Reviews of the 1995-96 Annual Reports of the Reserve Bank of Australia, Australian Securities Commission and the Insurance and Superannuation Commission

Report from the House of Representatives Standing Committee on Financial Institutions and Public Administration

September 1997

The Parliament of the Commonwealth of Australia

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FOREWORD

This report covers the reviews of the 1995-96 annual reports of the Reserve Bank of Australia, Australian Securities Commission and the Insurance and Superannuation Commission. This is the first year that the Committee has examined each of the Commonwealth financial regulators. The Committee considered it necessary to extend the review process because of the continuing trend for issues to cross over the traditional regulatory boundaries.

In the past the Committee has identified the growth in financial conglomerates as requiring a new approach to regulation and the Government's response to the Financial System Inquiry has borne out that concern. The Committee intends to continue this broad focus on the financial system and will be seeking to ensure that proposed new regulators continue to be accountable to the Parliament and the community.

The report canvasses a range of issues but the highlight was the first appearance by the new Governor of the Reserve Bank, Ian Macfarlane, to report on the conduct of monetary policy. This arrangement, whereby the Governor reports to the Committee twice a year, was agreed between the Governor and the Treasurer. This process is a very significant step in ensuring that the RBA is accountable for its conduct of monetary policy, and the Committee appreciates the positive approach adopted by the Bank. This is an example of how Parliament can assist the financial markets and the community to become more aware of this important aspect of economic management and to ensure that issues of public concern are given appropriate attention.

I thank members of the Committee for their participation in the conduct of the reviews and in the preparation of this report. The Committee extends its appreciation to Ian Macfarlane, Alan Cameron and George Pooley for their support and contributions to this process.

David Hawker MP
Chairman

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TERMS OF REFERENCE

The Standing Committee on Financial Institutions and Public Administration is empowered to inquire into and report on any matters referred to it by either the House or a Minister including any pre-legislation proposal, bill, motion, petition, vote or expenditure, other financial matter, report or paper.

Annual reports of government departments and authorities tabled in the House shall stand referred to the relevant committee for any inquiry the committee may wish to make. Reports shall stand referred to committees in accordance with a schedule tabled by the Speaker to record the areas of responsibility of each committee.

ACRONYMS AND ABBREVIATIONS

APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
ASC	Australian Securities Commission
ASX	Australian Stock Exchange
ATO	Australian Taxation Office
AWOTE	Average Weekly Ordinary Time Earnings
CASAC	Companies and Securities Advisory Committee
GDP	Gross Domestic Product
ISC	Insurance and Superannuation Commission
RTGS	Real Time Gross Settlement
RSA	Retirement Savings Account
RBA	Reserve Bank of Australia

RECOMMENDATIONS

1 That the Australian Prudential Regulation Authority be required to appear before the House of Representatives Standing Committee on Financial Institutions and Public Administration at a public hearing once a year to report on prudential supervision of the financial services industry. (paragraph 2.88)

2 In order to encourage private investment in small business enterprises, the Treasurer review the rules governing the issue of prospectuses with a view to reducing the costs and complexity of preparing a prospectus for small and medium companies. (paragraph 3.15)

CHAPTER ONE

REVIEW OF ANNUAL REPORTS 1995-96

Introduction

1.1 The House of Representatives Standing Committee on Financial Institutions and Public Administration has a long standing interest in the banking and financial services industry. The Committee considers that continued parliamentary oversight of developments and issues in the financial services industry can make a valuable contribution to public debate and policy making. In response to the increasing complexity of the financial services industry and blurring of the regulatory framework, the Committee resolved to examine each of the major financial industry regulators for which the Commonwealth has responsibility.

1.2 This report covers reviews of the annual reports of the Reserve Bank of Australia (RBA), the Insurance and Superannuation Commission (ISC) and the Australian Securities Commission (ASC).

1.3 In particular, the opportunity to discuss issues of current concern with the Reserve Bank is important from an accountability perspective. While the RBA publishes its views and comments on a wide variety of matters, the opportunity for scrutiny of the Bank's responsibilities and activities is limited. The Committee has been reviewing the RBA's annual reports since 1993.

1.4 The ISC has appeared before the Committee on one previous occasion and the ASC has not appeared before the Committee in the past. It is intended that both the ISC and ASC will now appear before the Committee each year to provide an opportunity to canvass a variety of issues, thus building on the accountability process developed over recent years with the RBA. Having each regulator (or their successor following consideration of the Wallis report) appear before the Committee provides an opportunity to more fully canvass issues in the financial services industry than has been possible in the past.

1.5 The authority for the Committee to inquire into matters arising from annual reports derives from standing order 28B(b) whereby the annual reports of the RBA, ISC and ASC stand referred to this Committee for any inquiry the Committee may wish to make.

1.6 In addition, in August 1996 the Treasurer, the Hon Peter Costello MP, issued a *Statement on the Conduct of Monetary Policy* which extended the accountability framework for the Reserve Bank. As part of that framework the Governor is to report twice a year on the conduct of monetary policy to this Committee. As part of this reporting process the Bank has

modified its publication of quarterly reports on the economy and financial markets and will now publish a *Semi-Annual Statement on Monetary Policy*[1] to coincide with its appearances before the Committee.

1.7 This examination of the three annual reports is a public process, although it is not intended to be as comprehensive as an inquiry into a specific reference. The Committee regards this process as a means of monitoring a wide variety of issues. If a particular matter gives cause for serious concern, the Committee has the option of following it up at the next round of report considerations, or it can seek a specific reference and conduct a more detailed inquiry.

Conduct of the reviews

1.8 The Committee conducted two public hearings with the RBA. The first in Canberra on 12 September 1996 and the second in Sydney on 8 May 1997. The second hearing was the first appearance by the Governor to report on the conduct of monetary policy in accord with the *Statement on the Conduct of Monetary Policy*. Public hearings with the ASC and ISC were held in Sydney on 29 January 1997 and in Canberra on 10 February 1997 respectively.

1.9 In addition to the transcripts of evidence, the Committee has also published a number of submissions from each of the regulators responding to written questions provided by the Committee (see Appendix 1 and 2).

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1 Reserve Bank of Australia. May 1997. *Semi-Annual Statement on Monetary Policy*. Sydney, RBA, 33p.

CHAPTER TWO

RESERVE BANK OF AUSTRALIA

Introduction

2.1 The Committee held two public hearings with the RBA, the first focussed directly on matters arising from Bank's annual report 1995-96. The second hearing arose from the Treasurer's *Statement on the Conduct of Monetary Policy* and focussed primarily on monetary policy. The public hearings covered the period over which Bernie Fraser completed his term as Governor and Ian Macfarlane's appointment as the new Governor. Future appearances by the Bank will take place in May and November each year.

2.2 The RBA plays a central role in setting and administering monetary policy in Australia. In the course of this review the Committee canvassed a number of matters related to monetary policy and economic conditions. This report touches on a number of issues that the Committee considers relevant for comment. As the two examinations were eight months apart, the report covers the evidence taken in relation to monetary policy at the appearance in September separately from the May appearance related to the *Semi-Annual Statement on Monetary Policy.*

Monetary and fiscal policy

2.3 This section of the report deals with the evidence taken at the September 1996 public hearing.

2.4 The Bank advised that it approves of the progress towards reducing the budget deficit, endorsing moving the budget into surplus as an effective way to raise national savings. While not making any comment on the fairness or otherwise of the measures that have been employed in reducing the budget deficit, the RBA stressed that fairness is important in fiscal and monetary policy matters.[1]

2.5 With regard to the current account deficit, the Bank maintained that it is not an impediment to faster growth. The former Governor, Mr Fraser, advised the Committee that the current account deficit was 4.2% as a percentage of GDP last year and is forecast to be marginally lower at 4% this year and that this is not impacting on the exchange rate or interest rates.[2]

2.6 In commenting on the impediments to growth, the former Governor noted that inflation and the current account deficit are the two traditional constraints that have caused growth to slow down in the past, but not at present. More investment, higher productivity and more employment are factors that will increase growth and that even though economic growth was good at the time, there is room for faster growth given the spare capacity in plants and in the labour market. However, it was noted that '...there are judgements about the

1 Evidence pp 7-8.
2 Evidence p 36.

risks...associated with forcing the pace, just as there are risks in not doing enough to keep it going.'[3]

Unemployment

2.7 The RBA advised that despite the relatively strong growth forecast for 1997 the unemployment rate was forecast to decline only marginally over the year ahead, and to remain at about 8.25% in mid-1997. When asked to make a realistic objective for reducing unemployment, Mr Fraser noted that reducing the level of unemployment was dependent on a number of factors that go beyond monetary policy but that he saw no reason why 'we could not be aiming to get down to five or six per cent'.[4]

2.8 The RBA also expressed the view that wage increases are under control as evidenced by the recent reduction in interest rates and the movement of inflation back into the 2% to 3% range.[5] Adding that, on average across the whole economy, a wages increase of 4% to 5% would be consistent with keeping inflation in the 2% to 3% range.[6]

2.9 In reference to the Accord and the new industrial relations legislation, Mr Fraser expressed the view that the Accord had contributed to wage restraint and lower inflation and that the new legislation would enhance prospects for growth insofar as it continues the process of relating wage increases to productivity increases. The Governor went on to say that it is not the changes to industrial relations legislation that will drive the necessary improvements in productivity, it will be the competitive forces that come from the Australian economy now being more open and subject to global competitive pressures.[7]

2.10 The annual report noted the concentration of unemployment in certain groups in the community, stating that '...there is a role for training and other programs targeted at groups figuring prominently among the unemployed'.[8] Mr Fraser said that the most effective thing that the bank itself can do to help reduce unemployment is to sustain a good rate of growth but that skills are changing rapidly with technology and growth may not be sufficient if the unemployed do not posses the skills and experience to fill the new jobs. What the annual report was saying was '...that properly targeted training and other labour market programs can...complement the creation of growth and the creation of more employment opportunities.'[9]

Interest rates and inflation

2.11 The RBA said that the interest rate cut of half a percentage point at end July 1996 was made because the benefits of a little insurance against a faltering economy outweighed any risk that inflation might kick up unexpectedly (See also para 2.35). As to the factors causing

3 Evidence p 37.
4 Evidence p 8.
5 Evidence p S4.
6 Evidence p 8.
7 Evidence p 20.
8 *Reserve Bank of Australia Annual Report 1995-96*. 1996. Sydney, RBA, p 13.
9 Evidence p 36.

the RBA to consider that the economy could falter, the Bank identified the possible slowing of the world economy.[10]

2.12 What prompted the reduction in the interest rate was the lack of improvement in the level of unemployment over the last 12 months and, as inflation was set to come back within 2% to 3%, it was considered that there was minimal risk in trying to ensure that growth would be maintained. The former Governor's view was that '...maintaining growth is the best way to sustain employment and thereby reduce unemployment.'[11]

2.13 With regard to the time taken for the effect of interest rate changes to be reflected in the economy, the former Governor advised that there can be an immediate effect on confidence. However, it does take time for the lower interest rates to be reflected in consumers' decisions to borrow to build a house or to get a car and that it takes even longer for businessmen and businesswomen to decide whether the lower interest rate environment is going to affect their investment decisions. 'There is a whole array of effects that start from the time the change is announced that run through perhaps for 12 to 18 months.'[12]

2.14 When making a pre-emptive move the RBA is looking forward to how it thinks the economy is likely to develop over the year ahead in terms of employment as well as wages and prices and how they might impact on inflation. The RBA makes judgements as to what it thinks might happen and adjusts monetary policy accordingly.[13]

2.15 When asked about the role of fiscal policy in the Bank's deliberations on monetary policy, Mr Fraser noted that they factor in what they thought might be in the budget and what its likely impact might be, but changes in fiscal policy do not have a major influence on the decision to change interest rates. The problem with fiscal policy, according to the Governor, is that while it impacts on activity, you can never be sure of the direction of that impact A reduction in the budget deficit will have a negative effect on government spending and a positive effect on the private economy.[14]

2.16 It was explained by the RBA that monetary policy, rather than fiscal policy, would be the instrument used when there is an unexpected shock to the economy. The impact on interest rates of fiscal policy (and monetary policy) is felt over the medium term, a sustained reduction in the budget deficit or a move into surplus will reduce the risk premium in longer term interest rates, these rates are determined by the market not the Reserve Bank.[15]

2.17 In reference to the impact of outcomes from changes to wage setting arrangements on inflation, the former Governor noted that the critical factor was the average level of wage increases across the whole economy. Under a centralised system it is relatively easy to get a picture of what is happening, it is more difficult to appreciate what is happening in the one-third of the economy where enterprise bargains are operating, the third where there are award

10 Evidence p 9.
11 Evidence pp 9-10.
12 Evidence p 13.
13 Evidence pp 13-14.
14 Evidence p 14.
15 Evidence pp 18 and 24.

systems and the remaining third where there are contract systems with executives. This however, is only a monitoring problem.[16]

2.18 If the average wage is to remain consistent with the inflation objective it may mean that if new enterprise bargains are turning out average increases that push up Average Weekly Ordinary Time Earnings (AWOTE), other parts of the work force will have to settle for much smaller increases.[17]

2.19 The Committee enquired whether, given the importance of inflation, the RBA thought there was room for Australia to publish monthly inflation figures as they do in the US. The RBA said it did not think that publishing monthly inflation figures would be useful as the figures jump around a good deal and would not improve the quality of decision making.[18]

Conduct of monetary policy

2.20 As noted earlier, in August 1996 the Treasurer issued a *Statement on the Conduct of Monetary Policy* (the Statement) which extended the accountability framework for the Reserve Bank. As part of that framework the Governor is to report twice a year on the conduct of monetary policy to this Committee. This section of the report canvasses discussion at the 12 September public hearing and the first report on monetary policy by new Governor, Ian Macfarlane on 8 May 1997.

2.21 At the September hearing the Committee canvassed the purpose of the statement issued by the Treasurer. The then Governor Designate, Mr Macfarlane, responded that the main purpose of the statement on the conduct of monetary policy was to formalise what is in the Act (*Reserve Bank Act 1959*), that the Reserve Bank has responsibility for monetary policy.[19] In other words, a clear statement that the Reserve Bank conducts an independent monetary policy. The other purpose was to have the inflation target endorsed by the Government.

2.22 When asked if the statement changed the RBA's interpretation of the Act, Mr Macfarlane said that it did not. The Bank's focus on an inflation target has been in place for a number of years and recognised that monetary policy can have an impact on inflation, 'but in the very long run, it cannot make the economy grow faster and achieve lower unemployment.'[20] Although Mr Macfarlane noted that if not handled properly, monetary policy can have adverse short term effects on unemployment and that is why the Bank uses a flexible inflation target. The major long term impact the Bank can have is to maintain low inflation. Mr Fraser advised the Committee that he felt the statement endorsed what was already in the Act, but would be concerned if inflation was 'more to centre stage.'[21]

2.23 The Bank's *Semi-Annual Statement on Monetary Policy* was released to the Committee at the public hearing on 8 May 1997. It is not the Committee's intention to repeat the detail of what was in the Statement in this report, but instead to note a number of the

16 Evidence p 17.
17 Evidence pp 17-18.
18 Evidence p 16.
19 Evidence p 10.
20 Evidence p 11.
21 Evidence p 10.

significant matters raised at the hearing. The Statement was widely distributed and copies are available from the Reserve Bank.

2.24 The Statement reported that GDP grew by around 3% in 1996 and underlying inflation was at about 2%, and while noting that growth in 1996 slowed, it represented the fifth year of economic growth. The Governor characterised the slowing in the growth rate as a mild mid term slowing. The Bank anticipated growth in 1997 would be at 4%, due to a projected increase in consumer demand, an upswing in residential construction and an overall increase in investment.[22]

2.25 With regard to employment, the Statement identified reasonable prospects for growth in employment, to help what Mr Macfarlane described as '...a lacklustre labour market.'[23] Although it should be noted that labour force figures had not given a clear indication of trends over recent months.

2.26 Inflation had peaked at 3.3% and had come down to 2.1% and it was this trend that had made possible the easings in monetary policy in the second half of 1996. The declining trend had been influenced by slower growth which resulted in increased competition and constrained price rises. Another factor was the strengthening Australian dollar. Mr Macfarlane also cited domestic costs and wages as significant factors over the longer term and the appreciating exchange rate as an additional factor over the short term.

2.27 The Bank expects low inflation to continue over the next year, though it was stressed that containing growth in labour costs will be a significant factor in future inflation outcomes.

2.28 The Governor also specifically addressed the inflation target, making the point that the target has helped reduce inflation expectations in the community and internationally. The latter point is important as this impacts on long term interest rates. The Governor also stressed that the existence of a target does not mean that attention is not paid to employment, advising the Committee that '...we do because our charter requires us to, but more importantly because it is sensible to do so.'[24] In working towards this objective, the Governor advised that the best way the Bank can assist employment growth is to encourage strong growth over extended periods, longer than has been the case in the recent past. This objective of extending periods of growth is a major theme in the statement.

2.29 Another theme in the Statement is that of wages growth. The Bank draws attention to the link between wages growth and inflation, expressing concern about the possibility that wages growth is accelerating. It points out that most other developed countries now have rates of inflation similar to that in Australia, but that Australia stands out in that low inflation has not yet translated into lower wage growth.[25]

2.30 The impact of the exchange rate on lowering inflation was also canvassed in the Statement. The Bank attributed most of the recent strengthening in Australia's trade-weighted exchange rate to the weakness in the Japanese yen and the yen's large share in the

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22 Evidence pp 42 and 57.
23 Evidence p 43.
24 Evidence p 44.
25 Evidence p 45.

trade weighted index, a reversal of which would place upward pressure on the Australian dollar.

2.31 The Committee asked the Governor whether an appreciation in the yen would have serious consequences for inflation in Australia. The response was that the growth in the trade weighted index has been significant since 1995 and some reduction would not be of great concern. 'We accept that the Australian dollar goes up and down around a flat trend.'[26]

2.32 The report also addressed interest rate developments, specifically the longer term rates set in capital markets. The fall in 10 year bonds to 7¾% was attributed to the fiscal position and low inflation. The point was also made that the fall is not only in absolute terms but also relative to those overseas, citing the narrowing of the difference with US bond yields from 250 basis points to 100 basis points.[27] Interest rates have fallen across the board, not just for housing loan mortgages, business loans have fallen by 1½% since mid 1996. As a result demand for credit across all sectors is growing at about 10% per annum.

2.33 Fiscal policy was raised by the Committee on number of occasions. The view expressed by the Bank was that the fiscal position does influence long term interest rates, stressing that the fiscal position should be viewed over a long term ie it does not mean that the Budget has to be balanced or in surplus each year.[28]The Bank made the point that the main role for fiscal policy is to ensure sound government finances, providing a basis for confidence in economic policy and contributing to national savings.[29]

2.34 In the course of the hearing labour force figures for April were released, they showed that unemployment remained at 8.7%. In light of what the Governor had said earlier about the prospect for continued low inflation and the strength of the dollar, he was asked whether there was now room for a further easing in monetary policy. The Bank acknowledged that it was interested in trying to bring down the rate of unemployment, advising the Committee that:

> It is quite clear; we agree with everyone that if you have got inflation of 2½% and unemployment of 8¾%, the thing that needs to be improved is the unemployment not the inflation.[30]

2.35 The Governor went on to reiterate that the Bank's objective is for a long lasting expansion, pointing out that at the moment things are under reasonable control while expressing some concern over wages. The Governor's view was that the Bank anticipated 4% growth for 1997 and that there was no cause for further easing of monetary policy. Elaborating on this matter, the Committee was advised that there was no one piece of data the Bank was looking for to indicate the effect of earlier easings in monetary policy, the assessment goes on continuously.[31] The Committee notes that the Bank eased rates by 0.5% on 23 May and again by 0.5% on 30 July, making a total interest rate reduction of 2.5% since 31 July 1996.

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26 Evidence pp 53-54.
27 Evidence pp 46 and 61.
28 Evidence p 61.
29 Evidence p S8.
30 Evidence p 64.
31 Evidence pp 64-66.

2.36 There was further discussion of the nature of the unemployment problem. Unemployment was described as having two components, one influenced by aggregate demand policies and the other '...which is structural and which is more a function of institutional arrangements.'[32] The Governor continued to stress the need for a longer period of growth than in the recent past, suggesting that it would be possible to get unemployment down to the low period of the 1980s of around 6%, although the Governor said that he did not want that treated as a target.[33]

2.37 There were a number of other issues discussed at the 8 May hearing, these are dealt with elsewhere in this report.

Small business

2.38 The Committee canvassed the perceived difficulties small business has in accessing finance and the interest rates applicable to small business. The view of the RBA is that once small businesses get started they do not have problems getting access to finance. They may pay a bit more for this finance but that is because lending to them carries a higher risk than lending to other borrowers.[34] The Committee intends to follow up on the matter of the risk margins applying to small business when it reviews the Bank's 1996-97 annual report.

2.39 While the funds management industry is growing more quickly than bank deposits, bank deposits remain a very stable proportion of GDP. As household borrowers are moving away from banks to tap into that pool of managed funds, this creates more funds for banks to lend to small business. Lending to small business is becoming the banks' bread and butter.[35]

2.40 This matter was also pursued at the 8 May hearing. The Governor expressed the view that competition is now entering a phase where small business needs are being addressed. He said that the reason it has taken so long for competition to focus on small business is that this is the hardest form of lending. The evidence of competition is beginning to show through: the Bank noted that, while the cash rate is 1½% higher than it was at the absolute low in 1973, the indicator rate for small and big business lending is now only a ¼% higher than it was then. The Governor was of the view that the competitive pressures evident on mortgage lending three or four years ago are now emerging for small business lending.[36]

2.41 When asked if this would involve other credit providers becoming involved in providing finance to small business, the Bank's response was that it would come from the banks themselves. Returning to the earlier theme of reduced margins for mortgage lending, the point was made that regional banks were suffering a decline in their ability to focus heavily on mortgage lending and were now turning to small business.

2.42 The Bank also noted other areas of competition such as banks going after specific areas of the market (particularly those where the risk of failure is judged to be relatively low) where these borrowers are being offered attractive terms for secured lending. Competition is also coming in the form of new products, such as discounted rates for new borrowers, which

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32 Evidence p 67.
33 Evidence pp 71 and 73.
34 Evidence p 19.
35 Evidence p 25.
36 Evidence p 49.

are similar to the 'honeymoon loans' offered to mortgage borrowers in the past. There is also some attempt being made to provide loans through mortgages which are then securitised, although there was doubt expressed by the Bank at the extent to which this is possible.[37]

2.43 The issue of banks often requiring the security of a mortgage was also explored. The response again stressed that small businesses will always be a difficult lending proposition, particularly very small business. In the case of very small and new small businesses, security of a mortgage was probably inevitable due to high failure rates and the fact that the idea of lending against cash flows for such businesses is not viable.[38]

Bank profitability

2.44 The annual report noted that the return on equity after tax was about 16% which is relatively high by international standards.[39] The RBA was asked whether it was concerned that the profitability of Australian banks is too high. The Bank advised that this was not a concern because:

- the banking sector has only had a couple of years of good profitability after recovering from their problems in the early 1990s by building up their reserves and reducing bad debts; and

- the competitive pressures coming into play, ie mortgage originators, will start to bite into the levels of profitability enjoyed by banks in the last couple of years. Margins are coming down in the housing lending area and this will flow through in time to lower profitability.[40]

2.45 Competition is expected to reduce bank profits. It has reduced margins on housing lending from over 4% to a little bit over 2% over the last three or four years and, with the increased focus on small business, is also affecting margins in small business.[41]

2.46 Recent studies conducted by the Bank, prompted by this Committee, have shown that bank interest rate margins were higher than the average of other comparable countries. On the other hand bank non-interest income - fees and charges - was lower than the average of those other countries.[42] The Committee considers that there has been a lot of change since the work on margins was done by the Bank in 1994. This is an issue which will be focussed on in the consideration of the Bank's 1996-97 annual report, particularly rates applying to small business and credit cards.

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37 Evidence p 51.
38 Evidence p 88.
39 *Reserve Bank of Australia Annual Report 1995-96* op cit p 42.
40 Evidence pp 27-28.
41 Evidence p 31.
42 Evidence p 28.

Future regulatory arrangements

2.47 The two hearings with the Bank took place before and after the Financial System Inquiry chaired by Stan Wallis reported. The Committee took the opportunity on both occasions to canvass the RBA's views on future regulatory arrangements.

2.48 At the September hearing the RBA told the Committee that if there was a desire to reduce the number of regulators, it would make sense to have the RBA continue to supervise the banks and to take on the supervision of other deposit taking institutions, such as credit unions and building societies. These institutions have similar prudential requirements to the banks. It would mean taking on responsibility for some 300 institutions and would require extra work, but it could be done, for little threat to the systemic viability of the financial system.[43]

2.49 The payments system has traditionally been the responsibility of the central bank and should stay with the central bank, says the RBA. In every country in the world the central bank is at the centre of the payments system.[44]

2.50 In response to whether regulating the function rather than regulating the institution is desirable, it was put to the Committee that there are two types of financial product available, they are:

- products such as deposits and life insurance where the public puts money in and expects to get that money back when required. Institutions accepting deposits have to remain solvent and the only way to supervise those products is to supervise the institution, this is prudential supervision; and

- the other product type is the sort provided by the funds management industry, where the investor is taking the risk, hoping for a high return but knowing that in any particular year the return may be low or even negative. This type of product is regulated by ensuring adequate disclosure is made of products on offer.[45]

2.51 The RBA's view was that the existing regulatory system works fairly well. The outcomes have indicated that the system has grown and evolved. The banks have been able to move into new fields such as funds management, and insurance companies have been able to own a bank. New developments and innovation have not been blocked by the regulatory system. It is a flexible system and at the same time maintains the necessary safety and soundness for the core parts of the system which are important for financial system stability.[46]

2.52 This issue was canvassed again at the 8 May hearing following the release of the Wallis report.[47]

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43 Evidence p 29.
44 Evidence p 30.
45 Evidence p 32.
46 Evidence pp 32-33.
47 Financial System Inquiry 1997, *Final Report*, (Stan Wallis, Chairman), AGPS, Canberra

2.53 The Bank advised that it had no difficulty with most of the recommendations and the system as proposed by Wallis would work, however, '...we are more comfortable with a model where a central bank supervises the banks.'[48]

2.54 The Governor made the point that the proposed model anticipates a significant role for the central bank through its responsibility for financial system stability. While this does not imply detailed supervision, in the event of a significant failure, the RBA would be expected to address that situation. The implication of this is that the RBA will have to duplicate the proposed Australian Prudential Regulation Authority (APRA) to some extent.[49]

2.55 The Governor also expressed some concern over the timeliness of a response to a situation requiring immediate attention. This is because it would require the coordination of two bodies 'because the new supervisor would not have a balance sheet, would not have a cheque book, whereas we would still retain the lender of last resort facility.'[50]

Cheque clearance

2.56 In response to a number of representations made over the time taken to clear cheques, the Committee sought information on the cheque clearance cycle from the RBA, the Australian Payments Clearing Association (APCA) and a number of banks. The responses have been published as submissions.

2.57 Despite the impact of new technology and predictions of a decline in the attractiveness of cheques, writing cheques continues to be popular. It is a flexible form of payment which can be revoked, can be sent through the mail and is a facility available to all customers. The RBA advised that in 1995 about 4 million cheques were processed each business day with a total value of about $25 billion.[51]

The cheque clearing process

2.58 The following is a brief description of the process for clearing cheques.[52]

2.59 When a customer deposits a cheque the customer's account is credited, but the funds cannot be accessed until the bank is satisfied that the cheque will be honoured. While the funds cannot be accessed, interest begins to accrue (if payable) or interest liability is reduced if the cheque had been paid into an account which is in overdraft.

2.60 That evening the cheque is transported to the bank's data centre and sorted according to the bank on which they are drawn. Cheques drawn on the bank in which the deposit has been made should be processed immediately. The sorted cheques are then exchanged, this should happen on the same day, although distance can be a factor. The cheques should then be processed and the data centre should debit the customer's account (same day as deposit).

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48 Evidence p 79.
49 Evidence pp 80 and 83.
50 Evidence p 80.
51 Evidence p S77.
52 For further details see Evidence p S 80 - Australian Payments System Council Information Paper, *The Cheque Clearing Cycle.*

2.61 The total value of exchanged cheques are agreed between banks and the net values are advised to the Reserve Bank (by 3.00am in Sydney). At 7.00am, each bank is advised of its obligations and receipts from the clearing system. At 9.00am the RBA posts entries to the Exchange Settlement Accounts ie value is exchanged and the cycle is complete. However the bank at which the cheque was deposited still does not know if the cheque will be honoured.

2.62 On the second day, cheques drawn on bank's branches will be delivered to the branches for verification of signatures and other details (distance can add time to this process). If the debit would overdraw the account, a decision to pay or dishonour is then made.

2.63 Dishonoured cheques are notified to the bank at which the cheque was deposited by returning the actual cheque. This should have occurred by day 4 or 5, although the Commonwealth Bank advised that an APCA survey showed that dishonours can take between 3 to 8 days, the average being 4 to 5.[53] It is after this period elapses that access to funds is generally given. The actual period is a matter for judgement by each bank.

2.64 From the responses received by the Committee, the waiting time for access to funds does not vary a great deal between banks, generally they are as follows:

- one day for cheques drawn on Commonwealth/State government departments;
- two days for cheques drawn on the same branch as the deposit account; and
- five days for other cheques.

2.65 All banks offer special clearance facilities which attract a fee.

Electronic presentment

2.66 The Reserve Bank supports the view that banks should take advantage of the benefits technology offers with respect to processing cheques. The APCA is currently developing a set of industry standards for the electronic presentment and dishonour of cheques. The RBA expressed some disappointment at the slow progress. Comments were sought from the banks and the APCA on what were the main impediments to the development of a common industry standard for the electronic presentment and dishonour of cheques. It would appear that significant progress has been made and that some bilateral pilots may commence this year. There are significant potential benefits, the RBA suggested that the proposed arrangements should allow a reduction of a least two days in the period before depositors can access funds.[54]

2.67 High value cheques will eventually (1998) be dealt with through the Real Time Gross Settlement (RTGS) system. The purpose of this system is remove interbank settlement risk from high value electronic payments. All high value payments will be settled on a payment by payment basis rather than netting for payment the following day. High value payments represent approximately 65% of the value of cleared payments.[55]

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53 Evidence p S31.
54 Evidence p S 76.
55 Evidence p S 78.

Costs associated with cheque processing

2.68 The cost of clearing cheques is significant, Wallis estimated the cost of cheques processing at between $1.50 and $3.00. It was also noted earlier that when a cheque is deposited, the funds cannot be immediately accessed but interest begins to accrue. Banks generally advise customers that interest is payable in their "terms and conditions" documentation.

2.69 A related issue commonly raised with the Committee is that by holding onto customer's funds longer than is necessary, the banks are able to take advantage of the difference in the interest available on the short term money market and that which they are obliged to pay on customers accounts. The RBA advised that the time taken to clear cheques gives rise to a pool of funds which banks can invest, generally on the short term money market at a rate of interest in excess of that paid to customers. This proposition is not accepted by the banks, some of which maintain that there is no float.[56] This is an interesting point given the emphasis now placed by banks on recovering costs, the Committee will be exploring this matter further at the next review.

Other matters

RBA's commercial operations

2.70 In the course of discussions the Committee has held with representatives from the banking industry there has been criticism of the Reserve Bank's involvement in commercial banking activities.

2.71 The commercial activities of the RBA include provision of government banking, banking for overseas agencies and securities clearing, registry and settlement services. The Bank's view is that if these services are being carried out efficiently and are being costed properly then there is no reason why these services should not be offered. There is no regulatory requirement for customers to use these services, the Bank's customers are free to use alternative providers. The commercial activities are being reviewed by a national competition policy task force. The Bank maintains that these services are not being cross subsidised by profits from other areas of activity and it supports the national competition policy review.[57]

Recent innovations

2.72 One area where banks have been developing new means of delivering financial services is through the Internet. The Committee sought the Bank's views on any concerns that it might have in monitoring these developments.

2.73 Services are provided by some banks over the Internet, at present most are basically information services, although at least one bank allows customers to log on to their own account and transfer funds between their own accounts. The RBA does not believe the

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56 Evidence pp S62, 73 and 78.
57 Evidence p 21.

Internet poses any regulatory concerns at present, viewing the main issues as being related to privacy and security. It is conceivable that an unregulated overseas bank may be able to offer financial services into the Australian community, that would be a case of buyer beware. Finally, at the international level, supervisors are cooperating and trying to produce common standards for all banks operating internationally.[58]

2.74 The RBA's view is that banks in Australia are seen as the safest part of the financial system for the community to deal with, along with building societies and credit unions. The RBA doubts whether a bank coming into Australia through the Internet would be able to attract a significant amount of business from people who would probably prefer to deal with reputable institutions.[59]

2.75 The Committee also raised the prospect of Smartcards. The annual report identified a number of public policy issues including; security, financial standing of card issuers, money laundering and seigniorage.[60]

2.76 The Bank advised that it was involved in the consideration of these issues, particularly any prudential issues. The matter of seigniorage, the profits earned from the issue of notes and coin, is ultimately an issue for government as all profits are passed on to the government.[61] A recent article in the *Reserve Bank Bulletin* provides an interesting discussion of seigniorage and notes that while currency remains the medium of exchange for small contracts, a variety of forms of electronic payment are developing for larger transactions. There is currently $1.5 billion of coin on issue and $20 billion in notes on issue.[62]

2.77 The Committee will monitor the potential impact on seigniorage of Smartcards and other forms of electronic transactions.

Derivatives

2.78 The Committee noted that in the RBA's submission to the Wallis Inquiry, it was mentioned that the use of financial derivatives by banks had risen fourfold over the last seven years and is still rising.[63] The Committee enquired whether this built into the banking system an inherent risk factor that had not been there in the past. The RBA said that derivatives essentially relocate risk between different parties and allows the banks more efficient management. It is possible to concentrate risk in a particular place and that could lead to problems, but it is also possible to use it in a sensible way to cut down risks and provide real services to business. Most of the business that is done in derivatives is on customer accounts. The positions that the banks take themselves in derivatives and underlying financial markets tend to be very small.[64]

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58 Evidence pp 33-34.
59 Evidence p 34.
60 *Reserve Bank of Australia Annual Report 1995-96* op cit p 50.
61 Evidence pp 35-36.
62 *Reserve Bank of Australia Bulletin*. July 1997. Sydney, RBA pp. 1-4.
63 Reserve Bank of Australia, *Submission to the Financial System Inquiry*. September 1997, RBA, p 99.
64 Evidence p. 37.

2.79 The RBA said it was moving towards monitoring derivatives activity more closely. and is incorporating market risk into the capital adequacy framework. The framework includes derivatives and physical positions in markets, covering risks that banks might lose money due to movements in exchange rates, interest rates, equities and so on. The capital adequacy requirement will come into effect at the end of 1997.[65]

2.80 The new prudential supervision guidelines for capital adequacy related to market risks were released in January 1997. These guidelines reflect the international guidelines issued by the Basle Committee on Banking Supervision. The guidelines address risks associated with losses arising from fluctuations in interest rates, exchange rates, equity prices and commodity prices. Banks are allowed to choose between two approaches to calculating market risk exposures, they can use a standard supervisory model or their own internal model. Internal models have to meet certain standards and criteria and must be approved by the RBA.[66]

2.81 The reason for the new requirements not coming into effect until the end of 1997 is that it allows time for resolution of technical issues, installation of improved risk-monitoring systems and validation of those systems by the RBA.

2.82 The focus of these new arrangements is on the responsibilities of boards and senior management to understand, monitor and manage bank trading room activities. It is a process of improving the risk management environment in each bank.[67]

2.83 More emphasis is being placed on analysing and monitoring banks' risk management systems to ensure that the banks are managing these risks in a forward looking way. The RBA is generally satisfied that banks have adequate systems in place, but notes that there is scope for improvement.[68]

Conclusion

2.84 This year's review has been a drawn out process due to the changed arrangements for appearances by the Bank following the Treasurer's *Statement on the Conduct of Monetary Policy*. In addition, the public hearings ran over the period of the finalisation of the Financial System Inquiry which has significant implications for the future role and responsibilities of the Reserve Bank.

2.85 The Committee strongly endorses the new arrangements whereby the Governor appears before this Committee twice a year to report on the conduct of monetary policy. This is a significant step forward in the accountability process and it also provides a valuable mechanism for the RBA to make its views known to the financial services industry, financial analysts and commentators and the broader community. This process has significantly heightened awareness of monetary policy and the factors which influence its development.

2.86 The future regulatory oversight of the financial services industry has now become clearer following the Treasurer's announcement of the government's response to the Wallis Inquiry. Prudential regulation will now be carried out by a new organisation, the Australian Prudential Regulation Authority (APRA). This body will be responsible for the prudential

65 Evidence pp 37-38.
66 *Reserve Bank of Australia Bulletin*. February 1997. Sydney, RBA pp. 28-29.
67 Evidence p S12.
68 Evidence p 38.

supervision of deposit taking institutions, life and general insurance companies and superannuation funds. The Reserve Bank will now focus on monetary policy, overall financial system stability and regulation of the payments system. A third organisation, the Australian Corporations and Financial Services Commission, will cover market integrity, disclosure and consumer protection issues.

2.87 The relationship between the RBA and the APRA will be critical for effective and efficient regulation of the financial services industry. The Committee believes that continued parliamentary scrutiny of both monetary policy and prudential supervision will assist in ensuring the success of the new arrangements. As this Committee has been providing that oversight of prudential supervision and monetary policy over the last five years, the Committee considers it desirable to put in place a similar arrangement for the APRA to that established under the Treasurer's *Statement on the Conduct of Monetary Policy*. If the Parliament is to be satisfied that the Bank and the APRA are working together effectively, it is essential that both bodies appear before this Committee on a regular basis.

2.88 **Recommendation 1**

> **That the Australian Prudential Regulation Authority be required to appear before the House of Representatives Standing Committee on Financial Institutions and Public Administration at a public hearing once a year to report on prudential supervision of the financial services industry.**

CHAPTER THREE

AUSTRALIAN SECURITIES COMMISSION

Introduction

3.1 The Australian Securities Commission (ASC) appeared before the Financial Institutions and Public Administration Committee on 29 January 1997, the appearance related to the Committee's review of the ASC's annual report 1995-96. The Committee notes that the ASC is oversighted by the Joint Statutory Committee on Corporations and Securities, the Financial Institutions Committee's interest in the ASC relates primarily to issues that impact on the broader financial services industry and the relationship between the financial regulators.

3.2 The Commission came into operation on 1 January 1991 and is responsible for the administration of the *Corporations Law* (the Law) throughout the Commonwealth, States and Territories. At the time of this review the ASC was chaired by Mr Alan Cameron.

Investment advisers

3.3 The Committee referred the Chairman to the Law Reform Commission Paper No. 53 of October 1992 where the Agnew Committee stated that notwithstanding some shortcomings the marketplace is the only economically efficient mechanism by which the competence of a responsible entity can be judged. The Committee questioned the need for regulating all financial advisers, particularly smaller operators.

3.4 The Chairman advised the Committee that it is among some of the smaller operators where the Commission had the greatest difficulties. The reason for licensing or registering advisers is that clients are not in a position to judge the competence and qualifications of people offering investment advice, it may be some time before such a judgement can be made. The Chairman noted that the ASC has '...not detected any public pressure to remove the licensing rules.'[1]

3.5 In response to the proposition that small advisers were finding it increasingly difficult to operate independently, the Chairman noted the development of franchising and grouping together of advisers. He noted that the future for advisers will see significant change particularly with the impact of new communications technology.

3.6 The Committee suggested that there is a distinction between selling and advising, the latter requiring competence and experience. The Commission responded that it has been seeking to enhance the role of the professional body, which it believes should be in a position to judge the professional skills of its members. The Commission's view is that it should be able to delegate some of its statutory role to industry bodies.[2]

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1 Evidence p 7.
2 Evidence pp 7-8.

3.7 The Committee enquired about the possible ramifications if an adviser chose to opt out of being regulated, advising clients of this fact. The Chairman returned to the point that clients had to be in a position to make an informed judgement, making the distinction between wealthy informed clients and those who are less well informed. '...We are more concerned about people who have had a redundancy payment or some compensation for an injury. They are the people who are exposed...they were the people who the gentleman in Perth had ripped off.'[3] This reference being to a recent conviction and goaling of a financial adviser.

3.8 The annual report notes that the Joint Committee on Corporations and Securities recommended that the five year time limit for laying criminal charges in serious matters be removed.[4] The Commission supported the recommendation, stating that the removal of the five year time limit would restore corporate crime to the same status as all other crime. In addition, corporate crime is frequently discovered late and preparing a case is a time consuming process. If a prosecution is brought too late then the court will intervene to stop the process.[5]

3.9 Following on from this the Committee raised the matter of the apparently lengthy periods of time taken to resolve some high profile cases. The ASC maintains that there are no ongoing investigations that predate the creation of the Commission, although there are some cases that are still being dealt with. The Chairman also noted that high profile cases usually involve complex transactions, deliberately organised that way by experts and that preparing a case can take a considerable amount of time. There are also delays in some jurisdictions in getting court time.[6]

Prospectuses

3.10 The Committee canvassed the issue of complexity of prospectuses and the time allowed between offer and closure.

3.11 The ASC advised that it had conducted a survey about three years ago to find out what use people made of prospectuses. The survey indicated that while most people do read prospectuses, they do not like them because of their complexity and they do not use them as the basis for the investment decision. People instead used advice from other sources such as investment advisers, brokers and the media. The Chairman added, 'so why are we spending all this money on the prospectuses is a very fair question.'[7]

3.12 The Chairman advised that the Commission has made several attempts to address this matter. The problem '...is that the law is very clear but very general.'[8] The law says that prospectuses must contain all of the information that is required for an investor to make an informed decision. As a result a prospectus tends to have everything included in order to ensure that those responsible for issuing the prospectus are not liable for future legal action. Consequently, it is difficult for the Commission to give guidance on what can be left out, it can only press for these documents to made more readable and useful. The Commission is

3 Evidence p 8.
4 *Australian Securities Commission annual report 1995-96*. Nov 1996. Sydney, ASC, p 23.
5 Evidence pp 35-36.
6 Evidence pp 36-37.
7 Evidence p 9.
8 Evidence p 9.

undertaking a significant initiative with the Investment Funds Association to come up with a minimum set of requirements for a unit trust prospectus. Unlike a prospectus for an initial public offering, unit trust prospectuses are regularly issued and it should be possible to make their preparation easier, less expensive and more useful to investors, 'the result that you want from a prospectus is that the investors have particular information.'[9]

3.13 The Committee enquired whether it was possible to have an abridged version of a prospectus, ie one that contains the information consumers really need and refers them to a larger text if they so choose. The Chairman advised that the Commission is exploring the possibility of an abbreviated prospectus that would satisfy the needs of the ordinary investor and that this is being done in the context of simplifying the Corporations Law.[10]

3.14 With regard to the costs associated with the preparation of a prospectus, and whether this is a barrier to small firms seeking equity capital, the Chairman agreed that the current prospectus regime is aimed at major issuers and is less useful for small and medium business.[11] The point was also made that the ASC is responsible for the process of raising capital and also for the protection of investor interests and it is not reasonable to expect that investor protection can be ignored in the case of small business.

3.15 **Recommendation 2**

> **In order to encourage private investment in small business enterprises, the Treasurer review the rules governing the issue of prospectuses with a view to reducing the costs and complexity of preparing a prospectus for small and medium companies.**

3.16 On a general point, the Chairman said the Commission's role is to encourage the formation of equity capital, and not to interpret and enforce the prospectus rules so strictly as to deter individuals from signing a prospectus. Part of this role is to ensure the law is interpreted and applied in such as way that it can achieve both sets of purposes; to protect investors, and to ensure that equity capital can be raised.[12]

3.17 On the issue of whether the ASC follows up on prospectuses that were subsequently found to contain false information, the Commission advised that it does follow up on forecasts. But, there is a particular problem with forecasts. As they are statements about the future, the law makes provision for a reversal of the onus of proof, ie '...if a forecast you make does not come true, then you are liable, unless you can show that you had reasonable grounds for making the forecast.'[13] This is one of the major reasons why so much time and money is spent preparing a prospectus, to make sure the reversal of the onus of proof can be established if needed.

3.18 The Transurban City Link Ltd prospectus was raised with the Commission. This was a 231 page document and was made available to the public for only two days before the offer closed. The Chairman advised that his personal view was that a prospectus should be issued

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9 Evidence pp 9-10.
10 Evidence pp 17-18.
11 Evidence p 11.
12 Evidence p 13.
13 Evidence p 13.

sufficiently ahead of closure date of the offer to allow people time to read and understand the document. While setting a minimum period may result in trade offs in a market sensitive situation, the Chairman believed that very few issues would be adversely affected.[14]

3.19 The Committee also referred to the Advance Bank takeover where unused votes were allowed to be deemed as being in favour of the takeover, asking whether this was a legitimate use of proxies and whether it will cause problems in the future. The Chairman said the Commission made it clear in its submission to the court that it supported the process in this particular instance, not as a general proposition. The ASC does not anticipate any future difficulties arising from that decision.[15]

3.20 The Commission had been criticised in the press for its handling of the Advance Bank takeover and it advised the Committee that there were some misconceptions regarding events that took place. The National Australia Bank was represented in the media as being strongly opposed to the merger and was said to have been lobbying the ASC to block the use of proxies. Despite denials from the bank and the ASC, the Chairman maintained that the media did not seem to accept that this was not the case, adding that the ASC had taken too long to form a view on the matter and to effectively communicate that view.[16]

Crown immunity

3.21 Committee asked the Chairman for his view on crown prospectuses. The Chairman said that a crown prospectus is a difficult issue because '...the community believes that something that looks and behaves like a prospectus is a prospectus in terms of the Corporations Law.'[17] The Commission has advised the government that the prospectuses issued by ministers are frequently not prospectuses but selling documents that fall outside the Corporations Law. These selling documents are not registered by the Commission, but they are lodged with the Commission purely for record purposes.[18]

3.22 As crown immunity applies to both state and federal governments, the Commission was seeking to have a set of rules that would be the same for the sale of state and federal businesses. The Committee's attention was drawn to the annual report:

> In general the ASC would prefer privatisations to be structured so that the prospectus provisions do apply...That is simply because we think the public just assume they do.[19]

3.23 While accepting that the intention has been to prepare those documents as though they were a prospectus, the Chairman advised that the difficulty is that the '...remedies that would apply simply are not there.'[20]

3.24 With regard to a privatisation, the organisation is usually incorporated just before it is publicly listed, it is therefore difficult to ask directors to sign a prospectus and take

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14 Evidence p 32.
15 Evidence p 34.
16 Evidence p 35.
17 Evidence p 14.
18 Evidence p 14.
19 *Australian Securities Commission annual report 1995-96* op cit p 28, and Evidence p 15.
20 Evidence p 15.

responsibility for forecasts contained in the prospectus. While this has happened in the past, there has been much debate and it is not always the case that directors had crown immunity.[21]

3.25 The issue of promoting public issues on television was also canvassed with the Commission. The Committee was advised that the ASC has attempted to issue guidelines on how it interprets the law with respect to advertising. The Commission has not sought to distinguish between privatisation floats, government floats and other very large floats. The point was made that very large floats would not succeed in the Australian equities market without advertising. While there have been some unsatisfactory cases in the past, this has not happened in recent years:

> We believe that those very large floats in the Australian national interest ought to have significant Australian participation...if you do not allow some promotion in the Australian market...it will just go overwhelmingly outside Australia, and we do not understand that to be the government's wish or the Australian community's wish.[22]

Changes to Corporations Law

3.26 The annual report notes that the Corporations Law simplification process began in 1993, with the first Bill dealing with share buybacks, share registers and accounting and audit requirements for proprietary companies becoming law in December 1995. Further Bills dealing with share capital, company incorporation and registration, financial statements and annual returns have not proceeded following the change of government.[23]

3.27 The ASC has been very active in the corporate law reform debate. The Australian Stock Exchange (ASX) has also been reported to have advocated substantial change, stressing the view that the existing law places Australia at a commercial disadvantage.[24]

3.28 In responding to the proposition that the process for reviewing the Corporations Law was unwieldy and that Australia risks being left behind in a legislative sense, the Chairman advised that the corporation's area is difficult to deal with because the Commonwealth is required to consult with the states and to have a three month exposure period under the terms of the corporations agreement. The Chairman agreed that in a world that is changing rapidly, Australia may have to find a new more flexible method of legislating, a more principles based approach was suggested as a possibility. Such an approach provides legislation at the broader level of principle and allows the detail to be provided through regulation or by agreement among professionals. The Chairman noted that the Corporations Law '...remains a monumental tome, despite the best efforts of the simplifiers.'[25]

3.29 The Committee considers that the process of simplifying the Corporations Law has not been a success. A greater focus needs to be placed on both the Law and the process for reviewing the Law. The creation of the proposed Australian Corporations and Financial Services Commission should provide an opportunity to address these matters as it will require consultation with the state and territory governments.

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21 Evidence p 16.
22 Evidence p 17.
23 *Australian Securities Commission annual report 1995-96* op cit p 39.
24 Bita, N. Rewrite law from scratch: ASX boss. *The Australian*, 6 January 1997.
25 Evidence p 19.

Phoenix companies

3.30 The annual report referred to assistance being given to small and medium sized companies to tackle the problems of trading while insolvent and 'phoenix companies'. Phoenix companies are those '...that fail leaving unpaid debts and then rise from ashes under similar management in the guise of a new company, disclaiming all the debts of its predecessor.'[26] This is quite common in the building industry. The Sydney Morning Herald reported that the ASC found over 9000 individual businesses were affected by phoenix company schemes each year costing the community up to $1.3 billion annually.[27]The Committee expressed the concern that phoenix companies persist in preying on people and on small businesses.

3.31 The Chairman pointed out that what makes a failed company into a phoenix company situation is some abusive act, giving the example of taking the goodwill of the former business without paying anything for it and continuing to trade on that goodwill. It is this abusive behaviour that the Commission is pursuing. The distinction was drawn between phoenix company activity and a simple company failure. 'We are not trying to send a message that it is a sin to fail in business and that you cannot start up again.'[28]

3.32 The Chairman explained that when an insolvent company continues to trade this is a civil penalty matter, not a criminal offence. When assets are improperly taken out of this company, then that becomes either a civil penalty or a criminal offence. While there has been created a public awareness of phoenix companies, there has also been a tendency to falsely identify a phoenix situation. Company failures are quite common, and there needs to be a better understanding of when they involve improper behaviour and when they simply involve a failure.[29]

3.33 On the matter of insolvency, the annual report notes that where company directors of financially troubled companies have on more than one occasion returned less than 50 cents in the dollar to creditors, they can be asked by the Commission to the show cause why they should not be removed. The Committee asked how the ASC assesses which directors should, and should not, be removed. The Chairman responded by saying that it is only when company directors fall within the technical description of the law - return less than 50 cents in the dollar to creditors more than once and that those companies have gone into liquidation, adding that 42 people had been banned recently in Victoria from managing companies in similar circumstances.[30]

3.34 While the process is designed to protect the public, the Commission is of the view that the process should be made easier to satisfy and has recommended to the simplification task force that it consider reducing the 'more than once' requirement down to 'one'. One of the reasons for this is not because the Commission wishes to get people who fail, they want to get the people who fail and continue to trade when they should not.[31]

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26 *Australian Securities Commission annual report 1995-96* op cit p 21.
27 Jones, M. ASC gunning for 'phoenix companies'. *Sydney Morning Herald*, 5 August 1996.
28 Evidence p 27.
29 Evidence p 27.
30 Evidence p 26.
31 Evidence pp 26-27.

Insider trading

3.35 The Committee sought the Commission's views on whether the current provisions in the Corporations Law relating to insider trading were adequate. The Chairman advised that the Commission now no longer has to prove the apparent offender is an insider. What has to be proved is that the person had information that was market sensitive and, while in possession of that information, either gave it to somebody else or used it to gain themselves an advantage.[32]

3.36 The Chairman added that he is of the view that there is more scope with the current state of the law to get results and to send out some clear messages. The point was also made that, with the cooperation of the Stock Exchange, the Commission should be able to satisfactorily deal with insider trading.[33]

3.37 The Committee enquired whether there was room to adopt the Japanese model, ie a voluntary code for insider trading. The Chairman said he would be surprised if the community would accept a voluntary admission of guilt and the giving back of the profits as sufficient penalty. In our society it is an offence to be an insider trader and if such an act became known it would impact on one's future career so much that one would not voluntarily make such a disclosure. The point was also made that unless the criminal law is used then individuals may consider it to be worth running the risk.[34]

Derivatives

3.38 While acknowledging its lack of jurisdiction over derivatives markets, the ASC reported its active involvement in international consideration of improving the operation of exchange-traded and over-the-counter derivatives markets.[35]

3.39 The Committee sought advice on the Companies and Securities Advisory Committee (CASAC) examination of the Corporations Law as it applies to derivatives. The Chairman advised that CASAC (of which he is a member) is reviewing the law with respect to derivatives. CASAC's submission to the Financial System Inquiry identifies some of the issues that will be canvassed in the final report. CASAC's view is that there is a case for a merger of the two divisions of the law that deal with securities and futures.[36]

3.40 The Committee also canvassed concerns that woolgrowers were restricted from becoming involved in derivatives markets. The concerns relate to the view that derivatives markets offer an opportunity to manage risk and that this opportunity should be available to individual woolgrowers. The concerns relate to section 1127 of the Corporations Law which relates to exemptions from the Law, in this case the exemption to operate a market requires the provider to have gross assets of $10 million.

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32 Evidence p 28.
33 Evidence p 29.
34 Evidence p 29.
35 *Australian Securities Commission annual report 1995-96* op cit p 34.
36 Evidence p 20.

3.41 The Committee was advised that, following a series of financial difficulties in the 1980s, futures industry legislation in each state was written so that you could not conduct a futures market unless you were licensed and all futures transactions had to be conducted on market. Because of this inflexible structure, an exemption power was created.[37]

3.42 While accepting that this would preclude the majority of woolgrowers from becoming involved, the Chairman advised that:

> This was an attempt by us to suggest which major providers of markets ought to be exempt from the current provisions of the Law...One of the characteristics is that, if gross assets of more than $10 million, we take the view that the government was entitled to conclude that you would be able to acquire enough advice to look after yourself...this is not section 1127; this is the exemption from section 1127.[38]

3.43 The Chairman noted that woolgrowers do have some capacity to operate in the derivatives market through the Sydney Futures Exchange (SFE). While accepting that woolgrowers can access the derivatives market through the SFE, there is limited capacity for the development of alternative markets and products to serve the needs of woolgrowers.

Proposed demutualisation of the Stock Exchange

3.44 The Australian Stock Exchange is proposing to move from a mutual organisation to a public company listed on its own Exchange. As to who should regulate the Exchange, the Committee noted that Mr Cameron had said in the media that there were other options to the Commission being the regulator. The Chairman said that there had been some misinterpretation of what he had said, he took that view to avoid being in the situation where it could be construed that the Commission would veto the listing if the ASX and the ASC did not agree upon the regulatory method. The Chairman went on to say that the Commission as the regulator is the most sensible option.[39]

3.45 There are however complex questions about the application of the Exchange's own listing rules to itself. For example, the granting of exemptions, the checking of disclosure notices lodged by the Exchange with itself would be things that somebody else has to monitor. That is where the ASC would be involved, using staff of the Exchange to assist under some form of contract or arrangement between the ASC and the ASX. Whilst the ASC and the ASX have agreed how this can be done in broad terms, the details have yet to be worked through with the involvement of government and in particular the business law division of Treasury.[40]

3.46 The Committee also sought the Commission's views on the proposition that individual stakes in the ASX company be limited to 5% to 10% and that the level of foreign ownership be restricted. The Commission advised the Committee that under current mutual arrangements there is a 'fit and proper person test' because they are required to be licensed dealers under the Corporations Law. Consideration is being given to how this would operate under a demutualised structure, where management and ownership are separated. One

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37 Evidence p 21.
38 Evidence p 21.
39 Evidence p 37.
40 Evidence pp 37-38.

possibility is to apply the test to any individual ownership of 5% or more of shares. The issue of foreign ownership is one for government policy.[41]

Council of Financial Supervisors

3.47 The Council was formed in 1992 and is a coordinating body which brings together the heads of Australia's main financial supervisory agencies. The ASC Chairman is a member of the Council and believes that it has improved coordination among the regulators and assisted each to become more effective. The Chairman cited two examples where there has been a need to harmonise areas of regulatory overlap between the ASC and the Insurance and Superannuation Commission (ISC). The first was the overlapping regulation of investment advisers and the second was the regulation of collective investments of managed funds.[42]

3.48 The Committee noted that while the Chairman viewed the Council in a positive light, he also considered there was still room for improvement. The Chairman stated bringing the ASC into the Treasury portfolio with the ISC and the Reserve Bank (RBA) means there is now less reason for not formalising the Council's structure under its own statute. The perceived need for amendments to existing legislation related to restrictions on government agencies releasing protected information. The ability to share information, according to the RBA '...is a cornerstone of effective regulatory coordination and cooperation, in particular in the oversight of financial conglomerates.'[43] This issue had been raised by the Council in its own submission to the Wallis Inquiry.[44] Now that the Government has responded to the Financial System Inquiry report, the Committee expects that this issue will be addressed when the new regulatory framework is introduced.

3.49 The Committee asked for an overall impression of the operation of the Council of Financial Supervisors. The Chairman advised that the Council has ensured that the regulators of the financial system understand what each other is doing and gave the development of a coherent and consistent approach on derivatives and the regulation of the official financial markets as an example. It was also pointed out that the Council is a very low cost operation, ie both efficient and effective.[45]

3.50 In conclusion, the Committee notes that the Treasurer's response to the Wallis inquiry makes significant changes to the regulatory framework. However there will still be a need for coordination between the regulators and this is acknowledged in the proposed changes with the establishment of a Council of Financial Regulators to replace the Council of Financial Supervisors. The establishment of the new Council should take account of past experience if it is to be an effective coordinating forum. The Committee notes that one of the significant difficulties experienced in the past, the ability to exchange information, is to be addressed under the new arrangements.

Funding cuts

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41 Evidence p S4.
42 Evidence p 4.
43 Evidence RBA p S14.
44 *Council of Financial Supervisors annual report 1996*. Nov 1996. Sydney, RBA, p 6.
45 Evidence p 33.

3.51 The Committee noted that the Commission is reported to be reducing its staff numbers from 1300 to 950 over the next 5 years and asked whether functions will suffer and whether public confidence in corporations will be maintained. The Chairman indicated that staff numbers would be reduced to about 1000. He also indicated that the ASC was examining ways of maintaining service delivery with reduced resources, indicating that it will be difficult to operate identical offices all around the country with the reduced resources. In particular the Commission is seeking to take advantage of the efficiencies offered by developments in communications, citing electronic lodgement of annual returns.[46]

3.52 The reduction in the Commission's funding over the next 4 year period is expected to be in the vicinity of $12m - $15m. Given that the budget reduction will result in significant staff reductions, the Committee was concerned that this would result in a diminution in the Commission's ability to deal with breaches of the Corporations Law. The Chairman acknowledged the potential problem and indicated that they intend to maintain a corporate regulatory presence across Australia and that the Commission will not be shedding any functions that are critical to the Commission's credibility as a regulator.[47]

3.53 Reference was also made to media reports that the ASC intended to consolidate some of its decentralised functions, the example given was the proposal to move mergers and acquisitions work from Brisbane and Adelaide to Sydney, Melbourne and Perth. The Chairman noted that the proposal had been put on hold after opposition from local business and State governments. The Chairman made the point that it no longer matters whether staff dealing with a particular issue are physically present in a particular location, identifying the appropriate people and expertise is the important factor. The Chairman added:

> ...the Commission ought to be given some capacity to manage its affairs in order to ensure that we deliver a high quality product...to be judged according to the services it provides...I know that it is not a popular argument and is one that we will have to continue to have for some time to come.[48]

3.54 The Committee reminded the Chairman that when the Commission was first established the concern among the smaller states including South Australia, Queensland and Western Australia was that it would be based mainly in Sydney. Any move towards centralising the Commission's activities could well leave the smaller states to feel they were led down the garden path. The Chairman responded that the commitment given by the Commonwealth in 1989 and 1990 was to provide a full service across the country. 'It was all about levels of service, and type and quality of service, so that the customers were actually getting what they wanted.'[49]

3.55 The Committee agrees with the view that centralising particular activities will always be contentious. However, stripping expertise out of a particular office has the potential to reduce the capacity of that office to provide other services and could lead to its closure.

3.56 The Committee noted that the revenue collected by the Commission has increased by 36% over the last 4 years, ie $203m in 1992-93 to $275m in 1995-96.[50] The Chairman's

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46 Evidence p 22.
47 Evidence pp 31-32.
48 Evidence p 25.
49 Evidence p 26.
50 *Australian Securities Commission annual report 1995-96* op cit p 42.

response was that respective governments have increased the fees payable. The Commission operates in a full cost recovery regime. Half the money goes to the States, less than half goes to the Commission and the balance of the moneys is used to pay various agencies such as the Australian Federal Police, the Director of Public Prosecutions, CASAC and the business law division of Treasury for their assistance in respect of all corporate law matters.[51]

51 Evidence p 38.

CHAPTER FOUR

INSURANCE AND SUPERANNUATION COMMISSION

Introduction

4.1 The Insurance and Superannuation Commission (ISC) appeared before the Financial Institutions and Public Administration Committee on 10 February 1997 and the appearance related to the Committee's review of the ISC's annual report 1995-96. The Committee's interest in the ISC relates primarily to issues that impact on the broader financial services industry and the relationship between the financial regulators.

4.2 The Commission was established in 1987 as the financial supervisor of the insurance and superannuation industries. The Commission's role is to prudentially supervise the insurance and superannuation industries in the interests of policyholders and fund members, and to ensure superannuation entities comply with the Commonwealth Government's retirement income standards.[1]

4.3 Supervision of the insurance industry is characterised by licensing (entry and ownership) restrictions and procedures for monitoring the solvency or financial soundness of individual insurance companies.

4.4 The large size and diverse structure of the superannuation industry restricts the Commission's ability to maintain close and frequent contact with every individual fund. The supervisory framework therefore is based on the principle that trustees are primarily responsible for the viable and prudent operation of funds and for compliance with the *Superannuation Industry (Supervision) Act 1993* (SIS). The Act codifies the main fiduciary duties of trustees and requires them to formulate and give effect to an investment strategy.[2]

4.5 The number of entities supervised by the Commission is as follows:

Type of entity	Number 1995-96	Total assets 1995-96	Number 1994-95	Total assets 1994-95	Change in No.	Change in assets
Life insurers	51	$31.0b	52	$33.0b	-1	-$2.0b
General insurers	166	$34.0b	162	$31.5b	4	$2.5b
Superannuation	140,000	$244.0b	107,000	$187.0b	33,000	$57.0b
Total	140,217	$309.0b	107,214	$251.5b	33,003	$57.5b

Source: *Insurance and Superannuation Commission annual report 1995-96,* p 1.

Derivatives

4.6 The Commissioner informed the Committee of progress in respect of supervision of the use of derivatives in the insurance and superannuation industries. The guidelines on derivatives for insurance and superannuation entities were issued in November 1995 and

1 *Insurance and Superannuation Commission annual report 1995-96*. 1996. Canberra, AGPS, p 1.
2 Ibid p 4.

were substantially based on Risk Management Guidelines for Derivatives produced by the Basle Committee on Banking Supervision. Prior to issue, the Commission consulted with other financial regulators (the Reserve Bank of Australia, the Australian Securities Commission and the Australian Financial Institutions Commission). The guidelines require insurance and superannuation entities to prepare risk management statements.[3]

4.7 The risk management statements focus on trustees' responsibilities with respect to all investments, with a particular focus on the risks associated with derivatives. With regard to superannuation, derivatives are not to be used for speculative purposes, or for gearing, because speculation is inconsistent with the 'prudent person' rule and gearing is prohibited under the superannuation legislation. These are the only restrictions on the use of derivatives.[4]

4.8 In April 1996 the Commission initiated a project to examine the use of derivatives by superannuation funds and to gauge how well the industry complies with the risk management requirements.[5] The report on the use of derivatives by superannuation funds was released on 17 February 1997. Key findings of the review are:

- only 4% of non-excluded funds use derivatives;
- derivative investments appeared to be well managed by the funds that use them;
- most funds use 'plain vanilla' instruments;
- the use of overseas currency management is increasing;
- trustees' knowledge and control of the use of the derivatives vary within the industry;
- there were some internal control problems with smaller funds; and
- response to risk management statements prepared by the industry was mixed.[6]

4.9 The principal outcomes are:

- an update to the Superannuation Circular II.D.7 (Superannuation), incorporating the Risk Management Guidelines into the Circular with an introduction to explain the major changes;
- a modification of Superannuation Industry (Supervision) Regulation 13.14 to allow a charge over the assets of the fund where the charge is in relation to a derivative transaction conducted on a recognised exchange;
- improved requirements for reporting to the Commission and members as part of the modification declaration above;

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3 Evidence pp 3 and S2.
4 Evidence pp. 3-4 and *Risk Management Statements for Superannuation Entities Investing in Derivatives Guidelines*. April 1996. Canberra, ISC, pp 15-16.
5 Evidence p 5.
6 Evidence pp S2-3.

- improved Commission's procedures in the examination of derivative use by trustees particularly in the internal control and monitoring procedures put in place by trustees; and

- development of trustee training in conjunction with the Sydney Futures Exchange to improve trustee knowledge of the derivatives market and appropriate risk management procedures.

4.10 The Commission does not propose to conduct a similar examination of the use of derivatives in the life and general insurance industries. The reason for this being that these industries are composed of far fewer companies (around 220) than the superannuation industry and they are all routinely inspected by ISC staff.[7]

4.11 The Committee noted the ISC's view that, generally, derivatives are well managed by super funds but it posed the question: what are the risks of a rogue fund having a blatant disregard for regulations? The Commissioner responded that the *SIS Act* requires trustees to ensure investments are prudent. However, the Commission cannot guarantee that a rogue super fund could not get into difficulty through disregarding the exercise of prudence over its investments through the use of derivatives or through a physical position.[8]

4.12 The Commission advised that ensuring compliance involves a framework covering audit by the ISC, member representation on the trustee board of employer funds, external audit, entry standards for retail funds and whistleblowing. If a fund does get into difficulty the Commission has a number of options including winding the fund up or putting in new trustees. The Chairman noted that losses have been small and that those losses have been in small funds.[9]

4.13 The level of use of derivatives by funds is quite low according to the report on the use of derivatives published by the ISC. It found that of 5462 non-excluded superannuation funds, 222 stated that they use derivatives, representing 4% of funds at the time. However, the report also notes that trustees demonstrated some confusion over the question in the survey and the result may be understated.[10] The Commission noted in the hearing that while use appears low, it will definitely increase as derivatives are used not only for risk management, but also for surrogate exposure ie buying an index rather than a physical stock. It considered that this will particularly apply as funds become larger and this type of instrument then becomes more viable. At the moment it appears that a fairly small proportion of funds directly use derivatives.[11]

4.14 The Committee also canvassed the use of derivatives by the life and general insurance industries. Although the risk management statement approach is being used to supervise derivatives use in both industries, the extent to which derivatives are used is quite different.

4.15 The Commission supervises 50 life insurance companies. The large companies have a long history of using derivatives and tend to have strict internal controls in place while

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7 Evidence p S3.
8 Evidence pp 5-6.
9 Evidence p 6.
10 *Report on the use of derivatives by superannuation funds*. February 1997. Canberra, ISC, p 3.
11 Evidence p 8.

smaller companies tend to not use derivatives. They are generally used for hedging and if they were used speculatively this would impact on capital adequacy calculations, requiring extra reserves. This mitigates against speculative use as most funds would not wish to have to hold extra reserves.[12]

4.16 The supervisory framework places a lot of emphasis on the actuary and the auditor. The *Life Insurance Act 1995* requires that if either has concerns about any particular matter they are required to take it up with the company and if their concerns are not satisfied then they must draw it to the attention of the ISC.[13] The Act also requires directors of a company to place the interests of policyholders before the interests of shareholders in the event of any conflict of interest between the two.

4.17 For five years the Commission has been requiring life companies to complete a return of their assets showing both physical holdings and the net effect of holdings of derivatives. This provides the Commission with information on the companies real risk in assets compared with apparent risk in terms of physical holdings. The Commission had no data on the extent of the use of derivatives in the life industry.[14]

4.18 The Commission advised that risk management statement requirements for general insurance did not come into effect until after 31 December 1996. The Commission is of the view that the 160 general insurance companies make little use of derivatives, relying almost entirely on policyholder and shareholder funds. They do not engage in borrowings and invest their funds in very liquid assets to enable them to meet claims. While there are no immediate concerns, the Commission will have the benefit of the new information that will be provided through the risk management statements.[15]

4.19 The Committee also asked the ISC whether it had consulted with other regulators on uniformity in disclosure requirements. The response was that '...uniform standards for disclosing derivatives activity and exposures in annual accounts...is still under development by the relevant accounting and professional bodies.[16]

Superannuation review program and outcome

4.20 The Commission supervises around 140,000 funds, of those funds, 90% of assets and 90% of members are concentrated in probably 800 or 900 larger funds. The Commission's review program is basically structured around the larger industry funds and public offer retail funds being cycled every three years and employer sponsored funds cycled every five years, a total of around 200 and 300 each year.[17]

4.21 The Commission confirmed it also reviewed excluded funds (funds with less than five members). There are approximately 130,000 excluded funds. The Commission said that

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12 Evidence pp 9-12.
13 Evidence p 11.
14 Evidence p 10.
15 Evidence p 10.
16 Evidence p S2.
17 Evidence p 18.

75% of excluded funds have no arms-length members, they are mainly 'mum and dad' super funds. The remaining 25% have one or two arms-length members.[18]

4.22 A review by the Commission of the superannuation funds disclosed that while most funds were found to be secure, 50% were found to have significant weaknesses and 5% to have serious weaknesses.[19] The annual report identifies the relative newness of the standards required under SIS as partially explaining some of the shortcomings. However, the Commission remains concerned that the review identifies continued inadequacy of trustee's understanding of the legislative requirements, their responsibilities and diligence. In some cases this translated into inadequate financial and internal controls within both the fund and trustee operations.

4.23 The Commission said most weaknesses were organisational problems related to internal administration. The example was given where one trustee may do everything related to the administration of a fund and the other trustees simply go along with that one person because they lack the relevant skills. This might expose the fund to the possibility of fraud and in such cases the Commission requires improvements be made in the administrative arrangements with appropriate checks and balances to limit the possibility of fraud.[20]

4.24 Another area of concern relates to the relationship between trustees and fund managers. Many superannuation funds have their funds managed and the agreements with the fund managers need to be thorough and performance needs to be monitored. The ISC identified the key ingredient in an agreement being a clear definition of responsibilities ie setting out what the provider of the service is responsible for, performance standards and penalty provisions for non-compliance.[21]

4.25 In view of the emphasis that the ISC places on getting management right, the Committee noted that the Commission has had concerns about the independence and competence of auditors. The Commission responded that it does have problems with a few auditors each year, pointing out that some auditors do not have expertise in auditing superannuation funds. Where the Commission finds that auditors have been dishonest or negligent, the Commission disqualifies them under the Act. If the Commission considers that an audit is inadequate, the Commission suggests the auditor cease auditing superannuation funds until they have successfully undertaken approved training. The Commission receives strong support from the profession in respect of such actions.[22]

4.26 The 5% of funds identified as having serious weaknesses have been promptly dealt with. The Commission would generally require the trustees to inform members of the Commission's concerns.[23] With regard to the funds in the 50% found with shortcomings which would create a potential risk to members interests, the Commission advised that it reviews the operation of the fund, reports problems found, and obtains the trustee's commitment to rectify the problems. Depending on the seriousness of the problems found, the Commission will go back within 6 months or within 24 months to check that the problems

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18 Evidence p 15.
19 *Insurance and Superannuation Commission annual report 1995-96* op cit p 65.
20 Evidence p 12.
21 Evidence pp 12-13.
22 Evidence p 15.
23 Evidence p 14.

have been rectified. If trustees do not cooperate, the Commission can use its enforcement powers to protect member's interests.[24]

4.27 The Committee asked whether a contributor is able to check with the ISC on the competency or otherwise of a fund. The Commission said the contributor would need to consult with the trustees and form their own view, although it conceded that majority of contributors would not know what questions to ask. It was pointed out that the *SIS Act* (s. 348(2)) precludes the identification of a superannuation entity and disclosure of information relating to the entity. The Commission is not in a position to grade funds (as do rating agencies) its responsibility is to minimise the prudential risk.[25]

4.28 The Committee sought comment on what could be done to ensure there is more information in the market place so that neither the fund nor the fund member is disadvantaged. The Commission replied that the information distributed to people could be standardised, in much the same way as has been done with the new prospectus and disclosure requirements for public offer retail funds. This standardisation of information would enable comparison between funds. Knowledge about the investments of funds can be improved, the requirement that trustees disclose big exposures should assist in that regard.[26]

4.29 What cannot be done through disclosure relates to the quality of the management or the operation of a fund. The difficulty with information flow is that you can make the funds feed people information, but to put a quality stamp on that information is not easy.[27]

4.30 The Committee asked what can be done to improve the public perception of superannuation. The Commission advised that if super funds achieve reasonable rates of return over a period of years through prudent investments, then this will increase confidence. The annual returns that people receive from their superannuation funds can assist them to focus on the fund's performance. Insofar as the Commission is concerned, it will continue with the review and education programs and publish guidance books to train trustees in their responsibilities. The Commission believes that over next 2 or 3 years the whole standard of trusteeship will rise and that this will improve confidence.[28]

Compensation for financial losses

4.31 The Committee noted that s.231 of the SIS Act allows the Treasurer to grant financial assistance to a fund that suffers loss as a result of fraud and asked whether any such assistance has been provided. The Committee also asked whether negligence is a concern and to what extent negligence has occurred and found to be proved in the courts.

4.32 The Commission replied that no financial assistance has been provided. With regard to proven negligence, the Commission conceded that some trustees have been negligent in

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24 Evidence p. 14 and *Insurance and Superannuation Commission annual report 1995-96* op cit p 66.
25 Evidence p 16.
26 Evidence p 7.
27 Evidence p 7.
28 Evidence p 17.

recognising their responsibilities, but that this negligence would fall far short of proven negligence.[29]

4.33 On the matter of investor compensation schemes, the Commission's view is that the ground should be as narrow and objective as possible to avoid open-ended liability on the part of industry, or ultimately the taxpayer. The Commission's preferred approach is to ensure that conduct is prudent to prevent problems arising and if a problem does arise, have control over the arrangements that might then be put in place to manage the process.[30]

4.34 The Commission explained to the Committee that trustees do not have to take out professional indemnity insurance, but if they do have such insurance then that needs to be disclosed. Retail funds are required to take out professional indemnity insurance as a condition of the approval arrangements. The Commission makes sure there are no abnormal exclusions or inclusions in these insurance policies.[31]

4.35 The Committee went on to canvass the operation of master funds and where liability lies if a problem arises. Master funds are funds where multiple managers look after an individual or corporate superannuation fund. The Commission advised that a collective investment is either managed by a SIS trustee or by a Corporations Law trustee. Where an investment is managed by a SIS trustee, this trustee is the responsible entity. If a SIS trustee delegates the funds management responsibility, then the agreement between the trustee and the manager should require that the manager have professional indemnity insurance. The delegation does not absolve the trustee of responsibility and it is the trustee that the Commission will hold accountable.[32]

4.36 While neither the SIS Act nor the ISC guarantee member's funds, the Committee sought the Commission's views on the perception by contributors to compulsory superannuation that the government will guarantee their funds. The Commission responded that the benefits derived from a market oriented approach would be diminished if a government guarantee was given. Furthermore, it suggested that trustees may be encouraged to take excessive risks, overlooking their prudential responsibilities in the knowledge that the government would be responsible in the event of investment losses.

4.37 The Commission has always emphasised that the *SIS Act* and the ISC seek to enhance safety and soundness, but do not guarantee the safety of member's funds. The regulatory framework cannot prevent bad management nor can it prevent fraud. Although losses arising from fraud can be compensated if the Treasurer judges it to be in the public interest.[33]

Fraud detection

4.38 In respect of fraud and investigation, the Committee referred to the Australian Institute of Criminology (AIC) paper on superannuation crime issued in June 1996 where it is stated:

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29 Evidence p 21.
30 Evidence p 21.
31 Evidence p 22.
32 Evidence pp 22-23.
33 Evidence p S7.

> The ISC is not alone in lacking experience in superannuation fraud control and investigation. The Australian Federal Police, the Director of Public Prosecution and the National Crime Authority all remain relative novices in the field and there is clearly scope for further research and cooperation between these agencies. In the meantime, state fraud squads remain severely under-resourced.[34]

4.39 The Commission advised that where fraud is suspected, the case is handed over to the relevant law enforcement agency. As to the suggestion that law enforcement agencies are severely under-resourced, the Commission said it was satisfied with the competency of the law enforcement agencies and did not consider them under-resourced.[35]

4.40 The Commission was asked whether the opportunity to commit fraud would increase with the growth in superannuation. The Commission pointed out that the opportunity to commit fraud is there for anybody who manages money, the checks and balances in superannuation under the SIS Act are designed to make committing fraud a difficult proposition. In addition, the Commission has conducted a series of anti-fraud seminars for trustees and advised that the response from trustees has been positive.[36] The Commission noted that there have not been significant problems to date, where a problem has arisen it has been referred to the police and dealt with and the Commission has not identified any resource problems. In the case of fraud against superannuation funds, the total known losses over the period 1988 to 1996 are in the order of $17m.[37]

4.41 The Committee again referred to the AIC paper where it stated that an audit by the Australian National Audit Office revealed that the Commission had serious weaknesses in the reporting regime between it and the Australian Taxation Office (ATO). It went on:

> The interface between the ISC and the ATO was of particular concern to the ANAO. Its audit of the ISC found that a comprehensive compatibility check of ISC and ATO records had never been undertaken and a pilot attempt to do so was thwarted by program errors in the ATO's database...Based on the results of the ANAO compatibility check there appears to be the potential for a significant loss of ISC revenue with the potential for a far greater loss to ATO revenue...The results of this check highlight the need for the ISC and the ATO to develop a more effective system of control to safeguard their respective revenue base derived under SIS.[38]

4.42 The Commission advised that the matter has been resolved by both bodies changing their respective computer systems to achieve compatibility and that the delay in achieving this has not been through any lack of goodwill on the part of either or both parties.[39]

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34 Freiberg, A. June 1996. Superannuation Crime. *Trends and issues in crime and criminal justice.* Canberra, Australian Institute of Criminology, p 6.
35 Evidence pp 23-24.
36 Evidence pp 24-25.
37 *Insurance and Superannuation Commission annual report 1995-96* op cit p 67.
38 Freiberg, A. op cit p 3.
39 Evidence p 25.

Retirement savings accounts

4.43 On 20 August 1996 the government announced it would allow banks, building societies, credit unions and life insurance companies to provide superannuation without a trust structure in the form of retirement savings accounts (RSAs). Assent was given to the Bills establishing RSAs on 28 May 1997.

4.44 The Commission views RSAs as a good product to add to the superannuation system; increasing choice, convenience and competition. The fact that it would result in providers of these products having two regulators was viewed as a complication, although the Committee notes that this concern will be resolved following the recently announced changes arising from the Wallis inquiry. The Committee will be interested to see how the new regulatory framework deals with a superannuation type product offered by a variety of financial institutions. Until the new arrangements are put in place they will have to be accommodated under the existing framework.[40]

Superannuation levy

4.45 The cost of the Commission's superannuation program is recovered through an annual levy on superannuation entities. Each fund is required to pay a minimum of $200 with an additional $200 per $500,000 of assets thereafter, up to a maximum of $14,000. This levy remained unchanged in the 1995-96 income year.

4.46 The Committee queried why the superannuation levy collected in 1995-96 was $25m compared with the levy collected in 1994-95 of $37m. It was explained by the Commission that $18.5m in levies that should have been collected in 1995-96 was not collected until the first part of 1996-97. The delay in levy collection was attributed to the replacement of the old system where levy moneys were required to be lodged with annual returns, with a new system where the Commission calculates the appropriate levy and invoices each fund for payment. The new system is considered to be administratively more efficient as it streamlines the payment process by eliminating the incidence of incorrect calculation of levy liability that then requires follow up action for both debtors (under paid levy) and creditors (over paid levy).[41]

The regulatory framework

4.47 The Committee sought the Commission's views on the mega regulator concept and on the effectiveness of the Council of Financial Supervisors. The Committee does not propose to canvass the detail of that discussion in this report as many of the issues have now been resolved following the government's response to the Wallis report. When the detailed administrative arrangements of the new regulatory structure are developed, the Committee will be interested to see that there is adequate differentiation between products where prudential supervision is necessary and those where a disclosure regime is appropriate.

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40 Evidence pp 27-28.
41 Submission pp S9-10.

4.48 Financial products where the investor takes a risk hoping for a high return but knowing that in any particular year the return may be low or even negative are best regulated under a regime based on disclosure. Where an investor puts money into a deposit taking institution expecting to get the money back at a later date, requires a regulatory regime where the institution is supervised as the return of funds is dependent on the solvency of the institution.

4.49 Superannuation has been afforded a higher degree of security than other managed investments due to its mandatory nature under the Superannuation Guarantee Charge and the need to maintain public confidence and encourage long term saving. Superannuation is a long term investment and there has been a relative lack of choice as to which fund contributions are made, although the latter may change to some extent. The new regulatory arrangements will need to take account of these factors.

David Hawker MP
Chairman
22 September 1997

APPENDIX 1

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APPENDIX 2

LIST OF HEARINGS AND WITNESSES

Reserve Bank of Australia

Canberra, Thursday 12 September 1996

Mr Bernie Fraser, Governor
Mr Ian Macfarlane, Deputy Governor
Mr Leslie Austin, Assistant Governor - Financial Institutions

Sydney, Thursday 8 May 1997

Mr Ian Macfarlane, Governor
Mr Graeme Thompson, Deputy Governor
Mr Glenn Stevens, Assistant Governor - Economics

Australian Securities Commission

Sydney, Wednesday 29 January 1997

Mr Alan Cameron, Chairman
Dr Michael Dunn, Director - Planning and Public Affairs
Ms Kerrie Palmer, Principal Policy Adviser - Government Relations

Insurance and Superannuation Commission

Canberra, Monday 10 February 1997

Mr Frederick Pooley, Commissioner
Mr Robert Glading, Deputy Commissioner - Life Insurance
Mr Richard Smith, Deputy Commissioner - General Insurance
Dr Darryl Roberts, First Assistant Commissioner - Policy, Legal and Actuarial Group
Mr Keith Chapman, Assistant Commissioner - Public Offer Branch
Mr Craig Thorburn, Australian Government Actuary

APPENDIX 3

STATEMENT ON THE CONDUCT OF MONETARY POLICY

TREASURER

STATEMENT ON THE CONDUCT OF MONETARY POLICY

THE TREASURER AND THE GOVERNOR (designate) OF THE RESERVE BANK

This statement records the common understanding of the Governor (designate) of the Reserve Bank and the Government on key aspects of Australia's monetary policy framework. It is designed to clarify respective roles and responsibilities.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, and given the appointment of a new Governor of the Reserve Bank, it is appropriate and timely for the Governor (designate) and the Government to set out clearly their mutual understanding of the operation of monetary policy in Australia.

It is expected that this statement will contribute to a better understanding both in Australia and overseas of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Bank.

RELATIONSHIP BETWEEN THE RESERVE BANK AND THE GOVERNMENT

The Reserve Bank Act gives the Reserve Bank Board the power to determine the Bank's monetary policy and take the necessary action to implement policy changes.

The Government recognises the independence of the Bank and its responsibility for monetary policy matters and intends to respect the Bank's independence as provided by statute.

Section 11 of the Reserve Bank Act prescribes procedures for the resolution of policy differences between the Bank and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Bank's independence. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Bank's responsibility for monetary policy the Act provides that the Board shall, from time to time, inform the Government of the Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other industrial countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time. However, the Government will no longer make parallel announcements of monetary policy adjustments, when the Reserve Bank changes the overnight cash rate. This will enhance both the perception, as well as the reality, of the independence of Reserve Bank decision making.

OBJECTIVES OF MONETARY POLICY

The framework for the operation of monetary policy is set out in the Reserve Bank Act 1959 which requires the Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to the objectives of:

(a) the stability of the currency of Australia;

(b) the maintenance of full employment in Australia; and

(c) the economic prosperity and welfare of the people of Australia.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed economic policy as a whole. These objectives allow the Reserve Bank to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium term price stability the Reserve Bank has adopted the objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in underlying inflation over the cycle while preserving a clearly identifiable benchmark performance over time.

The Governor (designate) takes this opportunity to express his commitment to the Reserve Bank's inflation objective, consistent with his duties under the Act. For its part the Government indicates again that it endorses the Bank's objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

TRANSPARENCY AND ACCOUNTABILITY

Monetary policy needs to be conducted in an open and forward looking way because policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Bank report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

In recent years the Reserve Bank has taken steps to make the conduct of policy more transparent. Changes in policy and related reasons are now clearly announced and explained. In addition, the Bank has upgraded its public commentary on the economic outlook and

issues bearing on monetary policy settings, through public addresses and its regular quarterly report on the economy. In furthering the arrangements already in place the Governor (designate) will support the release by the Bank of specific statements on monetary policy and the role it is playing in achieving the Bank's objectives. It is intended that these statements will include information on the outlook for inflation and will be released at roughly six monthly intervals.

The Governor (designate) has also indicated that he plans to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Financial Institutions and Public Administration.

The Treasurer expressed support for these arrangements, seeing them as a valuable step forward in enhancing transparency and accountability in the Reserve Bank's conduct of monetary policy - and therefore the credibility of policy itself.

The Government and Bank recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.

14 August 1996