for the last 5 years have shown that there have been significant increases in the costs to industry in the areas of information technology, regulatory compliance and customer service. The current cost for IFSA member companies to comply with the financial service industry regulation is about 10 to 15% of total operational costs.

Given that even minor regulatory changes will now generally involve some changes to the technology and operational systems underpinning the delivery of products and services, the compliance costs of relatively small regulatory changes may be quite high. The Committee, on behalf of the industry, must seek to ensure that the costs of change do not exceed the perceived benefits.

#### **4. EFFECTIVE CONSULTATION**

To address the regulatory trend for more rules and black letter law there needs to be a shift in regulatory design and more effective consultative processes.

The three pronged approach recommended by IFSA will involve:

- (a) greater reliance on the development of industry codes of practice and self enforcement;
- (b) the introduction of a formal consultative process for proposed regulatory changes and reform proposals; and
- (c) greater emphasis and reliance on the analysis of costs and benefits of regulatory proposals.

##### **4.1 Codes of Practice**

Since 1999, IFSA has had in place an *Industry Code of Ethics and Conduct* supported by a number of industry standards and guidelines that are designed to assist members achieve industry best practice, and to enhance consumer confidence<sup>10</sup>.

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<sup>10</sup> The current IFSA Standards are:

- No1: Code of Ethics and Conduct
- No2: Equity Trusts
- No4: Ongoing Fee Measurement
- No5: Operational Capability
- No6: Fund Performance, calculation of returns
- No7: Use of IFSA logo
- No8: Scheme Pricing
- No9: Valuation of Scheme assets & liabilities
- No10: Promotional Statements
- No11: Genetic Testing Policy
- No12: ASIC fee template
- No13: Proxy Voting
- No14: Alternative forms of remuneration
- No15: Rebates & related payments

Rigorous industry codes and standards are, in IFSA's view, an important component of the overall regime applying to industry regulation. Reliance on codes and standards can build public trust and consumer confidence in the industry as well as exerting moral and business pressures on those sections of the industry that may otherwise be tempted to behave in an unprofessional way. IFSA has shown that it is able to alter member behaviour through standards and guidance notes<sup>11</sup>.

The requirement for all IFSA members to conform to rigorous industry standards will support the use of principle based legislation by Government, and will promote market confidence and adherence to the principles of the legislation.

#### 4.2 Formal Consultative Process

It is IFSA's view that future regulatory changes must be considered in the context of their capacity to deliver actual positive benefits to consumers. Reactive regulatory responses are only justified where there is a market failure, or a reasonable possibility of market failure and intervention can be shown to be the only effective way of remedying or preventing such market failure.

Good quality analysis should be a feature of policy development and decisions at all points of the process. As such, this requires input from all affected stakeholders so that a considered approach to the issue becomes a vital ingredient to any new regulation.

Currently, the consultative arrangements with industry employed both by Government and the regulators operate in an 'ad hoc' fashion and lack any structure or arrangements for accountability. Our industry's discussions and lobbying efforts are not as effective as they could be simply because they can be dissipated amongst the various interested parties – other industry groups, regulators, Government officials, and members of Parliament. As with any area of endeavour, improvements can always be made and, we believe, a better system for consultation can be built.

As indicated in the introduction to this Headland Statement, "effective communication" is IFSA's primary tool in seeking to achieve a regulatory system that is effective, efficient, accountable, responsive, and that provides confidence and comfort to our customers.

To improve consultative arrangements we think that the existing policy and legislative delivery mechanisms need to be fine tuned or supplemented. Therefore, in addition to our recommendations for principles based legislation, the greater use of self regulatory codes, and closer attention being given to the costs of regulation, it is our recommendation that the Government endorse a formal consultative structure involving a 'gatekeeper' for proposed regulatory changes. For the purposes of the discussion we refer to the 'gatekeeper' as the Financial Services Committee (**FSC**) which would include representatives from each stakeholder group<sup>12</sup>.

This, of course, raises a number of questions:

- Won't a formal consultative structure simply create a new bureaucracy for industry to deal with?
- Why not use one of the existing consultative committees established by Government?
- What does a formal consultative structure look like and how does it operate?

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<sup>11</sup> See IFSA Standard No.13 Proxy Voting and IFSA/FPA Standard on Soft Dollars

<sup>12</sup> Financial Services Industry, Government and Regulators.

### **A new bureaucracy – existing Committees**

Government has, from time to time, established various advisory committees drawn from business, consumer and professional groups, and industry associations to assist it in providing independent guidance on specific legislative proposals and reforms<sup>13</sup>.

It may be appropriate for the role of an existing committee to be expanded or evolve to provide the functions envisaged for the FSC, or to simply establish the FSC as a permanent feature of the process of regulatory reform<sup>14</sup>.

### **Formal consultative structure**

The FSC should be a permanent consultative feature of the legislative and regulatory reform process. However, the FSC should only be an advisory body commenting on reform proposals in much the same way as a Parliamentary Scrutiny of Bills Committee, but with member representatives of Financial Services Industry, Government officials and Regulators. It is noted that reform proposals can take the form of draft legislation, regulations, legislative instruments<sup>15</sup> and, in some instances, policy papers and guidance notes.

Formal consultative arrangements should apply only to matters and issues having a broad impact on industry operations. They would not apply to individual relief applications. The FSC will, therefore, effectively have a role in pre-vetting legislative instruments as part of a formal consultation arrangement. It would, of course, still be open to regulators to make legislative instruments without the endorsement of the FSC. However, where such instruments are made without FSC endorsement they would, it is hoped, attract added Parliamentary scrutiny and be subject to possible disallowance<sup>16</sup>.

The consultative steps outlined below recognise both the Government and the Regulators as prime movers amongst a number of stakeholders with an interest in a reform issue.

1. Regulatory reform issue brought to the attention of the FSC by the Regulator or by Department of Treasury, the Minister or the Parliamentary Secretary.
2. The Treasury or Regulator develops, for consideration and revision by the FSC, a draft of proposed:
  - legislation / regulations
  - standard
  - guideline
  - class order
  - policy paper
  - practice note

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<sup>13</sup> Business Regulation Advisory Group (**BRAG**) - 1998; Financial Sector Advisory Council (**FSAC**) - 1998; Taskforce on Reducing the Regulatory Burden on Business – 2005; AML Ministerial Advisory Group – 2003.

<sup>14</sup> A recent industry initiative was the establishment in 2004 of the Finance Industry Council of Australia Ltd. FICA represents Australian Bankers Association, Australian Finance Conference, Insurance Council of Australia, Australian Financial Markets Association and the Investment and Financial Services Association. It provides a common forum for its member associations to address issues affecting financial services in Australia and fostering a competitive, free and efficient market for those services. It also provides a focus for the discussion of international issues affecting providers of financial services in Australia.

<sup>15</sup> See Legislative Instruments Act 2003 (Cth)

<sup>16</sup> This would not effect Part 3 of the Legislative Instruments Act 2003 – Consultation before making legislative instruments – but would identify it as not having been subject to FSA review.

3. FSC decides priorities and delegates the reform issue to a sub-committee for regulatory development. Sub-committee members represent the views of their associations / affiliations in the development / comment.
4. FSC provides comment and any recommendations to the Regulator or Treasury.
5. Regulator or Treasury release proposal for public comment. Comment considered in the finalisation of the reform proposal.
6. FSC provides comment / endorsement of the final reform proposal.
7. Reform proposal passed / allowed / disallowed by the Parliament.

#### 4.3 Analysis of costs and benefits

Proposed regulatory reforms to be considered by Government require “a regulation impact statement (**RIS**) to be prepared for all proposed new or amending legislation which directly affects business or which has a significant indirect effect on business or restricts competition”<sup>17</sup>

While the RIS requirement has been in place since 1997<sup>18</sup>, as an industry, we would like to see greater rigour in relation to RIS and have the requirement extended to a broader range of reform proposals impacting the financial services industry.

#### 5. CONCLUSION

Good commercial practice is underpinned by good regulation. If the Australian financial services industry is to continue to grow, be innovative and internationally competitive, we must continue to strive for greater cooperation and more efficient regulation. This is not the responsibility of Government alone, but one that is shared by industry, regulators and Government.

A lot of effort, energy and resources have been used designing and implementing a regulatory regime that will assist the development of the financial services industry in Australia in the 21<sup>st</sup> century and, that will maximise the returns for all Australians. It is now time to fine-tune the legislative and regulatory regime that was put in place with the commencement of FSRA.

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<sup>17</sup> Legislation Handbook, Department of Prime Minister and Cabinet, Canberra, paragraph 2.9 – Impact of legislation on business.

<sup>18</sup> Statement by the Prime Minister, the Hon John Howard, MP, *More Time for Business*, 24 March 1997, AGPS Canberra pages 66 to 67.

## **6. RECOMMENDATIONS**

### **Recommendation 1 - Principle Based Legislation**

IFSA recommends that every effort should be made to ensure that the drafting of legislation should be principles based.

### **Recommendation 2 - Industry Self Regulation**

IFSA recommends that greater use and reliance be placed on Industry Codes of Practice as a regulatory tool. This should be done conjunction with principles based legislation.

### **Recommendation 3 – Formal consultative process**

IFSA recommends that a formal consultative process be established for proposed Government legislation and regulations, and for standards, class orders, guidelines, policy statements and practice notes issued by regulators that have broad application to the financial services industry.

### **Recommendation 4 – Financial Services Committee**

IFSA recommends that a Financial Services Committee be established on a permanent basis to consider draft regulatory reforms and provide to Parliament its comments and/or endorsement of regulatory proposals.

### **Recommendation 5 - Risk/Benefit Approach to Regulation**

IFSA recommends that any future regulation of the financial services industry adopt a more rigorous and broader risk/benefit based approach to the financial services regulation.