COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference: International financial market effects on government policy

WEDNESDAY, 22 MARCH 2000

SYDNEY

BY AUTHORITY OF THE HOUSE OF REPRESENTATIVES

INTERNET

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **http://www.aph.gov.au/hansard**

HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Wednesday, 22 March 2000

Members: Mr Hawker *(Chair)*, Mr Albanese, Ms Burke, Ms Gambaro, Mrs Hull, Mr Latham, Mr Pyne, Mr Somlyay, Dr Southcott and Mr Wilton

Members in attendance: Ms Gambaro, Mr Hawker and Mr Pyne

Terms of reference for the inquiry:

Matters referred for inquiry into and report on:

1. The implications of the globalisation of international financial markets for the conduct of fiscal and monetary policies in Australia, including medium-term and other strategies to cope with potential volatility in markets.
2. Information requirements for the stable and efficient operation of international financial markets, including the provision of information by governments and disclosure by market participants, especially by large market participants including highly leveraged institutions.
3. The relevance to these issues of recent developments in the international framework for financial regulation.

WITNESSES

Committee met at 9.45 a.m.

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration's inquiry into international financial markets. This is the third public hearing for this inquiry, which is examining the effects of the globalisation of international financial markets on Australia's monetary and fiscal policies and the strategies needed to deal with market volatility.

A major aspect of this is to examine the role of hedge funds in the Asian financial crisis and especially their role in the attack on the Australian dollar in 1998. Other important aspects of the inquiry are to review information requirements for the stable and efficient operation of international financial markets and to examine the relevance of recent developments in the international financial architecture to Australia's situation.

The witnesses we will hear today are important members of Australia's financial community and we have the Australian Securities and Investments Commission, the Association of Superannuation Funds of Australia, the Investment and Financial Services Association and economist Dr John Edwards. The committee anticipates hearing some very useful evidence today, so I will move on to the procedure of calling the witnesses.

[9.47 a.m.]

6

LARCOS, Mr Andrew, Government Relations Officer, Australian Securities and Investments Commission

RODGERS, Mr Malcolm James, Director, Regulatory Policy, Australian Securities and Investments Commission

WEBB, Ms Rose, Director, Office of International Relations, Australian Securities and Investments Commission

CHAIR—I welcome today representatives of the Australian Securities and Investments Commission, and I remind you that the evidence you give at the public hearing today is considered to be part of the proceedings of the parliament. Accordingly I would advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt. The committee has received your submission numbered 8 and it has been authorised for publication. Are there any corrections or amendments you would like to make to your submission?

Mr Rodgers—No, not at this stage.

CHAIR—Would you like to make an opening statement before I invite members to proceed with questions?

Mr Rodgers—Might I say two things. One is to remind the committee that ASIC's activities are of perhaps indirect relevance to the main focus of the committee's inquiry. While we are happy to assist, our focus in the financial services area as a financial services regulator is on consumer protection and market integrity issues. What we take market integrity to encompass is to ensure that markets are not subject to disruptive volatility, are transparent, have a reliable price formation process and are free of abuses such as market manipulation, insider trading and so on. I just highlight that at the beginning of this.

The other thing that I should say is really to update the submission. The submission refers to work being done within IOSCO, in particular a task force on highly leveraged institutions—hedge funds. The IOSCO language for hedge funds is 'highly leveraged institutions'. I advise the committee that that task force report has now been completed and IOSCO produced a report towards the end of 1999. We have, I think, pretty accurately described the focus of that work in the submission but I might just highlight some of the conclusions in the final report. We are, I think, able to table that report as well, in case the committee has not had it.

CHAIR—We have found another one.

Mr Rodgers—So you have it. If I can summarise very briefly the results of that: the task force report which has now been adopted and published by IOSCO comes to the conclusion, after much debate, I must say—of which I was a part—that the principal focus in securities regulators dealing with hedge funds should be on transparency and risk management practices rather than the direct regulation of hedge funds activity as such. Secondly, the report recom-

mends that risk management processes at the level of regulated firms that deal with hedge funds be strengthened. Thirdly, the report recommends that regulators examine how they might be active in encouraging firms that they regulate to adopt sound practices in their dealing with highly leveraged institutions.

7

Fourthly, there are recommendations for improved information flows about activity by highly leveraged institutions, information flows between regulated counterparties—that is, regulated firms such as securities firms—between regulators themselves, market authorities—which in IOSCO language again normally means exchanges or others who have self-regulatory roles in market supervision—and generally information flows to the public about the nature and extent of HLI activities. Finally, the report recommends that IOSCO give consideration to further joint work with other regulatory organisations globally and also with the industry participants.

I note for the committee's benefit that there is a meeting of the Financial Stability Forum, to take place in Singapore at the end of this week and, as you are probably aware, Australia will be represented by Mr Battellino from the Reserve Bank, who is a member of that task force.

CHAIR—Thank you for that. Maybe we could just start on that point that you have just raised. With these moves, I suppose it raises a couple of questions. The first one is: how widely will those recommendations be adopted, in your opinion? Secondly, how will they affect those who want to base their operations out of havens?

Mr Rodgers—Within the IOSCO community, which is a fairly broad community of securities regulators, it is probably fair to say that there will be varying levels of implementation of those principles. Certainly the members of the committee where this work was done in IOSCO, and IOSCO members generally, have an obligation as members of IOSCO to take appropriate steps for implementation. Part of the debate that took place within IOSCO—and, indeed, has taken place elsewhere in the regulatory community—is that some of these recommendations are more difficult in the implementation than they might appear on the surface.

The question of how, for example, a regulated firm might in effect, before it chooses to deal with a hedge fund, require it to supply a high level of information, and some of it bordering on proprietary information, is something that was heavily debated within IOSCO because, in a sense, a dealing between, for example, a securities firm and a hedge fund is a dealing between competitors. They are, after all, proposing in their dealings with one another to take opposite sides in the same transaction, so there is some practical difficulty, I think, that was recognised and is recognised in the IOSCO report in implementation at the individual firm level. Generally speaking, I think we can be reasonably confident that the regulators themselves will be doing what they can. and there are clearly limits to their jurisdiction because one of the features of hedge funds that again was debated fairly extensively in this context was that hedge fund activity in most jurisdictions is not directly regulated and, in many cases, it is offshore, which brings me to the second question.

That is part of a broader question about the offshore nature of the work. One of the comforts I think the committee can take here is that while a hedge fund might be based or might have its headquarters in an offshore jurisdiction, in effect a large amount of the business that that hedge

fund will undertake will be taken in regulated jurisdictions, and that gives perhaps more purchase than its presence in a convenient offshore centre might lead you to believe.

CHAIR—Overall, if you could rate the outcome of the report and what is likely to be implemented, what is the level of risk of hedge funds in the future causing wild gyrations in the value of currencies and things like that?

8

Mr Rodgers—Some of that is beyond our ambit in the sense that the focus within IOSCO has been on the extent to which there are any consumer protection issues and short-run impacts on markets that are regulated through financial services. That does not include currency markets in most jurisdictions, except indirectly through the regulation of futures markets that have currency as underlying. I do not think that ASIC would have a position on the extent to which implementation of the IOSCO principles will have a stabilising effect on international markets. The focus within the IOSCO work has been really on the position of securities and other regulated firms that deal with hedge funds.

That was an issue in the failure of long-term capital management in the US because some large American securities firms had positions with long-term capital management that were of some concern to the SEC and they indeed participated in the managing out of long-term capital management. But it is really not an issue for securities regulators. The currency stability question is not an issue for securities regulators, except to the extent that it impacts on regulated markets.

CHAIR—Just taking that last point, to come back to my question, where do you rate the risk?

Mr Rodgers—I think it will contribute but it will not necessarily be the major contributor to that. I think the work that is being done between securities regulators, banking supervisors and other financial regulatory authorities is far more likely to have an impact over time than the individual work of the individual sectors, and that is the direction that future work has moved towards through the Financial Stability Forum.

CHAIR—How confident can we be? The market will be free to operate but it will not be easy to manipulate.

Mr Rodgers—I will leave aside here the currency market. It is really not within ASIC's jurisdiction or, indeed, my area of expertise. Will it be possible for hedge funds to take major positions in Australian markets that are regulated by us that have short-run, extreme volatility effects on those markets? The answer to that is that there is limited capacity for that—not so much as a result of the direct work that has been done over the last 18 months. In the wake of the failure of Barings, particularly, the futures markets of the world and future regulators developed protocols for communication about large position holdings in the communication of information between market authorities, exchanges particularly, and regulators.

That work was picked up by IOSCO, which issued a report and recommendations, I think in 1997, which were designed to create a network between regulators, both domestically and inter-

nationally, and between exchanges domestically and internationally, to communicate on large positions held by individuals or individual interests like a hedge fund. Most of the dealing of hedge funds has actually not been in exchanged traded instruments regulated by us or our counterparts. It has been what is traditionally called over-the-counter arrangements. Under the present Corporations Law, of course, there is a very partial jurisdiction for us in that area.

To be part of what we regulate, it has to either fall within the current definition of security or definition of futures contract, and the definition of futures contract, while it potentially catches this activity, is only partial in its application because the futures legislation was really designed to regulate exchange based futures, not OTC derivatives markets. It does partially catch OTC derivatives markets but only partially, and it is very much a legally driven definition and it is not difficult to create transactions which are not caught as futures contracts in this country, at least under the present Corporations Law.

9

Mr PYNE—I have some very basic questions. One of the aspects of this inquiry is to look at Australia and how Australia weathered the Asian financial crisis. Could you perhaps, from ASIC's point of view, set out the reasons why you think Australia had the institutions in position and what those institutions were that made it almost impossible for Australia to suffer the same fate that, say, South Korea or Thailand suffered through the Asian financial crisis? I know we are going back in time now but one of the aspects of the inquiry is to have a look at what Australian structures were in place and how they could perhaps better operate at an international level for other countries.

Mr Rodgers—I would suggest three things. One is that we have well-established securities and futures markets that have a long history of both self-regulation and regulation under the Corporations Law, we have well-established markets, and well-established practices within those markets for the supervision of market activity.

Secondly, the communication between regulators domestically and internationally and between regulators and exchanges domestically and internationally works quite well. From my perspective, when we discussed with exchanges what impact there might be on local markets as a result of what was clearly a very turbulent situation within the region that had the potential to be a form of global turbulence, we found the exchanges quite quickly and effectively moved into the next level of management.

It was never crisis management, because there was not a crisis, but they were at the next level of concern. They were able and willing to communicate with us and their counterparts within the region, any information they had that might suggest that there was any sense of stability in the Australian markets. I think those arrangements worked fairly well. We have subsequently done further work, both within ASIC and between ASIC and the exchanges, on developing protocols for dealing with market break-outs of any kind, really.

Thirdly, on the regulatory framework, the legislative regime in Australia came out fairly well out of that exercise. It is robust. It deals with many of the things that were not in place in other jurisdictions and it showed itself to be a relatively calm, comprehensive and effective regulatory

framework, able to get to grips with the problems that are often associated with sudden market break-outs.

Mr PYNE—You are suggesting that there was a level of sophistication in Australia between the players in the actual markets themselves which recognised that if you go too far everybody suffers, which perhaps was not there in the markets in, say, Thailand, South Korea and other countries where they thought you could just push the envelope as far as it went and eventually nothing would ever happen. Is that because of a lack of experience in those markets of past catastrophes, do you think?

Mr Rodgers—I think it is a combination of all three, and these are interrelated issues—the sophistication of the participants, the robustness of the regulatory framework in which things take place and, in effect, the long and relatively deep experience of those with regulatory or supervisory responsibilities. I think it is a combination of all of those, rather than a single factor.

10

Mr PYNE—Has ASIC been approached by regulators from other countries about what we do here that they do not do there, and training or new frameworks and things?

Ms Webb—Yes, very much so. In the last couple of years we have increased our technical assistance to the region enormously, and I think that has really been a product of the Asian crisis and a realisation that in those countries they may have had on paper some of the regulatory structures we have but the actual practice of implementing them might not have been as good as could be desired. We have certainly been participating in various multilateral initiatives. APEC, for example, has a securities regulator training initiative that we have been helping with a lot. We have sent someone up to help train regulators from about 10 or 12 APEC jurisdictions on a couple of occasions. We have had lots of bilateral visits, both people coming here and people from ASIC going to various countries in the region, and we run a summer school and some other projects as well. Certainly we are noticing that the level of requests for assistance has increased since the crisis.

Mr PYNE—What countries have requested assistance?

Ms Webb—Thailand, Malaysia, and Indonesia; two Koreans spent five weeks with us last year —

Mr Rodgers—South Koreans.

Ms Webb—South Koreans, yes and Chinese and Vietnamese and people from just about every country in the region. This week we are running a corporate governance course and we have people from nine jurisdictions—27 in total—who are visiting Sydney at the moment. They have had talks from ASIC and the ASX, and this morning they are at IFSA. They are doing the rounds of people who are involved in corporate governance issues, because I think they are realising that that is an important thing for them; that they might have had a company structure in operation, but in fact the practices and the transparency and the level of disclosure were deficient and that in turn caused some of the impact of the crisis to be worse. When they looked behind what was apparently an operating market they found that many of their companies were

not disclosing information that investors really needed, and when the crisis came that is when problems were caused to investors.

A lot of those countries are concerned to try and promote confidence in the market again, so even the government and the regulators have a function in just getting the markets working again and restoring investor confidence, so they are interested in our investor education programs as well as our regulation.

Mr PYNE—What sorts of levels of people are you training in Australia?

Ms Webb—The ones that come out tend to usually be people from the operational areas. We get formal visits from chairmen of commissions and things like that, but the people who come for the long-term assignments usually tend to be reasonably high level in terms of experience—usually they have six or eight years in an operational area—but very much the people conducting the operations in their countries' commissions.

11

Mr PYNE—Is it your view that there is a realisation amongst those countries that they had not put in place the sorts of frameworks that were necessary out of their lack of experience in the area, and that they will not probably have that same problem again because they will have a weather eye towards the difficulties that can arise?

Ms Webb—A large number of them are members of IOSCO and have subscribed in theory to all the principles, and have started to have legislation and things like that put in place, but I think they realise that the actual practical knowledge you need to conduct effective regulation might have been a bit lacking. In the past the SEC in America has been where lots of countries have looked because of the SEC's long experience in dealing with those issues, but I think in recent years countries in the region are starting to look to Australia as being closer to them and perhaps more able to give them assistance. We are finding that where in the past they might have all gone on visits to the US to get experience in securities regulation, they are now starting to look to us a lot more.

Mr PYNE—So in fact the financial crisis has enhanced Australia's reputation dramatically in the Asian region in particular?

Ms Webb—Yes, that would be my instinct from the feedback we get, and certainly the desire for them to come here to learn about how to regulate.

CHAIR—Does it mean you are export earning as well?

Ms Webb—Well, it is actually an issue for us because it is not part of our core business to be providing technical assistance to the region. It obviously creates an issue for resources because the people who are best placed to give this technical expertise are also the people who are our best operators here. We do have an issue of how much of this assistance we can give, and that is why programs through APEC and AusAID are obviously very important to us. AusAID are supporting the corporate governance course that I mentioned earlier, so that is providing us with some help.

Mr PYNE—Which countries are represented on the IOSCO Task Force on Hedge Funds and other high leveraged institutions?

Ms Webb—That was the technical committee of IOSCO, which comprises 16 of the major market jurisdictions.

Mr PYNE—Is Australia represented on that?

Ms Webb—Australia is represented.

Mr PYNE—By ASIC?

Ms Webb—Yes. Hong Kong and Japan are the other two Asian countries on that task force. Then it is the North Americans and the Europeans who make up the rest.

Mr PYNE—Is there a danger of not including any of the countries that have experienced the sorts of difficulties that were experienced in terms of having them accept the outcomes of the task force?

12

Ms Webb—Malcolm might have something to say about this as well, but IOSCO has an emerging markets committee as well which represents the other jurisdictions, or most of them, that are not on the IOSCO Technical Committee, and they published—towards the end of 1998 or the beginning of 1999—a paper on turbulence and issues in the region as well, so they have been doing some work there. A representative of the Emerging Markets Committee was on the IOSCO Technical Committee Task Force from Malaysia. There was an attempt to involve them in the process as well, but certainly their focus is slightly different. I think there will be continuing discussions.

Mr Rodgers—There was a debate within the broad IOSCO community that did tend to split along Technical Committee and Emerging Markets group lines because, as we said in our introduction, the Technical Committee's conclusion was that there was not a case for systematic, direct regulation of hedge fund activity. That was a controversial issue at some stages in the IOSCO debate for the Emerging Markets Committee, particularly led by some of our regional neighbours who felt that their own domestic experience suggested to them that there ought in fact to be direct regulation of hedge fund activity. That was well known as the position, for example, of the Malaysian government, and it was a representative from Malaysia who was involved with the Technical Committee Task Force. Those issues were debated at some length within IOSCO.

Ms GAMBARO—I want to turn to domestic areas. Can you give me your comments on some of the issues that you see in the Corporate Law Economic Reform Bill 1998 that are pertinent.

Mr Rodgers—When you say in the bill, there is the act, which has just come into force—

Ms GAMBARO—I should clarify that: the program act 1999.

Mr Rodgers—We might need to take some of these on notice.

Ms GAMBARO—Sure—and particularly in relation to options, if you would not mind. Is there a place for bond traders and fund managers to provide greater information to their clients on the risk of investments? Do you see yourself getting into that educating role?

Mr Rodgers—That is already part of our role in the sense that we administer disclosure laws, especially and particularly in the managed investments area but also generally for any offering of securities. We, like the rest of the regulatory community internationally and domestically, have been focusing increasingly in the last couple of years on disclosure of risk as a key point of disclosure. Generally the trend is that there is vastly enhanced direct retail participation in capital markets in Australia generally. There is increasing participation by retail level investors in increasingly sophisticated instruments—warrants, options, managed investments—that are sometimes marketed as hedge funds. That does mean that in our administration of the present law we have increasingly been focusing on the extent to which offerers of these products are disclosing properly—as they are required to do under the current law—the risks associated with investments of that kind. We do take action from time to time.

13

Ms GAMBARO—How do you police that? Is it a voluntary code, as such, or is it an industry code?

Mr Rodgers—We have a direct administrative role here in that the offering of these products involves the issuing of a prospectus and we have a direct obligation to make sure that people are complying with their prospectus obligations. We have a variety of remedies if people are not complying. We can stop the issue of the products. We can require people to correct or amplify information that they have given in the prospectus. The current law is patchy in its application here in the sense of the legal gateways that I talked about before. If it is a security, the prospectus rules apply, and they are directly administered by us. Under the current law, if it is a futures contract or something that would be regulated as a futures contract, there are no direct disclosure obligations there, other than the obligation generically to disclose that there are risks associated with these kinds of instruments.

Ms GAMBARO—Is that all they need to do? It is pretty general.

Mr Rodgers—That is what they need to do. It is an issue that is picked up in the government's proposals, not for the CLERP Act itself but the Corporate Law Economic Reform Program draft legislation commonly known as CLERP 6. This is the issue where there would be a much more uniform requirement for disclosure across financial products.

Ms GAMBARO—What do you think of that personally? Do you think that is a good thing?

Mr Rodgers—I am not sure I am in a position—

Ms GAMBARO—You are not in a position to comment on futures.

Mr Rodgers—in this context to talk personally.

Ms GAMBARO—Well, as a representative of your organisation. Is there much opposition to providing more regulation for the futures and more disclosure?

Mr Rodgers—My answer to that is that ASIC is considering its views at this stage and has not formulated them. Indeed, that is the position throughout the industry at the moment. There was quite extensive preliminary draft legislation released in February and I think industry players generally are looking at that. The issue of risk disclosure has been on the agenda of both industry and us as regulators for some time. My tentative proposition would be that there are no major surprises in the current propositions for industry or for us as a regulator.

CHAIR—I want to come back to the arrangements you have with the futures exchange and the Stock Exchange. You have more self-regulation. With the Stock Exchange now becoming a corporation in its own right, subject to certain restrictions, is there a danger that this self-regulation could lead to some problems—for example, if you get a rogue trader there or something? Wouldn't history suggest that there is always that risk that somewhere sooner or later that is going to happen, and what is going to be the way of managing this?

14

Mr Rodgers—With the demutualisation of exchanges, there is a move away from the traditional structure—the membership based structures to shareholding structures. There is interesting international information emerging here. Rose might be able to correct me on the number, but a very large proportion of stock exchanges around the world have either demutualised or are in the process of doing it or contemplating it. Rose has been at a technical committee meeting in the last couple of weeks and I think this was discussed at some length. Indeed, it will be discussed at the IOSCO annual meeting which is in Sydney in May.

There are clearly implications for the supervisory role that exchanges play which were not present in the old membership structures. We have dealt with some of those, including legislatively, in Australia in the sense that the supervision of ASX as a listed entity is not a responsibility of ASX; it is a responsibility of ASIC. What we see emerge with demutualisation is the potential for conflict of interest between the commercial operations of the exchanges and their public supervisory roles. There are very difficult questions, I think, which will need to be worked through in this country, as elsewhere, in the next few years with that, including how the cost of exchange supervision is to be paid for. Under the current regime it is effectively a user-pays system because it is a cost primarily directly borne by the exchanges themselves and, therefore, passed through to market users in the form of market charges. If there were to be changes, as there have been in other countries, about who does the direct supervision work, that would raise questions about how it has to be paid for.

There are a couple of examples. The Financial Services Authority in the UK has just announced proposals to take over the supervision of the listed companies. This has traditionally been done by the London Stock Exchange and is now to be done directly by the government regulator. In some small jurisdictions like the Netherlands, the statutory regulator has taken over entirely the supervision of exchange activity. The current legislation in Australia does not proceed on that premise and I am not suggesting that is necessarily where we will go. I am simply saying that all these issues are now being thrown up. The parliament has dealt with some of

them at the time of the demutualisation of ASX but, as we move forward, it perhaps needs a wider solution than that.

CHAIR—Are you suggesting there are still some serious question marks there?

Mr Rodgers—There are still issues to be worked through over time, I think. There are debates about what are now the two functions of exchanges. The traditional argument has always been that they are well placed to perform the public supervisory role—that they are close to the market; that they are looking at things on a daily basis; that the systems that they adopt for market trading are also a useful tool for market supervision. The model, which has been the worldwide model for many years, is that the exchange has what we have called in our context a front-line supervisory role and the role of the government regulator has been to ensure that that supervision is effective. That is beginning, I think, as a universal concept, to break down. There are issues from that which I think we will need to work through in this country.

CHAIR—Do you want to expand on that?

Mr Rodgers—Perhaps some of this we will need to take on notice. It begins from a conceptual argument. We are not pointing to any particular breakdown in practice. Let me give you a clear example. The changes to the legislation that were made when ASX did demutualise dealt with, among other things, the supervision of ASX as a listed entity. It moved that and created a special responsibility for ASIC to do that. We were not very long into that when there was an announcement of merger talks between the futures exchange and the Stock Exchange. Shortly after that a counterbid emerged for the Sydney Futures Exchange. Computershare announced that it was bidding. Computershare is a listed company and is supervised by ASX.

15

The legislation did not contemplate and does not deal with the conflict that might be seen to arise between ASX supervising one of its commercial competitors during a time when market announcements are likely to be required. We effectively put in place, by agreement between the third parties, what I think is probably best described as an administrative fix. Computershare, ASX and ourselves agreed that if there were any major issues to be determined by ASX—which actually has the statutory responsibility to make these decisions—which might in any way be tainted by the perception of a conflict of interest, they would not make a decision without consulting with us. But that is a short-term fix rather than a long-term solution to the conflict of interest question inherent in this.

CHAIR—We can get back to you for a bit more information. Ms Webb, do you want to add something to that?

Ms Webb—No.

CHAIR—I thought you wanted to talk about some earlier comments.

Ms Webb—The only thing is to confirm what Malcolm said about the trend being worldwide towards demutualisation. As Malcolm mentioned, at the moment it is being dealt with differently in lots of jurisdictions. Traditionally there have been three areas of self-regulation. One

has been the supervision of the listed companies, one has been the supervision of the brokers—the people trading—and one has been the supervision of the actual trading on the exchange, checking for manipulation and things like that. At the moment we are seeing a bit of dichotomy around the world where parts of those functions are being taken back into the government regulators.

For example, in Hong Kong the supervision of the broking industry has, in fact, been taken into their Securities and Futures Commission, so they have expanded that area of their operations and are no longer leaving it with the demutualised and merged stock exchange and futures exchange. They made a conscious decision to keep the supervision of listed companies with the exchange and, as Malcolm mentioned, in the UK a different approach has been taken. The trend around the world is that different solutions are being found at the moment. But I think everyone thinks that is a developing process and IOSCO is definitely starting to do some work on whether SROs in a demutualised scenario are the best way for regulation to go ahead.

Certainly at the moment, though, IOSCO's principles and the way of operating have been that the front-line regulator—regulation by the exchanges and the government having a supervisory role of the exchanges—has been traditionally seen as a very effective way of conducting regulation. But it is definitely changing.

CHAIR—Are you now saying we have gone out in the new territory but we have not really covered all the bases before we took off?

Ms Webb—I think it has been a change that people have been working through as it has happened. Malcolm will be able to comment on this. I think in Australia the situation has continued to work well, but there are issues coming up all the time, going forward.

16

CHAIR—What were the main advantages for making these changes?

Mr Rodgers—For the exchanges themselves?

CHAIR—Yes.

Mr Rodgers—I can recount to you the arguments that have applied both domestically and internationally. I think the argument is that they have reached the end of their useful lives, that exchanges driven by international competition really need to be able to conceive of themselves as commercial enterprises which need to move quickly and decisively to either defend themselves as commercial enterprises or pick up opportunities. Mutual structures of the kind that applied historically with exchanges are not really amenable vehicles to be meeting the present generation's round of commercial challenges for exchanges. It is a global market; people need to be able to respond quickly.

As long as they remain mutuals, there are increasingly embedded conflicts of interest between the participants. There are traditional small-scale stockbrokers, there are large international firms, and you can no longer presume a kind of community interest amongst members of exchanges that you would have taken for granted 25 years ago and, to survive as commercial enti-

ties, exchanges need to move beyond the limitations that those structures impose. It is an argument for demutualisation elsewhere as well, of course.

Mr PYNE—I want to ask a bit more about the international financial architecture situation. How far has ASIC adopted the objectives and principles of securities regulation proposed by IOSCO?

Ms Webb—IOSCO is at the moment conducting a fairly rigorous self-assessment process, which we are engaging in. A lot of these principles are cast in terms that are fairly broad—some of them are sort of aspirational—so on one analysis you could say that Australia maybe, arguably, complies with them all. The Treasury did a transparency report last year, where they found that basically we did. With the detailed IOSCO self-assessment process, some more probing questions are being asked. It is really an issue of a continuum, I think. It is not so much ASIC's adoption in many cases; it is more that the law we have in place, which we administer, means that we comply with a great many of them.

Of course, there are a few where we think perhaps we could do better or we say, 'Yes, in principle, we partially have implemented them,' but there are more things we are looking for or law reform proposals that the government has proposed which will mean that we comply with them even better, so we are just in the process at the moment of going through this self-assessment regime.

Mr PYNE—Which ones are they that we could improve, do you think, or that are open to possible change?

Ms Webb—There are ones dealing with the resources we have for regulation, and I suppose from ASIC's point of view we could always have more resources. So that may be an arguable one—whether we have sufficient resources to conduct everything we want to do. There are also ones dealing with this whole issue of regulation of the markets. As Malcolm mentioned, although the exchanges are regulated by us there is a great lot of trading in the over-the-counter markets and products that do not fall within either definition where the level of regulation is limited. Perhaps on a strict reading of the IOSCO principles some of those might be ones where you could say Australia does not comply as fully as it might because although we have very good regulation of the regulated markets we do not directly regulate a lot of other markets in Australia.

17

Mr PYNE—Are we helping other countries to meet the objectives of the standards?

Ms Webb—Yes. As part of this process that I spoke about before, that is part of it. Also, we have been quite active in this whole self-assessment process, and one part of that is just helping countries fill out the surveys and work out how they apply or work out whether the principles apply in their countries. Australia has actually undertaken to complete the process early and have our responses available for other members of IOSCO to give them some feel for how they should go about answering and conducting the self-assessment process.

Mr PYNE—Was that the purpose of last November's seminar for countries in the region that was hosted by ASIC?

Ms Webb—I am not quite sure which one you are talking about. Last November?

Mr PYNE—In our briefing notes it says that there was an international enforcement workshop.

Ms Webb—Yes, sorry. It actually took place in the first week of December in the end, so that threw me. No, that was very much an opportunity for ASIC to discuss issues with its peers. That was not so much one of our technical assistance processes but more to discuss issues with our enforcement peers. We had North America and England. We did have people from Malaysia and Hong Kong and places like that, but it was very much a peer type discussion. That was not one of our technical assistance programs so much.

Mr PYNE—Is there good sharing of information between foreign regulators at that level?

Ms Webb—Yes, it was quite noticeable that the issues that the people are dealing with are very similar. We have very good information-sharing powers to be able to help on day-to-day particular matters, if we are investigating something or another regulator is investigating something, to get information from each other in the jurisdictions. But I guess the emphasis of that conference was actually the process we use. A big issue at the moment, obviously, is Internet enforcement issues. Australia has been doing a lot of work on that, and a lot of work with our peers, on how you do conduct enforcement programs in relation to matters that arise on the Internet, for example. That was one of the features.

Mr PYNE—Do you want to expand on that aspect?

18

CHAIR—Yes, I was going to bring that up in the next question.

Ms Webb—I will be able to perhaps take that partly on notice, because enforcement is not my direct field of expertise any more, but the issue for regulators is that because the Internet is not strictly limited to one jurisdiction a lot of issues arise with having to trace sites that may be seen to be offering investment products or trying to offer financial scams to their source, and, because of the borderless nature of the Internet, people have conducted and are continuing to conduct scams—perhaps originating from Australia—where they send emails promoting a stock or something and that has an impact on a market in another jurisdiction. There is a very great need for cooperation between regulators in the actual technical practices they use to try and source where problems are coming from and how you track down sites and use Internet service providers to source the information, but often it leads offshore quite quickly, and then you need to call on the resources of your fellow regulators to help you follow it through.

Mr PYNE—What is the process for doing that? You cannot just close it down for the Australian area, obviously, because it is not feasible on the Internet. If it leads overseas, which it inevitably does, how do you then communicate with the foreign regulators to do something? What if it goes to the Cayman Islands?

Ms Webb—There are countries and countries, I guess is the answer to that. We do have mutual assistance arrangements with a large number of countries, and most IOSCO members have legislation or processes in place that allow them to conduct investigations and legal proceedings in aid of foreign regulators. So it does not have to be proved that a breach of, say, Australia's laws took place before we can go out and serve notices and seek to have bank accounts frozen and things like that, provided that the foreign regulator has indicated to us that the matter that they are investigating is a breach of their laws. Usually it will start with contact, regulator to regulator, sometimes on an informal basis to start with, but then you have to make a formal request for information or a formal request for investigative assistance from the other regulator. If it goes to an offshore jurisdiction, clearly the amount of cooperation can be limited and that can create problems.

Mr PYNE—Do the other foreign regulators have similar structures to ASIC or do you find that you have to deal with one for one particular issue and another for another particular issue that causes a breakdown in communications, or is there some attempt worldwide to try and have the regulation in one body so it is centralised?

Ms Webb—Yes. Australia is a little unusual in having criminal investigative powers in its securities regulators. In many other countries if the regulator calls in aid, it is criminal investigation departments or parts of the police forces and things like that, but there are usually very high cooperation levels between the regulator in that jurisdiction and the criminal law enforcement authorities, so ASIC by going through the securities regulator is then able to get its assistance in contacting them. We quite often have dealings with the Securities Fraud Office in the UK, for example, and our power to disclose information allows us to do it to any foreign agency undertaking this sort of work, so we are not limited in that sense. Generally there is quite good cooperation.

Ms GAMBARO—Can I just take up on that. When you are dealing with other international jurisdictions what do you do if you have a company whose prospectus has been issued in the Netherlands and they are operating out of the UK by telephone to unsuspecting old ladies in Brisbane? Which jurisdiction is it? Is it where the prospectus has been issued or is it where the company is operating out of?

19

Ms Webb—Our view generally is that if someone is selling securities in Australia they are in breach of the Australian laws unless they have gone through the prospectus process here or have a licence to deal in securities.

Ms GAMBARO—If they are not licensed to sell in Australia?

Ms Webb—Yes.

Mr Rodgers—The real question is where is the offer made? Even if you are sitting in front of a screen, if the offer is coming to you via a screen in Australia, the offer is being made in Australia and should be a regulated offer in Australia. We do have facilitative policy as ASIC to enable a US prospectus, for example, to be used in Australia as a complying Australian prospectus with minimal additional requirements. They are largely procedural requirements, so that the

prospectus in a number of jurisdictions—not universally, but in a number of jurisdictions that we have mentioned—really provide an equivalent level of protection at the offer stage.

Ms GAMBARO—You have a recognition of prospectuses in the United States and you would have an understanding of the United States, and you mentioned the UK.

Mr Rodgers—The UK. There are a number of jurisdictions.

Ms GAMBARO—Were they informally arranged? I know you get together and discuss all sorts of issues but was that something that came through over time or was it a special working body that did this?

Mr Rodgers—That was actually an act of ASIC itself. Partly it is about demand. It is partly about where are the offers coming from. We have looked at each of the jurisdictions and said on examination we think the regime that applies in the home jurisdiction with very minor modification can, in effect, turn the home jurisdiction offer document into a complying Australian offer document without having to start from scratch in Australia, as it were. We have done that. IOSCO has done work which we have implemented on Internet offers of securities. Given that most securities regulators are like us, they will say, 'If you make the offer in Australia it needs to comply with the Australian rules. Can you actually make an offer document that you post on the Internet that says, "This is not for you if you're in Australia"?' That is the question that IOSCO looked at.

They are really jurisdictional limitation clauses, saying, 'We're doing this because we want to sell this product in North America. We're not intending to offer it into Australia, although now we know, because we're putting the prospectus on the Internet, that you can access the prospectus from Australia. But there will be a prominent warning on that document saying, "This is not really intended for you in Australia."' That is something that we have done. The lead there was taken, I think, by the US, followed quickly by the UK and then Australia, and then that became an IOSCO document and, if you like, an IOSCO stance itself, generalised from the three or four particular examples of individual regulators who had done that.

CHAIR—Just following up on that; if someone offering a prospectus chose to thumb their nose at that, what can you do about it?

20

Ms Webb—We do have quite a few cases of people trying to sell securities in Australia and it is not through lack of having their prospectuses recognised, it is because they never intended to have a prospectus; they are essentially financial scams. At the moment, when that happens we have sort of got a two-pronged approach. One is a lot of education. We put out a lot of warning media releases that people should not buy securities unless there is a prospectus, unless they do it through a licensed operator, particularly if it has an overseas element, because your suspicions should immediately be raised that maybe your money is going offshore. The second thing we do is gather the information about that operation and send it back to the home jurisdiction where it is coming from. For example, there are a lot of boiler rooms operating in Thailand at the moment. They tell people they are listed on Nasdaq but most of the securities actually are not. We have sent a lot of that information to the Thai authorities and they are pursuing some investiga-

tions there to try and close down the operations. We are limited in what we can do actually here in Australia if it is coming by way of a phone call or something on the Internet, but we try and refer it back to the home jurisdiction.

Ms GAMBARO—Just on that, usually these prospectuses do arrive and they are beautiful, glossy prospectuses. They appear very legitimate. How do you get consumers to deal with registered brokers and how do you get that message across? I know that there are scams everywhere. Another thing I want to ask you is about the level of your investigative unit that deals with this. How adequate are your resources in dealing with these overseas threats?

Ms Webb—On the issue of investors, people can check whether a person is a licensed dealer by a free check on our Internet site. They can also do a free check on whether the prospectus has been lodged with us now on our Internet site. So we try to encourage people to just do very basic checks, and they do not have to pay money for the search or anything. They can find out.

Ms GAMBARO—And that is widely known?

Mr Rodgers—We would have to be in the top 10 of web sites in Australia in terms of the number of people who access it. It is working to that degree.

Mr Larcos—I thought it was in the top 100.

Mr Rodgers—ASX is in the top 10.

Mr Larcos—But even the top 100 is pretty good for a government statutory authority. Relative to other government agencies I think we do quite well, considering the number of web sites. We have an extraordinary response on our web site.

Mr Rodgers—We have put a lot of effort into that. We do have an Office of Consumer Protection who fairly systematically engage with the question of how it is that we can encourage investors and other buyers of financial services to act in their own interests. We have put resources into that. On the enforcement side we have also, within the last 12 months, set up what we have called the electronic enforcement unit which is designed to make sure that we have all the capabilities in the electronic environment that we have in the real world, as it were. I am pleased you asked the question about resources because that is the thing that I think we do see the need for us to devote resources to, to make sure that we remain a credible regulator in what is very clearly an environment that is moving very quickly—

21

Ms Webb—It is a difficult environment.

Mr Rodgers—towards a much more electronic environment where you cannot see a kind of national border as in any way a barrier to the activity.

CHAIR—Since you raised the point, maybe you would like to elaborate on that.

Mr Rodgers—I would not want to elaborate on it too far but I think—

CHAIR—It is a serious question. Are you seriously underresourced?

Mr Rodgers—The picture I would want to leave you with would be that we are endeavouring to respond in a number of areas, particularly the electronic environment and new consumer protection role, which, after all, in its full generic sense we have had for less than two years. I think it would be fair to say that that is a source of some concern as to how we devote our resources so that they are most effective. I would not want to pre-empt perhaps the more formal propositions that ASIC would want to put through the minister to government on these issues, other than to say that the question of resources, particularly the resourced new areas where inevitably we need in effect to be building our own infrastructure and capability, is a continuing question for ASIC.

Ms GAMBARO—May I ask a question about your consumer complaints unit or whatever it is called. Have the inquiries gone up about these types of overseas approaches? I know you are basically there to protect the domestic consumer against scams, et cetera, but electronically now it is much easier to create fraud via the Internet. You were talking about emerging areas. Do you see greater problems and greater inquiries in this area?

Ms Webb—Last year, as I mentioned, we conducted a serious investor education campaign and part of that campaign was encouraging people who did get these approaches or found these sites to report them to us. So I think it was a bit self-serving that the level of complaints that we received then increased quite a bit. A lot of those, fortunately, were people who had not invested their money but in fact were reporting that they had had an approach or that they had found a site, although a substantial amount, unfortunately, had also been invested. It is increasing. It is very hard for us to know whether the level of complaints that we receive is actually reflective of exactly how many people out there are being scammed by these people, because often, unfortunately, it is the people who are not aware of our existence or what we can do that are most easily targeted. Last year we had about 300 complaints about overseas telephone or Internet solicitations.

CHAIR—We have had a pretty interesting session here, so can I thank you all very much for coming before the committee. We will just take a short break.

Proceedings suspended from 10.50 a.m. to 10.55 a.m.

GILBERT, Mr Richard, Deputy Chief Executive Officer, Investment and Financial Services Association

NAUGHTON, Mr Gerald, Member, Collective Investment Vehicles Committee Task Force, Investment and Financial Services Association; Senior Investment Manager, AMP Asset Management

CHAIR—Welcome to today's public hearing. I remind you that the evidence you give at the public hearing is considered to be part of the proceedings of the parliament. Accordingly, any attempt to mislead the committee is a very serious matter and could amount to a contempt. The committee has received your submission numbered 15 and it has been authorised for publication. Are there any corrections or amendments you would like to make to your submission?

Mr Gilbert—No, Mr Chairman.

CHAIR—Do you wish to make a brief opening statement before proceeding to questions?

Mr Gilbert—A very brief one, Mr Chairman. I would like to thank the committee for allowing us to appear today to expand on our submission of 4 March. I would like to introduce Mr Gerald Naughton.

As the committee may well know, IFSA is the industry association for Australia's leading investment managers and life insurance companies. Our members hold about 90 per cent of Australia's $500 billion or so in funds under management. In recent times much of this work has focused on producing a business tax system which will introduce strong measures to encourage collective savings vehicles. In this regard we fully support, in concept, the proposal to introduce collective investment vehicles as proposed in the Ralph review. It is important that the new business tax system treat collective investments no differently than direct holdings in shares and property. This might seem a little off the topic here but it is very critical to the strength of this industry and its position as an international player and thereby relates to your terms of reference.

In this regard we have been pressing both the government and the opposition to pass laws which do not discriminate between these forms of savings when it comes to taxing investment and capital gains income. The process to introduce Ralph is still under way and, for the sake of the millions of Australians who do not come from the big end of town but who have an interest in collective investments, any support that you can give to achieving this outcome would be appreciated.

To summarise our submission the main points are: investment management of more than half a trillion Australian dollars conducted on behalf of more than nine million Australians plays a critical role in protecting the Australian economy from seismic shocks from overseas economies. It does this by boosting the stock of national savings, thereby reducing their reliance on overseas funds. As about 20 per cent of our funds are offshore, they generate a sizeable annual dividend cheque. If the 100 billion or so offshore is able to return a modest 10 per cent—and these returns have been greater than this in the past five years; some funds have been returning

20 to 25 per cent, even more—that means a credit to our balance of payments of about $10 billion a year, which is certainly not to be sneezed at.

24

Derivatives play an integral role in providing liquidity and managing risk associated with fluctuating exchange rates, interest rates and share and commodity prices. Generally, our industry uses derivatives to do just this, as opposed to their use for speculative purposes. There is a panoply of devices to ensure that the Australian funds managers do not engage in activities that would expose underlying investors unduly to the risks of offshore financial failure. These measures include superannuation law, APRA regulation, ASIC regulation, exchange regulation, clearing house and settlement systems, industry initiatives and standards, intermediaries and technology advancements. Essentially, our recommendations focus on bolstering the effectiveness of these devices and making them equal to fast-moving global financial markets. Mr Chairman, that concludes my brief opening statement.

CHAIR—Thank you. We might start with questions. In your recommendations you talk about the need to have appropriate liaison between the regulators and their international counterparts. Is that happening, or are there ways that need to be improved?

Mr Gilbert—What I might do is make a general statement and get Mr Naughton to back up what I said. I think essentially the system is working well now. I cannot see that that liaison has a lot of holes in it. But that does not mean there are not going to be information gaps in the future as markets change. That is why I think this committee has an opportunity to make recommendations to perhaps intensify that and perhaps to even increase the degree of industry involvement in that process. That is our general position. Perhaps Mr Naughton would like to add to that.

Mr PYNE—Just before he does, can you expand on the industry involvement?

Mr Gilbert—Yes. My industry's involvement includes the idea of liaison committees being more formally introduced, possibly with an onus on the regulators to report on those to the parliament. I am not saying that is not the case now, but I think into the future this may well be required. That is a possible recommendation the committee could look at. Gerald, would you like to add to that?

Mr Naughton—Mr Chairman, I think that coordination is important. As Mr Gilbert said, it has been working quite well in the past. An example is the use of derivatives. APRA, through the old ISC, have a number of circulars on how investment managers can use derivatives and they therefore have to have a risk management statement. ASIC, in its role of looking after managed investment funds generally—wholesale retail trusts that are offered to the public—is also looking at what controls on derivatives there should be. It would be useful if the two organisations came up with the same standard because ultimately the fund managers in most cases are very similar. It would be disappointing if we did not have very similar regulations. The old ISC, when it put together that use of derivatives, involved the industry in a task force and that was very useful from both points of view, with the industry understanding where the regulators' concerns came from.

Mr Gilbert—I will just add there, Mr Chairman, that 80 per cent of our moneys is generated from superannuation. You have the operation of the superannuation law under SIS working, but then most of those superannuation moneys are then governed by ASIC regulation laws and, increasingly, most collective investment vehicles will be regulated under the Management Investment Act. In effect, we have two systems controlling 80 per cent of our moneys in our industry. If it is done with the proper liaison and cooperation, that bolsters the level of protection and is a productive thing. As for future liaison, I think there is still room for improvement on the basis of what I just said and what Mr Naughton added.

25

CHAIR—We have had—I think the Treasurer has reminded us— some nine and a half years of constant growth in Australia. That is terrific for Australia but it does not really put to the test some of these regulations. If at some stage we do see a downturn—and no-one wants to see it but history tells us that we would be kidding ourselves that it is not going to happen, it is only when?—where are the likely gaps to come, when the pressure is on?

Mr Gilbert—I will make a general statement and Mr Naughton can follow up. Looking at the way the industry is running, it is the high risk ventures obviously—the funds and the people who are seeking high returns—because implicit in that is high risk. Overwhelmingly, the 80 per cent of our money invested in Australia is in moderate risk. It is only returning about nine or 10 per cent. It stands to reason that there is not a high degree of risk there. But people who are investing offshore are investing in higher risk projects. Their returns are greater so there is some small risk there. If there was to be a problem it probably would be with offshore moneys. However, the people who have invested in those areas are well aware of the risks. Mr Naughton can probably explain that better.

Mr Naughton—Mr Chairman, that disclosure issue is the main way, because it is going to be very difficult to frame regulations or even rules for an unexpected event. Really, it comes back to the fund manager, or whoever, setting out in the prospectus or the offering document what their policy is so that investors know what they are getting into. If they are investing in a high risk fund that invests in Outer Mongolian bonds or something like that, then they know that upfront; whereas if they are investing in a normal fund, in shares worldwide and shares in Australia, they understand that and they understand that markets do go up and down. Certainly the amount of education going to superannuation fund members—because of member choice and fund choice and all of those things coming up—is increasing members' understanding of those sorts of issues.

Mr Gilbert—If there is a risk it is probably going to be for those people who have only a small handful of shares. Investment analysis and research and theory tells us that the greater the diversification the less the risk. Our industry is in diversified stocks. If you are in an international share fund in Australia you are taking the top 200 companies in the world, for example. If you are saying there is a risk you are predicating it on being all 200 companies failing. The risks are probably those people who have their own shares in a small number of companies.

CHAIR—Let us just expand on this. You talk about the importance of shares, and the performance has been impressive over the last nearly 15 years, but if you went back over the previous period the growth in shares was minimal. Having had such a big growth, you cannot have

an expectation that it is going to continue. Therefore, at some point there is going to be more pressure coming on. One of the things we were talking about with ASIC, before you came, was the whole impact of demutualisation on the Stock Exchange and the futures exchange and so on. Their response was a 'Well, we are developing them as we go' type of response to whether or not this is going to have some shortcomings.

Mr Gilbert—Again, all of the disclosure documents that our members would publish run the line that these are long-haul investments. They are investments for between five and nine years and predicated in that is a chance those investments will actually lose value from time to time. That is to individuals. As for funds, again, super fund trustees, what is your view of that, Gerald?

26

Mr Naughton—I think, Mr Chairman, most funds have various offerings in terms of a conservative or a high risk type of spectrum; therefore members can choose. It is a very interesting issue, and a lot of discussion is going on at the moment because most people believe the US market is overvalued. Therefore, the very real issue is: should we be moving out of shares because if the US market corrects, that is going to have an impact worldwide, and how much do we expect it to happen?

Then there are these interesting economic arguments about this new paradigm and the fact that yes, we have had tremendous growth in the past, but, because of technology, it can continue—perhaps not to exactly the same extent and certainly not as high—but there is still an awful lot of profitability and productivity improvement that can come through from new technology. In itself, at least our view and the view of most people is that there is not a fundamental risk to the economies; they will still show some reasonable growth. In those sorts of environments shares generally have outperformed in the past. The concept that you are buying part of the ownership of companies means that they should outperform in general in the future.

As long as you have a diversified portfolio then you are not going to be at risk from your particular companies going broke; you are subject to market risk. That comes back to the fact that people need to consider what they are investing for. If it is superannuation it is long term, if they are saving for a car next year, then no, they would not invest in shares. That really has to come, I think, through education and disclosure. It is difficult to see how you can regulate there. An analogy is gambling: you cannot actually regulate to stop people. I suppose you could but it would be difficult to stop people gambling. People have to be aware of the risks involved.

Mr Gilbert—Another thing is that in our industry it would be wrong to just focus on shares. In our industry that is just one asset class. If there was a fall in shares you would probably see a commensurate rise in bonds and other short-term securities. There is inherently a risk-protective mechanism within our funds. An individual with a stock of five shares, if there is a market crash, will feel the full brunt of it. Our members will not feel the full brunt of it. That creates a smoothing device.

Mr Naughton—You see that in the past if you go back to just post the war. The large mutual funds that invested the superannuation in those days would have had mainly government bonds and very high weightings in direct property, the buildings around town. Gradually that has

changed over the years as market conditions have changed. We are continually adapting and we are endeavouring to find different types of investments to diversify that risk so that we are not all concentrated in one area. That is where derivatives can play a very valuable part, because from a temporary point of view they can protect you against market fluctuations. If you use them properly they are a very useful tool. Again that comes back to having proper internal controls in place and explanations to people so they know whether you are going to use derivatives for protection or for taking speculative moves, and they can make appropriate decisions.

CHAIR—But currently the majority of derivatives are not under those sorts of controls.

27

Mr Naughton—From the fund management industry they are indirectly under controls because of the superannuation industry. Because APRA, or the old ISC, requires superannuation funds to have a risk management statement and because so many funds from investment managers are commingled, the risk management statement has fallen through, so, from our own organisation's point of view, even though we are not required to have a risk management statement for our non-superannuation funds, in fact we use exactly the same one because that means all of our systems and all of our strategies are common.

CHAIR—You say, 'We use them,' but is that voluntarily?

Mr Naughton—We would have always had a basic philosophy on derivatives anyway, which is not to use them to gear, and the risk management statements just formalise the controls that we have in place and the explanations of how and when we use them.

CHAIR—Is this a voluntary compliance?

Mr Naughton—Yes. Well, it is more voluntary, I think. The circular from APRA requires that superannuation fund trustees—because they cannot regulate fund managers but they can regulate trustees—must have a risk management statement in place before they can use derivatives. There is a specific rule that trustees must have a risk management statement and then they therefore require fund managers to have a risk management statement before they can invest in funds that use derivatives.

Mr Gilbert—And there is another threshold of five per cent.

CHAIR—For superannuation, but other funds—

Mr Gilbert—True, but, Mr Chairman, 80 per cent of the moneys we have are super. The statement Mr Naughton was making was that, because of the commingling, super tends to dictate what the outcome is.

Ms GAMBARO—You spoke a little about transparency. Are there any methods that are being used by the industry to promote greater transparency among members, or what are your views on new technology in regard to achieving that transparency as well?

Mr Gilbert—We have a code of ethics, first of all, and also a body of standards with which our members, in order to be members of IFSA, need comply. Perhaps I could either run them off orally—

Ms GAMBARO—I am happy for you to expand.

Mr Gilbert—For example, disclosure of unit prices. Calculating a unit price is a very important point. If the fund is not performing well, the only way an investor knows is in the unit price. We have a common way of measuring a unit price. As members sign up to that, theoretically if they do not comply with that they could have the ACCC breathing down their necks, because they advertised to members that they are complying with our standard on unit prices and that could well put them in breach of section 52 of the TPA.

28

Ms GAMBARO—Do you have a standard formula that you use there?

Mr Gilbert—Yes, and another one is fund valuation. For example, if you own a property trust I think you have to have an annual valuation on that property, a very critical point of fund valuation and transparency.

Ms GAMBARO—Who does the auditing of that?

Mr Gilbert—For private companies I guess it is the big five or six accounting firms that would audit those, and sign off, according to the Australian accounting standard.

Ms GAMBARO—They are in the code of ethics and the minute you sign up, that is a code, so it is a voluntary code as such.

Mr Gilbert—If you are a member of IFSA, if it is a standard, you need to comply.

Ms GAMBARO—What happens if companies do not comply and what measures do you take then?

Mr Gilbert—That is a good question. We have not encountered that yet. We have only been running in those standards for two years. We are just coming through the first round of sign-offs. We are implementing procedures. Ultimately under our constitution if a member does not comply they are removed from the IFSA membership. You might say, 'Well, so what?'

Ms GAMBARO—Can't they come back quickly?

Mr Gilbert—They could if they complied. If they were forced out of the IFSA membership, it would very quickly get around the market because you have asset consultants, who are another layer of protection, doing due diligence on this aspect of the operations, and I think the asset consultants would be saying to the super fund trustees and others, 'Don't invest with this company because it does not comply with industry standards.'

Ms GAMBARO—You are saying the market would get the information out there?

Mr Gilbert—I think so.

Ms GAMBARO—It has not come up, I know, but will you have an exclusion period for you to prevent companies who have not complied from reapplying?

Mr Gilbert—That we have not encountered, no. We are currently redrafting these provisions, and that is one thing we could take on board. It is a good point.

Ms GAMBARO—What about new technology? Can it help you to get the transparency message across? We spoke earlier to ASIC, who spoke about the Internet and the offers on the Internet, and I think they have had 300 inquiries about companies who had approached people from offshore areas. Does this present some challenges for you?

29

Mr Gilbert—It does. Our industry is probably one of the more technology based industries. It is worth alerting you to the fact that there is currently a move to get global straight-through processing. Mr Naughton can explain how processing works at present. What happens at present is that you make a decision to buy stock offshore and there can be as long as a four- or five-day period where everything is in suspension and nobody really knows who owns the money or who owns the funds, and that is always a risk. In order to reduce that time, we are working in projects now to try and have real-time settlement of these transactions.

Ms GAMBARO—Yes, I was going to ask you about real-time settlement. Thank you.

Mr Gilbert—That can only happen through electronic means. Gerald, would you like to elaborate on that?

Mr Naughton—A simple example is shares. Generally speaking, if you buy shares in Australia there is a two-day settlement time frame and it can go out to five days, and therefore for a period it is a matter of, 'Well, I've put an order on the market so therefore in theory I own those shares but at what stage do I actually part with the money and get the piece of paper or the electronic record that I own those shares?' When you are dealing internationally, the time frames can go out and also, of course, because you are changing time zones, you can have some interesting problems of just how you deal on international markets.

If we can move all of that to instantaneous settlement by moving the money through the bank accounts and moving the registered ownership at the same time, it removes that time period. We monitor all of our what we call counterparty exposures—just how much we have invested in any one organisation at any time—and if we are buying a share in, say, the US in Microsoft or something, ultimately we are going to measure what is our exposure to Microsoft and ask whether we are comfortable with that. But for a period we would be exposed to either the Stock Exchange itself or one of the brokers, and we monitor just how big that exposure is to any of the brokers that are buying the shares. If we can get that time frame down, then it removes another risk equation from the exercise, because your risk is that the broker does not deliver and therefore if the price has moved in the meantime you are exposed to that price move.

Ms GAMBARO—I was going to ask you what the problems were if it is delayed, and you just answered that. Are there any other problems when you have that time gap?

Mr Naughton—Generally, most brokers are going to have somebody of substance behind them, so it is unlikely to happen. The worst event is if you are dealing with a very small broker who has nobody supporting them. You pay over your money for the shares, they cannot deliver the shares, so effectively you have lost the whole amount. That is unlikely to happen because generally you would not deal with those small brokers.

Ms GAMBARO—But it could happen?

Mr Naughton—In theory, yes, it can happen, and that is why we are going to be dealing with the major brokers that have worldwide connections and, for example, they will have a big international bank behind them because most financial intermediaries are becoming part of international conglomerates. There can be a risk that we deal at a point in time and then, because of delayed settlement, prices move, so our profit or loss is at risk from the point of buying until it eventually gets sorted out. The more you can reduce the time frames, the less risk there is on that. There are also simple procedural issues, that if we authorise a bank transfer today and for some reason it does not occur, we may find we are in default for 24 hours because it has not actually gone through the system, so we may be up for a little bit of interest or something like that.

30

Ms GAMBARO—Is global straight-through processing fairly advanced? Where are you with it? Is there good progress?

Mr Gilbert—It is being run out of London. I would be better off getting some additional material. It is embryonic. I think Australia is seen as one of the nations which will be in the vanguard of that. We are doing it in a micro sense. We are beginning another project in a micro sense for superannuation for fund members. With superannuation choice coming, we are working in a project with the tax office and also with NOIE, which looks as if it is going to assist in some funding—and we applaud the government's initiative in that regard—which will allow superannuation funds, both the data and the moneys, to be transferred electronically.

CHAIR—What is the full name of NOIE?

Mr Gilbert—National Office of Information Economy. It comes under Senator Richard Alston's portfolio. In a micro sense, if we can achieve significant progress on that, I think we will be a world leader to push this global straight-through processing. There is a good opportunity there for Australia to take a stake there. No other country will have a superannuation system with dollar and information flows as we have if we can get this project moving in the right direction.

Ms GAMBARO—Can I go back to the superannuation. That means that if people are working in three part-time jobs, for example, with three different super funds, they are able to instantaneously remedy that situation, whereas in the past it was some great big paper trail.

Mr Gilbert—That is a very good summary. For example, I employed a new research adviser just recently and he came to me and said, 'I'd like to stay in the fund I'm in.' Under this new system he will be able to stay there because as a small employer we will be able to send electronically the funds and the information, so we do not insist that he comes into our fund and thereby ends up with two accounts, both of which have very low balances, which are diminishing. That is the sort of advantage you get.

Ms GAMBARO—So compliance is being reduced.

Mr Gilbert—Compliance costs for employers certainly will go down.

Ms GAMBARO—What you are saying is that the success of this superannuation project will impact on the global processing?

Mr Gilbert—Definitely.

31

Ms GAMBARO—And that is being used as a test for the global processing—

Mr Gilbert—In part thereof. The superannuation has a life of its own but the lessons we learn from that will, I think, make us a leader internationally on this global straight-through settlement.

Ms GAMBARO—So we are leading the push on that and we are well ahead?

Mr Gilbert—I think that is a fair summary.

Mr PYNE—In your submission you talk about the need for closer cooperation between national and international regulators in your area, and we have just heard from ASIC, who seem to be quite pleased with the role that they are playing on an international level, bringing about closer regulation and better cooperation. In what areas could you see more cooperation and better cooperation to bring about closer regulation?

Mr Gilbert—Obviously harmonising regulatory regimes is one. I am not saying that it is not well harmonised now but what we must remember is that if there are changes in market conditions and changes in government with changes of regimes, that liaison becomes even more heightened. Our comment was not meant to be critical of the existing but rather to be looking over the horizon to see how we can do it better. In that regard, if our members were to invest in a number of economies outside those traditional 20 or 30 OECD economies, that is where perhaps there might be some improvement needed, so in the newly developing economies that might be something we can gain advantages on.

Mr Naughton—I think, just to support those comments, more and more institutions and fund managers are investing throughout the world, and the greater the commonality between at least Europe, America, Japan and Australia the better. As Richard says, the difficulty is with some of your developing countries that may not have the standard of compliance or regulation that we have, and I guess we can support them in terms of developing some of the rules that we have.

Mr PYNE—In reality, though, we do not do a lot of investing in countries outside the OECD, do we?

Mr Naughton—Yes. In dollar terms perhaps it is not significant in terms of hundreds of billions of dollars, but certainly there is a growing investment in those areas. Most—AMP and National Mutual—have investments throughout Asia. People are looking more and more at widespread investments and there is a growing band of investments called emerging markets, which are investing in Latin America, Africa, throughout the Middle East and Asia. They are very small in dollar terms, but again it is to get some of this diversification, and away from just the big US or Japanese markets.

Mr Gilbert—Mr Pyne, could I just add there that it is not only regulation in terms of prudential and disclosure, it is also tax regulation that is important. That is why I made my statements about collective investment vehicles and the taxation thereof. If we do not get the right outcomes from the Ralph inquiry on collective investment vehicles our industry will find it very difficult to compete with the US mutuals, which are operating under a certain tax regime which has been running since 1942. They are very strongly growing vehicles. They have been given some preferment to enter the Australian economy, which we do not contest, but what is important is that the taxation arrangements be reasonably harmonised. If we were to lose pass-through on certain of our products and also proper treatment—

32

Mr PYNE—Going to lose pass-through?

Mr Gilbert—Pass-through, yes. It is something that we have been advocating to the government, and to the opposition, for quite some time.

Mr PYNE—What is pass-through?

Mr Gilbert—Pass-through is not having a withholding tax on investments. In other words, if you have investments in BHP shares, there is no withholding tax on the dividends that they are paying to you. If you have a collection of shares, there should be the same treatment. That is what we have been advocating to the government, both in terms of the investment income and also the capital gains tax arrangements. That sort of harmonisation is important, too, if we are going to have a strong and viable Australian managed funds industry.

Mr PYNE—This committee is also interested to discover what your opinion would be about how regulatory bodies can work more cooperatively together to make your industry more transparent, faster, more efficient, more profitable. What would be your suggestions in that regard with particular reference, obviously, to the Asian financial crisis? That was, of course, some time ago, but this committee is trying to find out how international financial markets operate and how regulators can better regulate, and I would have thought you might have some opinions on the international framework.

Mr Gilbert—My observation of IOSCO is that it is a very competent and effective organisation in terms of coping with the current arrangements. Where there might be a weakness is in bringing the IOSCO group into the same room as the industry in terms of the region, or in terms

of the world. I am not sure there are those mechanisms in place. In other words, it is all very fine for regulators to meet internationally, but do they need to meet with the funds managers as well, many of whom are international funds managers? So that might be a point where there could perhaps be enhanced liaison in a more formal sense. I am not saying it does not happen now, but it perhaps could be more formalised.

Mr PYNE—If you had the chance to meet with the regulators at an international level, what sort of concrete proposal would you put to them that they could adopt?

Mr Gilbert—That may well be one proposal.

Mr PYNE—Just having a meeting?

Mr Gilbert—What would be on the agenda? Okay, I take your point. Obviously on the agenda would be to identify issues which pose risks to managed funds internationally and to work out mechanisms to address those and perhaps report back to governments such that there is a consistent message and a consistent set of regulations arising.

33

Mr PYNE—You would agree that the Asian financial crisis gave a new impetus to this movement, wouldn't you?

Mr Gilbert—Yes, it certainly did. I went to a meeting of Asian funds managers shortly after it, and they were very keen on exchanging information on where the risks are in various economies and they wanted a lead from Australia.

Mr PYNE—Is there a mechanism that has been established to have that information passed over to markets outside Australia? Is there any international body that exchanges information in that regard outside the regulators?

Mr Gilbert—Unfortunately, the answer is no, in a global sense. There is an international meeting of funds managers which happens once a year, but it tends to be on the retail side of the funds management industry, not on the wholesale side. From your comment, I can see implicit in that that there is a weakness that perhaps needs to be addressed.

Mr Naughton—Mr Chairman, there are a couple of international bodies that I am aware of—one Asian—and the Securities Institute in Australia, which is effectively the analyst in Australia. There is an Asian association—I cannot remember its exact name—that meets regularly and has conferences where analysts from around the Asian area will go to, and various regulators and various companies address them. That is the sort of forum there, and likewise that goes to a peak international analyst body. The mechanisms are in place and it is a matter of talking to them.

There was one—and I cannot for the life of me remember who did it, whether it was an international regulatory group or an analysts association—which produced a list of international risk standards, if you like—how they would see that globally companies or financial organisations should manage risk. There is a set of principles that does exist. I will try and dig out a copy and

I can send one through Richard. But the mechanisms are in there, and some work has been done on general principles and I guess it is a matter of then expanding that. At an international level I think you will only ever be able to get down to principles because of sovereignty of parliaments and whatnot. You are not going to actually surrender the regulatory management, but if you can have some agreement on the basic principles then that would be worthwhile.

CHAIR—I want to come back to a couple of points, Mr Gilbert. You were talking about the rights of IFSA to self-regulate and if someone does not meet your standards then you can withdraw that. In practice, you are a voluntary association, yes?

Mr Gilbert—True.

CHAIR—Therefore if a major player for technical reasons was not meeting the standards, there would be enormous pressure on you to say, 'Look, just go and fix it, even if it takes you three months or whatever, before we formally do this.' This could be seriously costly to this particular player if, for whatever reasons, they are not meeting your standards.

Mr Gilbert—Yes.

34

CHAIR—How in practice are you going to deal with that conflict where you want to hold your members and yet you have one who is maybe not quite playing the game?

Mr Gilbert—It is a good question. Fortunately for us, we have not had that problem arise—yet. I think you would find—again—that the market talk and the market information is such, the grapevine is such, that the big manager concerned would have to go and fix whatever. The money that is invested in these funds is very fluid. It can move at an overnight's notice. Is that right, Mr Naughton?

Mr Naughton—Yes.

Mr Gilbert—So if the message gets around that a major fund manager is not complying with one of our standards, then that goes to the heart of investor security or integrity and I think you would find the asset consultants putting a 'hold' notice or a 'sell' notice on those funds and the money would flow very quickly.

CHAIR—Yes, but how are they going to find out? You do not want them to find out if you are going to lose a member.

Mr Gilbert—Again, the market has ways. There are many checks and balances on the market. Do you want to run some particular examples to explain it?

Mr Naughton—In terms of the large funds management industry, as Mr Gilbert mentioned before, there are a whole range of asset consultants or actuarial consultants, and there are perhaps three or four major ones in Australia, and they are dealing with superannuation primarily. On the retail side there are three or four main consulting groups. Basically, if an organisation wants to market through the independent financial advisory network through independent finan-

cial advisers and planners then we have to get some form of rating from those consultants. They are continually monitoring us. It depends on the nature of the breach. If, for example, we breach one of our derivatives guidelines and we do something we should not, then we are under virtual contractual obligation to notify our client and to rectify it, so at that very basic level, if we do something that is outside contract then we have to notify them and get it corrected.

The consultants are continually talking to us—both the retail and the super ones—so that they are asking us what our policies are and where we are going. While you can lie for a little while, it is going to be very hard to continually say, 'There's nothing wrong. There's nothing wrong,' without something coming up, because it is obviously going to come out on performance or your ASIC structures before too long. It will come out fairly quickly if you are a big organisation. There is always a risk if you are a very small player that you can just ignore it and not do anything about it, but if you are one of the large investment management organisations, that is where perhaps the pressure is on.

Between the consultants and the clients, they are going to start putting pressure on us, depending on the nature of the breach. Every quarter on derivatives, for example, we have to say whether we have complied with our statements, so if we do not put a statement in our quarterly report saying, 'There have been no complaints or breaches,' then people are going to start asking the questions.

CHAIR—But you are still going to face the situation—maybe not with the large organisations but, say, with a small to medium one—where you have the knowledge that if you put this out you are immediately going to disadvantage the superannuation contributors and you could cost them a lot of money if there is an overreaction from the market, for example.

35

Mr Naughton—It depends on what level you are talking about, because there is the fund management company, which is a business in its own right, and then it invests through trusts or through a custodian arrangement, the money of the super fund. The fact that something is going wrong may impact upon the reputation, and hence the future business viability, of the fund manager, but it should not impact upon the trusts themselves because they are separate assets and quite distinct from the manager—unless, of course, the manager has actually gone and lost the money and therefore, whether people know about it or not, the money is not going to be there.

I suppose if you took it to an extreme, if some bad news came out that impacted upon AMP or Colonial as listed companies, then that could impact on their share price and that could flow back through to investors' money, but that is normal market activity. I do not think the fact that a manager has been doing something that nobody knows about, and the public knowledge of that is in itself going to damage the superannuation funds. Either the manager has lost the money or has not. The super funds are not going to suffer any more from that knowledge.

CHAIR—But you have cited a simple case where someone has lost money, 'Do we disclose or don't we?' Well, obviously it is going to be disclosed one way or another. But it is more the question of someone not meeting the technical requirements. You could damage the investment of the individual superannuant. The pressure would come on you in that situation, and that is

what I am really leading up to. I am not questioning the fact that you have this principle there—and it is an admirable one—but is there a fail-safe mechanism to make sure that if, for whatever reason, there is a hesitation, there is still some protection for the investor?

Mr Gilbert—Let us examine first who might find that there was a breach. You have reasonably regular fund audits from APRA and ASIC—separate audits. If it is a managed investment you have got a compliance committee which has independent directors sitting on it. I used to work in a retail fund. Every month as the responsible officer under SIS, which carries various provisions, I had to sign off a compliance statement saying that to the best of my knowledge there were no breaches of compliance. That might happen at three or four levels within a company. Is that correct?

Mr Naughton—Yes.

Mr Gilbert—So the compliance committee is going to find out about the breach. Just the fact that there is a breach does not really—unless money is defalcated—affect the individual investors because their investments are downstream in another public company or government bonds or cash. I just have trouble getting the connection between the impact on the investors and the compliance in the fund, unless the compliance procedure is such that it went to a dodgy investment or an unsound investment when, yes, your point is correct. But if it is a matter of fund accounting or fund valuation then I am unable to see how individual investors might be affected by virtue of that bad news getting out.

Mr Naughton—The one thing you might be referring to is going back to the old life office environment, perhaps, rather than a trust. With a trust, the investor actually invests in the trust, to which there is then a responsible entity or a manager, so if the manager goes under, the trust should be protected, unless there is fraud going on. With a life office, the investor actually has a life policy and therefore if it became news that the life office was insolvent then, yes, that would have an impact. That is where the regular quarterly APRA reports will pick that up and APRA have various statutory authorities to come in and take over. There is always a risk there that people will be doing things they should not and that it does not come out or people try and cover it up. I am not sure how investors would be any more at risk.

36

I suppose the possibility is that if a manager is doing things which should not be done and they do not become public, then people will be continuing to invest through that manager's trusts. Again, I think all we can rely on is the fact that there are disclosure requirements for new prospectuses and, with better member education and with the manager or the responsible entity having to give regular reports and sign-offs, things are all right. Once you start getting beyond that into real fraud situations, then there are laws that deal with that. But up front, you are not going to stop people acting fraudulently.

CHAIR—Is IFSA going to enforce this standard?

Mr Gilbert—It is in our constitution that the board has those powers and it is for the good of the industry that it have integrity.

CHAIR—Yes.

Mr Gilbert—My feeling would be that if someone is operating contrary to the standards which they have signed up for, the board would certainly be conducting an inquiry with a view to either correction or exclusion. Just taking up the point that Ms Gambaro raised earlier about whether they could come back quickly, my view would be that the more quickly they comply, the more quickly they come back into the fold.

Ms GAMBARO—You are saying that in franchising industries, for example, regularly published names of noncompliant companies would be listed in the franchising journals or publications?

Mr Gilbert—Yes.

Ms GAMBARO—You would not do anything like that because of the market sensitivity perhaps. But that was a method of discouraging noncompliance, rogue companies from trading with the consumer, because if they were not a member of the Franchisors Association that is what was done. There were periods of non-exclusion, for coming back into the industry, but you are saying in this case you try and get them back as quickly as possible.

Mr Gilbert—So they are complying with all the standards.

Ms GAMBARO—Taking the chairman's point, is that stick big enough to ensure they are doing the right thing? The checks and the audits, you are telling me, are already in place, so by the time they come to your body that would be the third line, pretty much.

Mr Gilbert—I think that is right. We are still working through how we are going to ensure compliance in a formal sense. I would like to take all of the remarks the committee has made back to the board as they work through this process and, when we get our compliance procedures bedded down, we could come back to you. You have made some very good points which we at this stage have not countenanced; for example, the exclusion—for how long?

37

Ms GAMBARO—I am sorry I am a bit cynical, but I think I have dealt with too many voluntary codes of conduct. I did not realise you had so many checks along the way. But voluntary codes of conduct do work in the majority of cases—70 to 80 per cent of people do the right thing—and they are usually the good, reputable companies. That was the case in franchising and would be the case in your industry as well, so there is a great deal more to be gained from being compliant and from doing the right thing. But because it is relatively new, it may be something that confronts you sooner than you may have anticipated. You are not quite ready for it.

Mr Gilbert—I will add there that IFSA had predecessor bodies, all of whom had guidelines and standards. One was the Investment Funds Association which in its formative years had to deal with the collapse of Estate Mortgage and others, so a lot of the standards that the old Investment Funds Association developed were in response to that failing and, to that extent, we have learnt from the past. But how can one predict the future perfectly?

Mr Naughton—Certainly the consultants do make known their opinions of the major fund managers and, if we were to be kicked out of IFSA or a manager was to be kicked out of IFSA, then the consultants would be aware of that and would probably make comment on it. If we went straight back two months later, I think there would be a few cynical views out there until they were happy, because their reputations are also at risk, independent of our reputations, if they are going to recommend the manager.

Mr Gilbert—The mere changing of senior management is enough to put a fund on hold or sell in our industry.

Mr Naughton—An example of that was when BT was for sale. The consultants generally all came out with a recommendation, 'Place on hold until we see who actually buys BT at the end of the day.' There was nothing untoward about that; it was simply the way the intermediaries reacted until there was certainty about what was happening.

Ms GAMBARO—You are saying the market will more or less control market information and knowledge?

Mr Gilbert—Provided it is near perfect and strong. That is the point. We have a lot of people poring over our figures.

Mr Naughton—There are different organisations, fund managers, trustees, industry associations, the consultants, as well as the regulators, who are all watching everybody else. Generally speaking, somebody will blow the whistle if there is something going on.

CHAIR—You may say this is hypothetical, but at what stage does the number of players become so few that you create a new problem? You mentioned the move to global conglomerates and some of them are absolutely huge. At what stage does government have to say, 'Hang on. There's too much concentrated with too few'?

38

Mr Gilbert—We have 70 members at present and IFSA's fee income relies on there being a large number of members. It is my fervent hope that we do not have a substantial conglomeration, an aggregation. However, you have to look at the industry worldwide, not just Australia. In terms of the world scene, it is still a very competitive market in terms of market size, number of market players. I think it is going to be a good way down the track before there is pressure. It is worth looking at the fund flows. We have one manager—who I will not name, if you do not mind, because it may be free advertising—who, two years ago, was probably No. 30 in terms of funds under management and is now up there at No. 10. It has jumped 20 places purely by good performance. It is a big international player but it is in Australia and growing very strongly. That is the sort of competition we have. If you can perform in funds management, you will achieve the business, regardless of your size.

CHAIR—Yes, I accept your point. But as you would appreciate, once the horse has bolted, so to speak, it is very hard for governments to catch it should the warning bells go off.

Mr Gilbert—When our numbers get below 20, then you would be worried. It is a long way off that.

Ms GAMBARO—On the membership, how do you levy your membership fees? Is it based on the size of the company or is it a straight membership fee?

Mr Gilbert—It is a fixed fee. There are three functional activities that operate in our industry. You do retail investment management—like unit trusts and cash management trusts—wholesale investment management and life insurance. They are the three dimensions. There is a fixed fee and then you are levied according to your funds under management in each of those three activities.

Ms GAMBARO—If they get bigger, you levy a greater amount.

Mr Gilbert—We have a maximum levy. But, interestingly, we are courting the small managers very strongly, because we believe the industry is only as strong as its weakest link. For that reason we want the smaller players in—and it is active board policy—so they do comply with the guidelines and standards. We are doing a marketing drive now to get those managers into our fold. It is not a lot of money; it is less than $10,000 to join for a smaller manager, which is small in comparison to the funds that are generated.

CHAIR—This is a casual observation. Are small or big managers performing better? Is there any difference?

Mr Naughton—Small managers can establish little boutique type operations and they can be very successful, because our industry is primarily a people type industry and, if you have a couple of really good people, they can get some fantastic performances—and that has happened. But what tends to happen is, after a while they hit a ceiling, because there is only so much that two or three people, the key players, can do. They can only handle so much. What will tend to happen is they do very well, hit a ceiling and then either they sit at that ceiling or they sell out to a bigger manager.

39

Longer-term big managers should be more consistent, more reliable and tend towards the average. You will get the smaller players that come and have a very stellar type performance, reach their peak and then perhaps come off. I think the studies we have done—we do it for our own marketing, of course—do not really point either way. Just because you are big or small does not necessarily prove that you will in the long term be substantially better.

Mr Gilbert—I will add there, Mr Chairman, that we have some small managers who in global terms are big managers. They are getting investment expertise and research from New York or London. They might not have a lot of funds under management in Australia, but their performance is up near the top. It depends on how you define a small or a big manager.

CHAIR—There is another point I want to go back to. You were talking about the importance of technological change in reducing systemic risks and market instability. Firstly, you might like

to expand a bit on that point and then also comment on the role of the Internet, because it can be rather difficult to regulate.

Mr Gilbert—In a retail or a wholesale sense? Would you prefer it consumer based or funds management?

CHAIR—Both, if you like.

Mr Gilbert—Let us take retail. Our take-up of Internet by the retail funds managers has been slow. The information is there, but the actual electronic commerce component has been slow, for the reason that we did not as an industry develop the appropriate standards and protocols to allow the transfers to take place—hence that super e-commerce project I was alluding to. The other barrier to moving it fast was electronic signatures. That has been something we have had to be very measured on, and understandably so. Once the super e-commerce project gets legs—and it has legs now—I think you will find that the Internet take-up is great.

Australian investors are not able, under ASIC requirements, to buy investments in retail funds offshore. There is a proscription on that. Even if it were allowed, the Australian investors, I suspect, would factor in their inability to be able to get at a defaulting party if they needed to. They would be on their own, unless they could get someone to represent them offshore, which I think would be unlikely. I do not think the Australian government would want to support somebody legally to do that. Domestically, if we get the right tax system, if we can get electronic commerce running in the superannuation environment, I think we will have a very strong retail electronic funds management industry. Do you want to add to that in the retail industry?

Mr Naughton—Where it is coming in is in trying to get more information more quickly to investors, so that if we have a problem it is becoming harder and harder to find. In the old days we might have had a month or two, or three months, before we had to report our performance. Now you virtually have to be out the same day or a couple of days later to say what your unit price is, so if there are any problems, it is going to become evident fairly quickly that you are underperforming or overperforming in the industry. From that point of view, it is just speeding up the whole information flow and education.

Mr Gilbert—Can I add there that something like 90 per cent of our managers now have daily unit pricing, which is driven by electronics. You could not have daily unit pricing if you did not have an electronic system. At 4 o'clock every day we can price the units as they are valued at Greenwich Mean Time—every day—and that is a result of electronic commerce. I think that is a very strong point. I can go into my retail fund—non-super and super—every night and see its unit price. Regrettably, not all super funds are like that. That is why I think choice of fund will be a critical development. In one of the super funds I am in, I get a report once a year. That is a long time between drinks. I think the best way of measuring performance is to have daily access or weekly access to the unit prices.

40

CHAIR—Does that encourage good investment policies?

Mr Naughton—That is one of the arguments the fund managers have always put up. Against the monthly surveys the consultants do, for superannuation we are trying to invest long term and if you are going to look at everything daily or weekly you can push towards short-term investments and not take longer-term views. I think that is a factor we have to build in. In itself, again, it comes back to education—provided people know what they are doing. Most of the people monitoring their daily unit prices are probably aware of the basic issues, therefore they are not going to be sidetracked from a share fund today because of a movement in price. They may well want to sell one or two individual shares but there is always an offset to that. The more information you have and the faster it goes out, the more educated your investors have to be so they do not flop around every day because of the latest buzz.

Mr Gilbert—Equally when I am reading the unit prices I am also looking at the one-, three-, five- and 10-year results for that fund, so it is a balance operation.

CHAIR—Sorry, I interrupted you. We have done the retail side and you wanted to—

Mr Gilbert—Yes. In the wholesale sense, as I said, 90 per cent of the funds now do daily unit pricing which is really predicated on electronic commerce. What we do not have as well as we might, perhaps, is electronic movement of funds. Would that be correct? Is that something we are developing?

Mr Naughton—It is happening more and more but, as Mr Gilbert said, there are a number of legal issues with actually signing on to prospectuses up-front. Generally speaking, if a superannuation fund in the wholesale environment wants information, they can dial up on our web page and they will find out what the value of their units is and what their current asset mix is. They may then say, 'Right, we want to move some money from Australian shares to Australian fixed interest.' At the moment we will not—at least in our case and I think it is generally true—allow them to actually transact that then and there, but they can see what they want to do and they can then place the order with us and we will transact and get back to them.

Mr Gilbert—Then to that you add the global straight-through processing which is a way of minimising that cyberspace time. That is something again that needs, I think, progress and strong support from the government and regulators.

Mr Naughton—The more technology we can put in place so that we know all of these cash flows the better. One of our big issues as investment managers is if money is moving in and out of the retail front end. In the old days there may have been a week or two weeks or three weeks lag before it actually went into somebody's bank account and the fund manager was actually told and could invest it. That time frame has been brought down. Again, with less time between when the investor says, 'Right, I'll put my money in here,' and when the person on the dealing desk can actually invest it, that reduces all of the risks involved as well and hence being able to get all of that information from lots and lots of sources consolidated into one figure and able to tell the share manager, 'Go and sell'—or buy—'a million dollars worth of shares.'

41

CHAIR—You touched on one aspect of the Ralph report. Was there anything else you wanted to say?

Mr Gilbert—This is time for advertising! We strongly support the government's decision of 22 February last year to announce that there will be such a thing as collective investment vehicles. For the sake of this industry, we would seek this committee's, and indeed the government's and the opposition's, support to ensure that as many of our vehicles as possible come under that regime. The last thing the industry needs is a massive restructure, having just been through GST, having just been through the Management Investment Act changeover, which were very costly arrangements when you are working on very thin margins. For many of our funds—as may well happen if we do not get a good result—having to restructure would be a very adverse outcome for the industry and something which will make it very hard for us to compete offshore with people coming in working under a better tax system.

We would put this case very strongly to the government. It affects listed property trusts as well. They are very strongly adversely affected in terms of how the structure is working. It affects wholesale managed investments and retail managed investments and it also affects life insurance companies. There we are working through a transition through tax on that where Ralph promised a one-third exclusion of fees during a five-year transition period. I think life companies and cigarette companies were the only companies to be hit with an increase in tax. Every other company is getting a tax reduction from 36 down to 30, which we applauded and which we strongly support, but by virtue of restructuring the life insurance tax arrangements, which are very complex, life companies will be paying another $400 million annually in tax, and we would want that cushioned. We are happy to move to the new tax system but we put to the government that we would like a cushioning for five years, which Ralph supported and which we would hope is delivered in the legislation which is due to hit the House of Representatives on 6 April.

CHAIR—Right. Thank you very much for that. That has certainly been very valuable. Thank you for the submission and for your time today.

Proceedings suspended from 12 noon to 1.37 p.m.

43

EDWARDS, Dr John Ker (Private capacity)

CHAIR—Welcome. This is a public hearing. I would remind you that the evidence you give at the public hearing is considered to be part of the proceedings of parliament and, accordingly, I advise you that any attempt to mislead the committee is a very serious matter, and could amount to a contempt. Would you like to make a brief opening statement before we proceed to questions?

Dr Edwards—Could I begin by apologising. I had hoped at this point to have a formal presentation. We have had this morning a typical incident in the relationship between Australia and global financial markets in that the Fed raised rates and we have been flat out all morning changing our views and presenting them to clients.

CHAIR—Do you want to give us some of your views, too?

Dr Edwards—I am happy to do so. It is one thing I have got off pat. As I said, I am here in my private capacity. I am the chief economist for HSBC Australia. In that role I have taken a keen interest in the issues of concern to this committee, but I do not purport at all to speak on behalf of HSBC, and I offer my views as those of an economist who is engaged in these areas.

I should say also that I have been commissioned by CEDA—the Committee of Economic Development for Australia—to head a project in which we will examine these issues and come up with an Australian perspective on enhancing global financial stability as a companion piece to a report from the parallel organisation in the US, the Committee for Economic Development. That activity, when we have finalised it, will I hope allow us to test private sector views in Australia very broadly on the issues before the committee.

Could I also say by way of introduction that I think the transcripts of the committee's hearings that I have read are very informative. As I was remarking before, I doubt there is a committee of the legislature in the world, other than on Capitol Hill in Washington, that would be as well-informed as this committee will be to make the Australian parliament be on these issues.

The background against which the committee is looking at these issues, of course, is one of—come July—nine years of uninterrupted success in the Australian economic expansion, characterised by a higher growth rate than has been obtainable in any of the G7 economies, including the US, and for the first time in our experience by consistent and high productivity growth which also, until recently, exceeded that of the US. I would make the point in respect of that record of success that much of it is dependent upon reforms in the economy that we have made here over the last 15 years. The intent of the bulk of those was to increase our openness to the global economy, and we have benefited hugely from those reforms—in particular, tariff cuts, float of the currency and deregulation of financial markets—as much from opening ourselves to the world as from changes we have been able to make internally, such as deregulation of the labour market and improvements to our taxation system.

I do not think there is any doubt—and I am sure there is none in the minds of this committee—that Australia's commitment as an economy to the globalisation process is irreversible. That said, we did see during the Asia crisis, the crisis in Russia, and the crisis that originated from Long-Term Capital Management in the US, that the current architecture of international financial arrangements is highly vulnerable, and did produce, in the case of Asia, a very severe outcome from which Asia is only just emerging. There is no doubt whatever that there are issues there that have to be addressed by the Australian parliament, despite the extraordinary resilience that the Australian economy itself displayed during that period.

44

I might just note in passing that our resilience is, in retrospect, if not surprising, at least worthy of closer examination. At the time of the Asian crisis we shared many of the vulnerabilities that posed a significant issue for Asian economies. Our current account deficit was around about the same size as Korea's, our debt was around about the same size as Korea's, and its maturity structure was not very different from Korea's, and at the same time our foreign reserves were, at that point, less than Indonesia's, so it was not an absolutely foregone conclusion that Australia would survive that period.

I am in complete unanimity with the view the Reserve Bank Governor has put to this committee, and which has been put elsewhere, that the strength of the Australian banking system was tremendously important—its strength and reliability, its success in internal prudential controls, and the success of its supervisory institutions—as well as the floating Australian dollar. Nonetheless, as the committee has heard, Australia did have experiences with hedge funds in 1998 which made the Australian currency very much more volatile than it needed to have been, which could—were they to have been more successful—have forced the Australian Reserve Bank into monetary policy actions that would have had a very unfavourable effect on domestic growth. Even though we escaped the capital inflow issues of the Asia crisis, we ourselves did demonstrate a vulnerability to the impact of highly leveraged institutions.

The committee has heard that in the aftermath of those events in 1997 and 1998 globally there was an agenda for reform developed, in particular in respect of highly leveraged institutions and in respect of capital flows, which grew steadily in volume, detail and dimension to quite awesome proportions over the last 18 months. I have to say as an observer of this process who, at the beginning of it, was very sceptical as to whether any coordination could be exercised, whether there were any mechanisms of global governance likely to pull this together and produce a result, that my pessimism and scepticism prove to have been unjustified. We are certainly a long way from achieving the outcomes which I suspect some members of this committee would wish to see, but nonetheless the activity generated over the last year has been formidable.

In a sense, your hearing is very timely because the Financial Stability Forum, I understand, has a meeting in Singapore on Sunday, so that we are now only a week away from publication of the final reports of this group, on which Australia is represented, on highly leveraged institutions and on capital flows, and an agenda for reform in that area that goes beyond the reforms already made. In my view, the way in which the contents of these FSF reports are handled by the world media, world legislatures and by global supervisory groups and the global investing community, will determine the outcome of the issues which have engaged this committee.

Certainly a lot remains to be done, a lot of which we can only gauge when we see the recommendations of these two working committees next week. But, in the meantime, an immense amount has happened, as you are aware. There is now a bill from Congressman Baker before the US Congress, which I see US Treasury Secretary Larry Summers was strongly supporting this week, which will extend a regulatory framework to highly leveraged institutions, hedge funds. Since these are primarily, if not legally, based in the US, are using US funds and have their offices and make their decisions in the US, the extension of a regulatory framework to these institutions to my mind brings us much closer to effective control.

45

The committee would also be aware of the anniversary review of the Brockmeijer report of the Basle Committee on Banking Supervision which eight weeks ago produced an assessment of the responses of global commercial and investment banks to the earlier recommendations on improvements in banking supervision and, in particular, the Brockmeijer anniversary review did record that in its view and in the view of the supervisory institutions which it represents and which operate in the G10 countries, commercial and investment banks and supervisory institutions in those countries had vastly improved their game in respect of risk assessment of credit extended to highly leveraged institutions.

I would make the point, as others no doubt have to you, that whilst at the end of the day we may not have reliable regulatory control over highly leveraged institutions, we do have more confidence in the credit risk assessment by investment and commercial banks which extend credit and maintain the leveraged positions of hedge funds and a lot of the activities which were so perilous to the Australian dollar in 1998 have become difficult to operate. We have seen movement there.

We have seen a great deal of movement from the IMF—not as much as some people would have wished, but we have seen additional funding. We have seen the creation of a facility for a pre-approved line of credit that would be available to nations, which means that nations which are following good economic policies will have some protection against stampede and contagion of the kind we saw in 1997. We have also seen the IMF willing to loan into arrears, which effectively means, as I understand it, that recipient nations do not need to requite all their obligations to private sector lenders before the IMF will participate in a restructuring.

We have also seen the US President's task force which came up with very forceful resolutions or recommendations on highly leveraged institutions and investment banks. We have seen the Bank for International Settlements produce a new set of recommendations for capital adequacy weighting which may—we have yet to see the outcome—reduce the preference that commercial banks inevitably have for loans of one year or less, and we are seeing activities in a number of other groups of almost blindingly confusing acronyms.

Could I very briefly foreshadow the direction that CEDA is taking as a research group representing the Australian business community, by way of conclusion to this statement. Whilst the recommendations have not been finalised and have not gone through the CEDA approval process, I think it is fair to say that the CEDA view will end up endorsing with enthusiasm the recommendations made globally for greater transparency, for greater disclosure, for better risk

management by investment and commercial banks globally and for more stringency in credit risk evaluation.

Moving into somewhat more contentious areas, I think CEDA will go along with the new G7 view—which marks a departure from the former IMF orthodoxy—that there are circumstances in which particularly developing countries may, quite properly, impose capital controls on inward-bound capital certainly. I think CEDA will be inclined to support the extension of regulatory frameworks to highly leveraged institutions and will support the capital adequacy recommendations of the BIS which go to removing the preference for short-term loans. The issues that CEDA will find more difficult, as this committee I suspect will find more difficult, are those at the more radical end of the spectrum for reform—that is, are there mechanisms for bail-in the private sector in loans to developing countries that would prevent contagion and stampede, and is there a proper role for collective action clauses in bond agreements that would also prevent bond loans from being withdrawn in the same circumstances? Thank you.

46

CHAIR—Thank you, Dr Edwards. You have covered an enormous amount of material in that so-called brief. It was excellent, thank you. You have given the committee a lot of very valuable information. You said 'bail-in'. Do you mean 'bail-in' or 'bailout'?

Dr Edwards—Bail-in. The idea is, instead of allowing private lenders to bail out of a situation, you force them to remain; a very difficult issue for commercial banks.

CHAIR—I would say, if you do want to make a submission to the committee later, of course it would be well received.

Dr Edwards—Thank you, yes.

CHAIR—I want to go back to one of the earlier points where you were talking about Australia's position at the beginning of the Asian crisis and how we had some similarities with countries that did not weather it too well and yet we did come through it a lot better, for various reasons. There was an article on the back page of the *Financial Review* yesterday which tried to imply that there was a convergence of a whole lot of issues that allowed Australia to do it, rather than some of the more accepted views like the ones you put today. Did you see the article?

Dr Edwards—No.

CHAIR—It listed a whole lot of things that had converged for the Australian economy at the right time, like the demutualisation of the AMP and a number of other issues. The inference from the article was that there was more luck than good management there.

Dr Edwards—I think that is partly true, Mr Chairman. There is another aspect to that which is the fact that we were unaffected—we were not subject to contagion and stampede, as Korea was, although Korea had externally similar characteristics—due to the soundness of the banking system. However, the fact that we grew faster during the Asian crisis than before, or for that matter since, is entirely fortuitous and it does, I think, rest on a conjunction of factors, one of

which was privatisation but the main one of which was that for completely serendipitous reasons the Reserve Bank had embarked upon an easing of monetary policy one year before the crisis broke and its easing had ended, for other reasons, just as soon as it broke. We were carried forward on this surge of domestic demand which meant our growth rate was quite spectacular.

CHAIR—You were talking about the move in the US Congress by Congressman Baker. Could you expand a bit on that bill?

Dr Edwards—I have not seen a copy of the bill.

CHAIR—What its intentions are.

Dr Edwards—The basic idea, as I understand it, is to implement some of the recommendations of the President's task force which reported in the middle of last year. I understand the bill has the support of the US treasury and, to a lesser extent, the support of the US Federal Reserve—which is much more, I think, sceptical of the utility of this kind of regulation. But the broad idea, as I understand it, is to bring within the supervisory net highly leveraged institutions which at the moment, as you know, are generally registered in Nassau in the Bahamas, although they operate out of New York.

47

CHAIR—Thank you for that. When we talk about globalisation, how much does it reduce a government's scope for independent economic policy? I am looking at what sort of additional disciplines it is placing on governments nowadays that were not there, say, 15 years ago.

Dr Edwards—It is a very difficult question, because in some respects Australia has acquired more control over policy, or perhaps different sorts of control, from other changes it has made. For example, the float, whilst it has made the currency susceptible to determination by outside forces, has restored to us control over interest rates so that we can, as we do at the moment, run monetary policy to some extent independently to the rest of the world. In some respects our control over monetary policy instruments has been increased, but I think in general we are in the midst of a very long-term process in which all major economic decisions are going to be made by shifting coalitions of nation states, regulators, global institutions and we are not as yet aware of how this pattern will develop—for example, will it always be led by the US? This episode over the last year has been very revealing in this respect. Can it be done by coalitions, of which the US is a member, but in which other quite minor players like ourselves can importantly participate, as Ian Macfarlane and Peter Costello are participating in this?

CHAIR—I will ask one more question and then I will hand over to the members. You have talked about Australia having nine years of very good growth and, I guess, the globalisation and freeing up of the economy has had a lot to do with that. The question does arise, though, with this move to globalisation of whether it is, in fact, creating a bigger gap between the haves and the have-nots in the world. Is there a risk that we are going to find countries getting further behind, or is it going to work the other way?

Dr Edwards—In respect to the world, it is hugely beneficial to poor countries. China is a very good example but also, let us say over the last 20 years, all of South-East Asia. Korea is

soon to be restored as a fully-fledged and successful OECD economy, Singapore now has average incomes exceeding ours. These are countries which were quite poor 20 years ago and which have been enriched by their participation in the global economy. Within a country, as within this one, I do not think there is any doubt whatever, as you suggest, that globalisation does encourage inequality because it appears to be rewarding skills at a global pay scale, as it were, and paying lack of skills, again, at a global pay scale. That is increasing inequalities between Australian incomes; even at the middle we are getting greater stratification, let alone at the bottom and the top. This is a big issue, I think.

Mr PYNE—I am interested in what you said about whether future globalisation would be led by the United States every time. The history of world foreign policies up until the end of the Second World War, the history of balance of power foreign policy and, as Henry Kissinger calls it, 'raison d'Etat' or each national interest determining foreign policy: I am interested in whether you think there is the potential in the future for there to be economic balance of power arguments between other countries that are not as powerful as the United States but seek to group together to make themselves as powerful as the United States so, therefore, there is not an imbalance in the world's economic power. Do you think there is some potential for that down the track, or is it happening now?

48

Dr Edwards—I do think there is a huge conceptual difference between the kinds of considerations you apply to security affairs and those you apply to economic affairs. Security affairs are principally issues that go to the heart of the balance of power. It is about the balance of power, it is about protecting territory and discouraging the existence of coalitions which are capable of dominating your territory, whereas economic globalisation really is about creating a single global economy in which, over time, nation states are deprived of former functions. Even within a decade I think we will be having a debate about what nation states are and what they do.

Mr PYNE—That is my point.

Dr Edwards—This would include the US.

Mr PYNE—Sure. But if, theoretically, boundaries between nations are no longer important and, therefore, balance of power at a foreign policy level is no longer important and the focus of everyone's attention shifts to economics, then isn't there potential for the same sorts of arguments to shift to economic empires, if you like? Or do you think that, because the boundaries will be so porous, the United States will be only as powerful or less powerful than the particular transaction that is being conducted at any one particular time?

Dr Edwards—No, what I really mean is that the only economic power of successful globalisation is achieved by merging your economy with others.

Mr PYNE—So there will not be any boundaries in economics or politics, theoretically?

Dr Edwards—There will be, because—

Mr PYNE—There will always be on paper.

Dr Edwards—we still feel Australian, Americans still feel American. It is not just cheering for a particular football team, it is an entire culture that will be resilient. A perfect example is this inquiry where you are assembling a very good transcript, developing insights, becoming well informed about an issue over which the Australian parliament has very little legislative authority, but it is vital that you should do so because this is part of how we participate in global decision making in this area.

Ms GAMBARO—Dr Edwards, with respect to capital controls, you were speaking a little about capital bail-ins. Can there be a greater role for the private sector in times of economic crisis in countries where they can play a part in a financial crisis situation? Or is it solely the role of government to see a country through its bad patch?

Dr Edwards—It is a very difficult issue for commercial banks. Certainly it was a very difficult issue in the Asia crisis where so much of the funds that were withdrawn were withdrawn by commercial banks. I will make three or four points in relation to that. One is that inevitably the private sector does participate. Whilst offshore lenders were assisted by IMF participation, nonetheless offshore lenders in the Asia crisis lost countless billions of dollars. All banks which were participants lost quite a lot of money, so banks do not get off scot-free. Another point is, whilst we talk now about the bail-in of the private sector lenders as a new policy development, in fact it has been characteristic of all financial crises that I can recall from the early eighties onwards, where the commercial banks participating, for example, in loans to South America—Argentina, Brazil—were forced to roll over by their regulator—in that instance, the US Fed.

49

Ms GAMBARO—Yes.

Dr Edwards—Similarly in Mexico, similarly in Korea, where the US Fed and other central banking supervisors obliged offshore lenders to roll over their debt. The argument is really: are there ways of setting this sort of thing up in advance? There is certainly a strong point of view amongst commercial banks that commercial bank lending cannot take place if it is subject to an unknown trigger of indefinitely extending the duration of the loan in circumstances in which the bank would be unable to even negotiate. I think that is the difficulty that global supervisors in commercial banks are now encountering.

Ms GAMBARO—When a nation is in crisis, is there some sort of early warning signal or something that can alert private investors to what is going on or does it just happen spontaneously, at the moment? There are people that come in and invest in these crises who take over undervalued companies, and then you have the bail-outs.

Dr Edwards—Yes.

Ms GAMBARO—Has Malaysia done anything differently regarding capital controls, or have there been any other countries that have successfully introduced capital controls? Or is it something that is done begrudgingly?

Dr Edwards—Of course, we used to do it, and quite successfully, and Chile I think continues—or may recently have abandoned—exactly the forms of capital controls that we used to impose through the seventies. Malaysia, I think, is the only successful example in the Asia crisis, Russia being the unsuccessful one, where they attempted to impose controls on the short-term exited funds and the whole thing crashed.

Ms GAMBARO—Would you say that would be the worst example?

Dr Edwards—Yes.

Ms GAMBARO—The Russian situation?

Dr Edwards—Yes. The big difference between them is really that Malaysia's current account deficit support was primarily coming through equity liabilities—that is, Japanese firms went in there and built factories which they could not take away—whereas Russia's was entirely short-term obligations.

CHAIR—Speculative—

Ms GAMBARO—So there was greater capital investment.

50

Dr Edwards—Absolutely—speculation on the idea that the IMF would bail them out, and it did not.

Ms GAMBARO—So there was greater capital investment in Malaysia of the type that was long-term capital investment—

Dr Edwards—Foreign direct investment—that is right.

Ms GAMBARO—where it was a short-term situation.

Dr Edwards—Yes.

Ms GAMBARO—Thank you for that.

CHAIR—Just come back to that situation in 1998 when the hedge funds were giving the Australian dollar a hard time. Do you think we are now in a stronger position to be able to withstand that, or have things improved in other ways for the better so that that could not be repeated?

Dr Edwards—What is probably highly likely true is that hedge funds are in a much weaker position to impose it, for two reasons. Firstly, commercial banks and investment banks are far more stringent in the imposition of risk assessment and credit standards than they were prior to the collapse of long-term capital management. Secondly, hedge funds, partly because of this new stringency by lenders, have lost their aura. They did have, particularly in 1998, the ability

to suggest to markets that their funding was limitless and they could hold a position forever, and go further. Once that was believed then ordinary trade in our currency—which is importers and exporters and so forth—just goes to the sidelines, leaving it to the big guys. That reputation has been damaged, perhaps not irrevocably, but given that we are likely to see more regulatory interest going forward, I think that sort of situation is less likely. It is certainly true that although the currency now is quite low—under 61c today—we do not detect any serious hedge fund activity driving it down.

CHAIR—Are you saying that because they have lost their aura, they have also lost their strength or their power to really go after the currency of a smaller country? Or is that something where they can regroup and we will see another form of it reappear in a year or so's time?

Dr Edwards—I do not think they are able to leverage as much as they did because they are not getting funding to do it, but certainly given the current regulatory framework I do not think you can assume they will not be back. Of course, to a very large extent we would wish to see hedge funds remain in the markets as participants because they do provide liquidity and deepen the market.

Mr PYNE—The Asian financial crisis has been a great impetus to establish international regulatory frameworks and cooperation between the regulators of different countries. Would you like to comment on those attempts and whether Australia is playing the role that you think it should play in international regulatory frameworks or seminars or any of the things that the IMF have established, or whether there is more that we could be doing.

Dr Edwards—So far as participation in the global framework is concerned, we are doing very well indeed. I do think we are punching above our weight.

51

Mr PYNE—We do seem to be on almost all the key bodies, don't we?

Dr Edwards—Yes. I mentioned earlier the Financial Stability Forum meeting in Singapore on Sunday, and I believe the Governor of the Reserve Bank is going up for that. It will be producing two public reports next week which I think will be the key to the next move in the agenda of issues which concern this committee, and Australia will have made a very important contribution to it. You can find out as much about those sorts of issues reading the testimony of this committee and talking to the people who provided testimony as you could anywhere in the world, which is good for Australia's ability to exercise influence on those things.

I do think there is an issue as to whether we have figured out a way of integrating this new influence that Australia has acquired in this global issue with other ways in which we go about our business of influencing global outcomes. For example, this whole thing seems to be proceeding with no input from the Department of Foreign Affairs and Trade. That may be inevitable but I do think that if we are to fully use the kind of leverage that that gives us, then we need to let it flow through the Canberra bureaucracy more widely than it does.

Mr PYNE—So you think it is mostly coming out of the Reserve Bank and the Treasury?

Dr Edwards—Absolutely, yes.

Mr PYNE—The Reserve Bank Governor gave evidence to another inquiry earlier this year on this subject of international financial markets and we talked to him, obviously, about that recent decision to increase interest rates. One of the things he talked about was Australia's role in many of these global organisations. He did largely state the case that the Reserve Bank had the momentum behind it, backed by Treasury. He did not actually mention Foreign Affairs and Trade once, which ties in with exactly what you are saying.

Dr Edwards—Yes.

Mr PYNE—I assume that you believe that Australia is being listened to and encouraged to be part of most of the smaller committees that deal with this because of our weathering of the Asian financial crisis, or do you think that it is a long-time recognition of Australia's regulatory framework being one of the better ones in the world?

Dr Edwards—I think the truth is that within this time zone the Reserve Bank of Australia would be probably the most highly regarded.

Mr PYNE—Who does that include? Japan?

Dr Edwards—In my own view, that would include Japan, Hong Kong and Singapore—the only serious candidates. Hong Kong has an excellent monetary authority but it is a fixed exchange rate and it is a totally different operation from the one that we follow—or Europe or the US—so that they are part of a different conversation. The Bank of Japan I think is going in the right direction but, for example, it does not have monetary targets and it has not yet demonstrated its independence from government. Singapore is, again, not an independent authority and does not have the same weight of research capacity as the RBA. Australia does have the capacity—and the RBA demonstrates it, and also our earlier role in APEC demonstrated it—to exercise an influence merely through quality of thought. That is what I think the RBA has been able to demonstrate, certainly backed up by your other point that we do have a record of success during the Asia crisis.

52

Mr PYNE—I guess we are of a size that is not intimidatory to many other countries, so they are prepared to let us take the lead on issues.

Dr Edwards—Yes.

Mr PYNE—Whereas if they sit back and let the United States take a lead on issues, they feel that they are being patronised, perhaps, by a great power.

Dr Edwards—Yes.

CHAIR—Just on the Asian crisis, one of the things that was interesting—and I suppose disturbing in some ways—was the contagion effect.

Dr Edwards—Yes.

CHAIR—Are we in a position today to say that we have better safeguards against that occurring again?

Dr Edwards—In Asia?

CHAIR—Yes.

Dr Edwards—We do at the moment. One powerful reason is that it is in such recent memory. Commercial bank lending into Asia has not resumed. In numbers it is still negative; that is, commercial banks are still being repaid from previous loans, and they are not extending any new loans. Capital funding into Asia, into the most affected economies from the last episode, is primarily IMF or World Bank money, or foreign direct investment, or—increasingly—portfolio equity flows, but it is not commercial bank lending, which was the most volatile element in the previous withdrawal, so in that sense it cannot recur quickly.

Whether it can recur in the long term I do think depends very much on how much of this agenda we have been discussing is ultimately adopted. A good part has been. Many more things have happened as a consequence of the Asia crisis than happened as a consequence of the Tequila crisis in 1994, or the Latin American debt crisis of the early eighties. The global response has been quite extraordinary and probably unprecedented in the degree of cooperation in the activity engendered—documentation, meetings, proposals—and every now and then in the adoption of proposals. I think a critical test of your question, Mr Chairman, is the way in which the two reports from the Financial Stability Forum next week are implemented.

CHAIR—We have spoken a lot about the benefits of better transparency and more openness, better control of the risks and so on. What are the downsides of this?

Dr Edwards—Of transparency?

53

CHAIR—Yes.

Dr Edwards—The main downside of transparency is that we expect more from it than it can ever possibly deliver. We had the example of Brazil and Argentina in 1998 which really could not have been more transparent about their monetary and fiscal policies or the daily state of their reserves, and this merely signalled to the market how desperate things were becoming. It is notorious, for example, that after the Tequila crisis the IMF promulgated new standards for disclosure and transparency which, just prior to the Asia crisis the deputy director, Mr Fisher, then stated, as I recall, had been widely accepted, yet that whole sequence of events occurred nonetheless. I think the real problem with transparency is that people expect too much of it.

CHAIR—They expect it to solve too much, yes.

Ms GAMBARO—We spoke to the Investment and Financial Services Association earlier about the effect of virtual simultaneous transactions and their real-time gross settlements—faster settlements. What sort of an impact does that have? Does it make things more

r settlements. What sort of an impact does that have? Does it make things more unmanageable for regulatory authorities? What does it do?

Dr Edwards—Real-time gross settlement just reduces risk all round. It means that one bank cannot be as deeply affected by the failure of another bank because it has no outstanding dealings with that bank.

Ms GAMBARO—So the lag time is reduced.

Dr Edwards—Yes.

Ms GAMBARO—And that lead-time risk is minimised.

Dr Edwards—That is right. Therefore, as the RBA or APRA would say, the systemic risk is reduced. You will always have the risk that any one financial institution will collapse, which is not all that important. What is important is if the collapse of one institution leads to the collapse of all the others, which is systemic risk.

Ms GAMBARO—Yes.

Dr Edwards—To the extent that you have real-time settlements then that risk is reduced.

Ms GAMBARO—Are smaller firms more vulnerable in this situation? Are there any downsides to it, basically, or all round do you see it as a very positive thing?

Dr Edwards—Very positive but none of these things are completely positive if people are excluded from them who would be able otherwise to participate in that market.

Ms GAMBARO—Thank you for that, Dr Edwards.

CHAIR—Can we get back to your subject of this morning. I was wondering if you could give us your summary of it all, and the impact.

54

Dr Edwards—Yes. The Fed has tightened rates a quarter of a percentage point and this is the fifth tightening in a row. The market has responded ebulliently. The Dow had a record overnight and US interest rates have fallen, all but the very short end, and here too, and the Australian dollar—paradoxically—is stronger. There was a weakening just as I left the room, so I am not sure where it is now, but there has been, on the whole, a paradoxical reaction. That arises from two circumstances. One is that the less informed parts of the market I think feared that the Fed would raise rates a half a percentage point rather than a quarter, so it was a relief in that sense. And amongst the more informed parts of the market, particularly in respect of the long end of the currency, of the yield curve, the fact that the US Fed is continuing to tighten means that ultimately the US has to slow down, and therefore credit demands will fall, so rates fall.

CHAIR—So you are pretty upbeat about it?

Dr Edwards—No. I think it does pose a bit of a problem to have these paradoxical reactions. It just means that it has to continue tightening until it does get the slowdown that it wants, which ultimately we will get.

CHAIR—Dr Edwards, thank you very much for that. That has been extremely valuable for the committee. We really appreciate your coming here, the time you have taken and the frank way you have given us your views on this subject. It really has been a very valuable contribution.

Dr Edwards—Thank you very much.

[2.35 p.m.]

56

CLARE, Mr Ross William, Principal Researcher, Association of Superannuation Funds of Australia

SMITH, Ms Philippa Judith, Chief Executive Officer, Association of Superannuation Funds of Australia

CHAIR—I welcome the representatives of the Association of Superannuation Funds to today's public hearing. I remind you the evidence you give at the public hearing is considered to be part of the proceedings of parliament and accordingly I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt. The committee has received your submission numbered 5 and it has been authorised for publication. Are there any corrections or amendments you would like to make to the submission?

Ms Smith—No. There is an addition we can provide to you and I will leave that with the committee.

CHAIR—We can accept that now and have it authorised for publication, if you like.

Ms Smith—Yes, okay.

Resolved (on motion by **Mr Pyne**, seconded by **Ms Gambaro**):

That this committee authorises for publication the addition to the submission.

CHAIR—Would you like to make a brief opening statement before I invite members to proceed with questions?

Ms Smith—Yes. The point we are making is a relatively simple story in a sense. It relates mostly to your reference 2 and the issues about reducing volatility in terms of international markets. The view we have is that Australia can best take advantage of opportunities provided by globalisation and reduce the risks of that globalisation by running sound domestic economic and social policies. In particular, we would see the potential of volatility being largely linked with the short-term and long-term net indebtedness to overseas parties, the link being that the higher level of domestic savings we see as reducing the risk of that indebtedness. Within that context, superannuation is playing an increasingly important role in terms of household savings and, as you would be aware, super now stands at $415 billion and the future projections have it growing to about $1,300 billion by the year 2015. That is largely compulsory savings kicking in to its full extent.

To the extent that voluntary savings can be made to be higher for superannuation or compulsory savings are made higher, of course that would increase the pool of savings that is available. For the record, that $415 billion is already playing a fairly important role in the Australian economy. The super fund holdings represent about 25 per cent of the All Ordinaries Index as it

stands and superannuation now stands as the major form of household savings, second to housing. Housing is still up there as the number one form of savings.

Mr PYNE—What is the percentage? Do you know the percentage of households versus superannuation?

57

Mr Clare—Domestic housing is about 50 per cent of household wealth, superannuation is about 20 per cent of household wealth and rising, and then the other bits and pieces are bank accounts, interest bearing or shares.

Mr PYNE—I just wanted to see what the proportions were.

Ms Smith—Yes. The benefit of superannuation as opposed to housing is that it is a pool of money that is available for investment strategy generally, rather than just being a more fixed asset that people are holding. Household savings as an overall figure, you would be aware, are at a historic low level—about one per cent or slightly less than one per cent, and some predictions are saying it will weaken—and that, I think, does mean that other strategies in terms of reinforcing household savings do deserve some merit and consideration. The other thing to bring to your attention is the high level of transactions or engagement vis-a-vis Australia's turnover in foreign exchange markets. Australia is ranked about ninth in world order in terms of foreign exchange turnovers, but in terms of our GDP we are ranked about 14th.

The heavy turnover you might say at one point equates with efficient operation. It is not necessarily a bad thing in itself but it is a potential source of instability and volatility. To the extent that there is any weakness in currency or equity value, we are susceptible to the external shocks that are there, so our message is that we see superannuation as already playing a significant role, but potentially it could play a more significant role in terms of giving a savings and investment pool for the Australian economy and, perhaps to the extent that we can enhance that, it reduces the need for business and others to look to international debt in terms of their borrowings and investment strategies.

The other major point we are bringing to the table is the diversification of superannuation investments more generally. As I already indicated, of that $415 billion there now in super, about 40 per cent is invested in shares and that in turn makes up 25 per cent of the All Ordinaries Index, if you follow the circle. Nineteen per cent all up is invested in international markets. We would say that is a good thing. We are not suggesting caps or anything like that because it is a necessary part of the super funds finding diversification and maximising their returns for the final retirement income payout. The Australian market has about one to two per cent of total world investment opportunities, so put in that context it is a useful thing for some element of the funds' investments to be in other countries apart from Australia.

Hedging is used as a mechanism to some extent by funds, but it is a relatively small part of super funds strategy and, indeed, the guidelines that are in play by the ISC—which were put in place in 1997—govern the use of derivative transactions by funds. Those regulations give pretty strict conditions and they require that the level is small and that it is disclosed and, if it is used,

there are risk management strategies in play. If it goes above the five per cent mark of their investment, then it has to be fully disclosed by their annual reports and the like.

That is by way of background. It is a fairly small part of the strategy of funds at the moment. We are certainly not proposing any caps be put on that. My belief is that it will continue to be a small part of the strategy of funds. My belief also is that with good disclosure and good prudential controls—which I think we have—it goes to increasing the confidence in both superannuation funds and the Australian economy, which hopefully promotes investment in Australia more generally. What we are bringing to the table is a little bit of a picture and background as to what we see as being an increasingly important part of the Australian economy.

58

CHAIR—Thank you very much for that. By way of background, what is the linkage between your association and IFSA and when there is a policy matter, how do you resolve it if there is a difference?

Ms Smith—We are the peak association for the superannuation funds, so we cover all sectors of the superannuation funds. We have in membership, going across the full spectrum, the corporate sector, the public sector funds, the industry funds, the retail and service providers. Through our membership, the funds control about 80 per cent of the superannuation assets and we have in membership a bit over 80 per cent of members—or public—in the funds. IFSA is coming more from the retail sector managed fund portfolio and insurance base, so there is some overlap of membership, mostly at the retail end. They have about 60 members all up. The overlap is in that section of the retail, so they would not be covering the other sectors of the superannuation industry.

Mr Clare—They do represent some parts of the finance sector that we do not represent: the straight fund managers and—

Ms Smith—Fund managers and the insurance companies. To the extent that the insurance companies have superannuation interests, there may be some overlap there.

CHAIR—In your opening remarks you were talking about the high level of turnover of the Australian dollar in the foreign exchange markets as a possible source of instability. Could you offer us a reason why that turnover is so high in the Australian dollar? Is it a problem? You mentioned the instability question.

Mr Clare—There is both cause and effect. With some other currencies you can see a fairly rational reason for them being traded to a great extent. The US dollar is a common currency for trade. The Australian dollar, in terms of our exposure to world trade, is probable a little bit higher than our GDP weighting. As a country we do trade a lot, so that brings us up into the more traded area. It is also a reward for being different from some of the other countries. We are quite resource intensive in terms of our exports, primary produce, minerals. The composition of our exports is different from the US, the UK and Japan, for instance, so if people are interested in dealing with the consequences of currency movements that differ from those other major currencies, the Australian currency is the obvious port of call.

There are a number of reasons why I can see it getting traded above our natural weighting and some of those commodity reasons are quite important, just in terms of the natural tendencies of the producers to want to hedge their positions, the tendencies of the buyers. We also are running quite a large current account deficit. We receive quite a large volume of overseas investment, both short and long term, so all those factors contribute to the relatively heavy trade in the dollar A. It is getting out of my area of expertise these days for where we are precisely in the scale, but I think those factors are important.

CHAIR—In your submission you are talking about the need for an increased level of transparency. What do you see as the inadequacies of the current system?

59

Ms Smith—To put that into context, I think the steps that are being taken are useful. If you look at recent history, there were some nasty shocks for some of the international areas in understanding the real risk and accounting issues that were relevant in different countries. I have some doubts as to whether they will ever be fully resolved at an international level. As I was indicating, getting our own house in order is an issue of confidence and importance for us as a whole and I think we are doing not too badly on that front, particularly given the APRA. If I talk about our own area, the APRA area of requirements for disclosure around the derivatives is fairly strict.

Mr Clare—Some of the examples of inadequate disclosure have related to international operations and organisations which may operate in some Australian financial markets but tend to have domiciles in the Cayman Islands or other spots where the governments are not very interested in requiring disclosure of any sort. We have also seen some problems in a number of more developed, more regulated countries with their banking sectors and emerging exposures to the loans attained by some of these groups. The Australian system does not seem to have had those sorts of problems in recent years. If you go back a few years there were certainly some cases where Australian banks had too high levels of exposure to some organisations, not so much in the international context—we seem to have more domestic borrowers going astray rather than it being tied up with the international transactions—but the lessons from that episode have not been forgotten yet.

Our regulatory structure and the operations of APRA in regard to the major deposit taking institutions require sound prudential practices and the protection of the interests of the public in terms of where the deposits go. I think there will always be problems when there are other people operating. If they obtain their funds through direct partnerships, loans around the world or make use of banking systems where levels of disclosure and prudential requirements are less, then there will be a problem. The Australian system still has some gaps and the operation will always be difficult if someone does not want to disclose, but we have a very sound framework in place.

CHAIR—What particular gaps do you see still there?

Mr Clare—It comes back to the nature of some of the derivative instruments and a matter of pricing them. The exposures through derivatives can be more problematic to report on a continuous basis because their value is contingent on developments. You may have a very small

exposure, given a certain level of pricing in either a currency or a commodity but, if there are adverse developments, that exposure can change. It also comes down to how much disclosure deposit taking institutions should make about who they lend to and what you can do with that information. The downside of disclosure is that it can give you too much information. And what do you make of it? Disclosure of significant events seems to be more of a useful thing, but then you have to determine what is significant, rather than the complete client list of a bank, for instance, where you might be able to decipher something about every client. It is difficult to get to that stage where you only have that significant information disclosed.

Ms GAMBARO—Following on from that, are there any perceived advantages in information sharing between regulators, in your opinion?

Ms Smith—In my view, yes, it makes sense if it can be achieved. If we are talking about a global market and the interlinks that are occurring, yes, we would support that.

60

Ms GAMBARO—We were talking about too much disclosure having an adverse effect.

Mr Clare—I think disclosure between the international regulators is more focused and it is a more expert audience. The downside or the shortcoming of that information sharing is that it normally occurs after the horse has bolted.

Ms GAMBARO—Yes, unfortunately.

Mr Clare—And fair enough, too, in a way. I do not think an Australian regulator wants to know the ins and outs of all the dealings of the American regulator, except when it becomes of relevance to Australia. Normally that becomes apparent when the horse has bolted and an overseas entity is under stress or going into default; then it may come down to what the strategy is for dealing with the defaults or the weaknesses that have occurred. The international regulators seem to be struggling with the prevention in the first place. There we do have some jurisdictions which do not provide as much support as others and those who engage in speculative behaviour and are perhaps the ones where disclosure would provide the greatest benefits are the most secretive and resident in the most inaccessible spots. So in terms of the behaviours which will give rise to problems, they tend to shy away from regulators.

Ms GAMBARO—For obvious reasons.

Mr Clare—Yes. International cooperation can help, but they tend to shy away from the regulators.

Ms GAMBARO—They are not the first ones to put their hands up. You touched briefly on accounting standards in your submission. What is your view at the moment on accounting standards? Again, you have probably covered it in different ways by disclosure. Do we have enough accounting standards in this area or, in your opinion, are there any weak links that can be improved?

Mr Clare—Again, I think it is around the edges of the core interests of the superannuation industry. It comes back to some of these difficulties in pricing to market exposures in various ways and also it is a matter of enforcement and interpretation. If accounting standards were strictly complied with and in the spirit of them, then many things would be disclosed. But as we see from the aftermath of collapses, there has often been some creative accounting along the way. Sometimes it is a function of the accounting standards not perhaps requiring notification or separate identification of certain developments, but it can often be an unwillingness to comply with the intent of the standards. Sometimes it can be avoided through devices, sometimes the auditors should have picked it up.

I am not sure I would want to offer improvements on particular accounting standards, other than the disclosure of material events. The implications for the financial situation of an entity is very important for outsiders to understand what is going on. All we can do is commend the efforts of those who have the very difficult task of trying to improve them. It is not for a lack of trying; it is the difficulties in conceptual terms and also in the application of those to actual behaviours, because you do not always have goodwill and willingness to comply with the intent.

61

Ms GAMBARO—I can understand that. Thank you very much.

Mr PYNE—Is ASFA a member of any international organisations to do with superannuation?

Ms Smith—We certainly have a lot of interaction. There is not an international association, at this point in time. There potentially will be. I am going to a meeting later this month with the view of setting up an international association.

Mr PYNE—What relationships do you have with commensurate organisations in other Western nations?

Ms Smith—It is largely between our research centres where we have quite an active email dialogue and sharing of information with a lot of the British, Canadian and US associations. ASFA is a little unique in having such a broad spread of members. In most other countries it is more a segmented nature of interests.

Mr PYNE—Do you have any comment to make about Australia's performance in international terms regarding regulations and regulation authorities and the efforts they are making now post the Asian financial crisis to coordinate better between regulatory authorities?

Ms Smith—No. I do not feel equipped to draw such a broad canvass. The structure that we have in superannuation areas, particularly with the SIS legislation and APRA, have proven to be quite strong and quite useful. Again, superannuation in Australia is a little unique because of the compulsory superannuation arrangements and the way that the private sector in fact invests and manages those funds and, with that, brought the frame of regulatory structures that we have in Australia, which is increasingly being looked upon as a possible way forward for the US and a number of other countries.

Mr PYNE—Do you have any anecdotal examples of where you have known other organisations such as yours to have picked up the framework that they have experienced here in Australia, that they know is in place in Australia, for managing their own superannuation?

Ms Smith—The US at the moment is actively looking at the Australian system.

Mr PYNE—Do you have counterparts in research centres asking questions?

Ms Smith—Last week there was a delegation here from the UK, wanting to look at both the frame of the Australian superannuation system and some of the regulatory issues. Poland comes next week; Kazakhstan came about a month back. The UN and others often look at the structure that Australia has around the superannuation system as being representative of best practice. It is often cited as that. We know the structure is there. We are conscious of some of the things that are not being used to their full extent and looking at ways of reinforcing the three pillar structure and reducing some of the complexity that has built up over the years but, overall, I think the general frame is a good one.

Mr PYNE—The Kazakhs, Poles and British people who have come are representing whom? Do you know where they are from exactly?

62

Ms Smith—Largely they are parliamentary delegations.

Mr PYNE—Have they met with you?

Ms Smith—Yes.

Mr PYNE—And others as well.

Ms Smith—Yes.

Mr PYNE—To advise about our structures.

Ms Smith—Yes.

Mr PYNE—So not necessarily people from the same organisations, like yours, in those countries, but parliamentarians?

Ms Smith—Largely the delegations have been parliamentary delegations.

Mr Clare—None of them are at the stage where there is an industry. Their parliamentarians are visiting to have a look at moving from basically totally government funded schemes to ones where there is a greater private sector involvement, so that is why they are coming to visit. Once there is that greater private sector involvement and a range of providers, then the opportunity will arise for a greater role for associations. The UK has a bit of a tradition of employer schemes, corporate schemes. They have a national association of pension funds which comes

out of that background. The US are all over the place, as they are wont to be. There are different providers of different products and they have more research groupings than representative or lobbying groups. After that, many of the countries have not got to the stage where they have an industry structure that would generate an industry association. It had a domination of a government role in the provision of retirement incomes. Those schemes are starting to suffer as a result of demographics and rising costs and problems for government. They are looking at the solutions. Australia gets quite a few visits; Chile and some of the South Americans do as well.

CHAIR—Could we come back to the question of the regulation of superannuation. Some people are critical that Australia has grown like Topsy, that it is very complex. Is that a reasonable criticism, compared with other countries?

Ms Smith—I suppose that was what I was trying to distinguish before. In terms of the frame that we have of what we call a three-pillar system—age pension as a safety net, the compulsory savings and voluntary savings—it is regarded as best practice. Equally, the regulatory structure that then was built around that in terms of prudential controls and the SIS legislation is regarded as solid and a good frame. But the criticism, I think, has come about because of the increased taxation complexity that has developed over the year and the ongoing tinkering with some of the smaller administrative and procedural and legislative rules, the preservation and some of the grandfathering that has occurred. We are the only country that has a tax on contributions, a tax on earnings and a tax on benefits. We are the only country that taxes at every point of life of super.

63

Those are the things that have built up the complexity and the criticism about super. There is in fact—from the research we have done—a very high level of support of super and, indeed, of compulsory super, surprisingly. People understand the need. What is eroding that confidence is a concern about the complexity of it, people no longer being able to understand it and a feeling that there are too many government hands in the honey pot. That is the story. It is a bit of a paradox. We can be very proud of the structure we have, but we have been eroding it over the years.

Ms GAMBARO—Just on superannuation, you said you were going to get together and form some cooperative international type of body. Are you able to give me a bit of insight into the United States and their policies on superannuation? In comparison to the United States model do we still have the best practice model?

Ms Smith—I think we do in terms of the structure because the structure that we have, with an element of compulsory savings being managed by the private sector rather than just an accrual base and with adequate prudential controls around that, means that the money is being actively invested and therefore it is growing at a much faster rate than just being set aside as a bookkeeping liability in the government coffers.

Ms GAMBARO—With the tightening of the social security system do you anticipate an increase in the uptake of super in the United States?

Ms Smith—Yes. They have their model of 401K, which is largely an incentive plan arrangement. What you have to realise though in superannuation is that any changes in policies and incentives have long lead times. Perhaps the biggest issue being debated in the USA at the moment is the need for government to use some of the money it has now to do away with the foreshadowed accrued liability that is there and for that money to be invested by the private sector. That is what they are trying to come to grips with at the moment.

Mr Clare—The 401K products are much simpler in taxation terms and more attractive than the Australian system because, basically, you are allowed a deduction for contributions to the 401K and it is taxed on the way out. That is a nice, simple model that is attractive for people and that is driving the growth there.

Ms GAMBARO—So you get hit once by tax on the way out. The tax man is good to you on the way in and bad to you on the way out. It is only in the one hit.

Ms Smith—Yes.

Mr Clare—It is nice and simple.

Ms Smith—That is our preferred model. If you look at the barriers, one is the cloudiness of the incentives. Superannuation is still tax advantaged but it is hard for people to understand that and make any sense of it because of the arrangements in place and the incentives having been squeezed over time. Our research shows that it is the tax at the contributions start-up that is the real barrier for people. Our preference would be for an exempt-exempt tax model which has the full advantages of getting the money in, the money growing in an accumulative sense and then for it to be fully taxed on the way out. You can deal with the equity issues much more fully at that point.

Ms GAMBARO—You may not be able to answer this but, offhand, do you know the tax rate on the way out in the US, or could you give us that information?

Ms Smith—I think it is the marginal rate, isn't it?

Mr Clare—It would tend to be just the straight marginal.

Ms GAMBARO—Thank you.

CHAIR—Thank you very much.

Resolved (on motion by **Ms Gambaro**, seconded by **Mr Pyne**):

That this committee authorises publication, including publication on the parliamentary database of the proof transcript of the evidence given before it at public hearing this day.