

**Senate Select Committee on
Superannuation and Financial Services**

**Main Inquiry
Reference (b)**

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AFMA

14 September, 2000



Ms Sue Morton
The Secretary
Senate Select Committee on Superannuation & Financial Services
Parliament House
CANBERRA ACT 2600

- Initially by e-mail without attachments -

Dear Secretary

Australia's Centres for Global Financial Services

The Australian Financial Markets Association (AFMA) would like to thank the Committee for the opportunity to present our views on Australia's centres for global financial services.

We refer to your earlier letter, in which you ask us to further elaborate on our evidence, particularly regarding the matter of industry representation. We will also take this opportunity to expand on a number of our responses to questions raised by the Committee which, at the time, we were unable to answer more completely.

1. Industry representation

In our evidence we have identified the need for further rationalisation of industry representative bodies. We refer to "rationalisation" in the sense of "restructuring", not "downsizing". The point of that restructuring is threefold. First, to gain economies of operations. This has already been achieved by those associations who use the facilities and staff of AFMA – notably Securities & Derivatives Industry Association, Australian Treasury Operations Association, and ACI Australia (formerly Australian FOREX Association).

The second benefit of restructuring is the development of business services for the industry, at this stage primarily training and education. These business services require the economies of scale only available when taking a "whole-of-industry" approach. In the case of education, this should not be interpreted to indicate the development of "one-size-fits-all" courses. Rather, in order to maximise the economies of scale, the design and delivery methodology have a uniform and consistent approach.

Finally, closer ties between associations allow greater policy coordination within the financial services industry – particularly that aspect relating to wholesale transactions. In recognition of the position that financial service providers in Australia are a single industry, AFMA has

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A U S T R A L I A N F I N A N C I A L M A R K E T S A S S O C I A T I O N

adopted a policy of working with other associations (and the exchanges) to present a position to government that is joint, co-badged, or mutually supportive. Sometimes this is not possible particularly where associations take the view "... the issue is not relevant to our members, but it might be relevant to other people..."¹

The work of industry representative bodies has grown over the past 5 years and we are forecasting that it will continue to grow as stakeholders look to associations for policy outcomes and industry-based deliverables, such as accreditation and professionalism.

To a very great extent the current structure of financial services industry associations retains the historical regulatory distinctions. That historical distinction was based on sub-sectors of the financial services industry or activities: banking (Australian based and offshore based), insurance, stockbroking, superannuation, etc. Businesses were also once structured along these lines and associations were created with a mandate to assist these specialised businesses to deal collectively with the specific issues of their industry sub-sector. In that period, before the effects of deregulation had devolved, increased "openness" to the global economy was not fully felt. The focus of the financial services sector was inward and domestic militating towards divisiveness. The formation of the Financial Services (Ministerial) Advisory Committee (FSAC) and increased focus on Australian financial services centres as part of a global economy is evidence of the changes in industry perception and viewpoint.

The first structural casualty of deregulation was the "silo" approach to financial services business. For example, the artefact-like distinction between international and domestic banks became arbitrary – particularly in the eye of the consumer. Many organisations are now "allfinanz" or spanning all aspects of the financial services sector under a single organisation or holding company. Banks own fund managers, and insurance company's own banks. Non-finance holding companies can own banks, broking, insurance, and fund management operations.

Finally, many of the historical regulatory and governmental distinctions have been dismantled through the recommendation of the Financial System Inquiry (FSI) and government's acceptance and implementation of those recommendations through the CLERP program. The first and best initiative in this transformation, taken before either CLERP or FSI, were the steps taken by the Treasurer to corral all the aspects of government relating to financial services into the Treasury. Second in line were the statutory regulators – APRA, RBA, ASIC – all reformed and with new "whole-of-financial-sector" responsibilities. More recently the formation and support of an outward looking Centre for Global Finance (now AXISS), which serves to reinforce to the financial services sector that we are one in a very large global economy.

We consider that all that remains is for the associations to adapt to these structural changes and pull together to serve the financial services industry and its stakeholders more efficiently.

2. Accounting Standards

During our evidence, the Committee inquired about global harmonisation of accounting standards² - not an easy task for the complex and infinitely variable transactions of the over-the-counter (or off-exchange) financial markets.

¹ Committee Hansard, 16 May 2000, p.139

² Committee Hansard, 16 May 2000, pp 140-41

To support our evidence, we have attached a copy of *Accounting for Financial Instruments – Survey 2000 Results*, published by AFMA in May 2000, and a joint press release; *Survey Reveals Financial Markets in Need of Accounting Reform*.

The *Accounting for Financial Instruments Survey* showed that clear accounting guidance was required in Australia, and that integrating international accounting standards into Australia, or harmonising global accounting standards, will be challenging and is still some way from having a clear path forward.

3. Legislation

During our evidence the Committee inquired about the ability of legislation to keep pace with technological improvements³. As we showed by our responses, AFMA are unable to comment on whether legislation is keeping pace with “technology and trading practices”. We can say that legislation has not kept pace with the evolution of financial markets.

The financial markets are still operating under legislation drafted in the early 1980s, with very few amendments. That legislation, the Corporations Law, does not have any provisions directly relating to over-the-counter transactions. The law has been extrapolated by ASIC in its 165 (or so) Policy Statements. While the legislation has not changed the world has, and OTC transactions represent the vast majority of financial transactions, in Australia and globally. This situation, thankfully, will be remedied when the Financial Services Reform Bill (FSRB) is enacted.

Unfortunately even the FSRB, before introduction to Parliament, has flaws that indicate a lack of willingness by drafters to accept “technology and trading practices”. The most obvious example is the definition of a financial market, where two persons trading with each other using a “facility” are deemed to have traded on an authorised market - that is, an exchange. The term “facility” is defined so that a telephone system may require licensing as a financial market.

The Australian Financial Markets Association have concluded that it may not be possible for legislation to keep pace with changes in “technology”. We consider this a serious argument supporting the movement that legislation be drafted using a principles-based approach, to ensure that it endures, or as some form of insurance against technological evolution. The detail of the law should be devolved to regulations and policy. Such is the case in the OTC markets, due largely to the accountability created by an effective self-regulatory regime (rather than compliance).

While on the matter of enduring legislation, as mentioned in our evidence, the participants in the financial services industry have been expecting the outcome of the review of the Bills of Exchange Act for some time to incorporate e-commerce. Any encouragement by the Committee, for Treasury to complete that review would be appreciated.

In conclusion, while AFMA does not consider legislation, of itself, to be a material limitation to the further development of Australian financial centres, it is clear that the underpinnings of the legislation require continual policy improvement, rather than occasional inquiries (the Wallis and Campbell inquiries were 17 years apart).

³ Committee Hansard, 16 May 2000, p. 142

4. Commercial outcomes vs industry-wide efficiency gains

Our evidence given on 16 May 2000, was our first appearance before the Committee, and we are more than happy to assist the Committee, wherever we can, in its deliberations.

On reading the Hansard for that day we were surprised to see evidence given that clearly militated towards special pleading for an organisation, or sub-sector of the financial services sector.

For example, the argument regarding retail investors' ability to invest in interest bearing securities is misleading. While it is true that retail investors rarely directly invest in interest bearing securities, they invest indirectly through balanced funds, and funds whose only objective is investment in interest bearing securities. It is hardly the case that retail investors cannot have portfolio exposure to bonds. In summary, the lengthy argument put to the Committee, which by our analysis may only benefit the organisation who presented the "evidence", is one of whether retail persons should invest directly (exposing themselves to portfolio risks) or indirectly (where they can gain the benefits of being part of any number of diversified portfolios). We would consider that the arguments made to the Committee were product marketing, which may alter the distribution channel, but would not ultimately assist Australia's position as a provider of global financial services. A level playing field requires that changes to rules benefit the entire industry not single organisations.

Finally, in the words of Ken Farrow, CEO AFMA, given as evidence to the Committee; "We are happy to help"

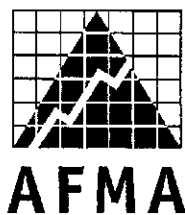
Yours sincerely



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Attach:



MEDIA RELEASE

Survey Reveals Financial Markets in Need of Accounting Reform

According to a recent industry survey, financial market participants have overwhelmingly indicated the need for further guidance from accounting standard setters and Government in the complex area of accounting for financial instruments.

Only sixteen percent (16%) of all participants surveyed, including representatives from most major financial market houses operating in Australia, indicated that existing Australian accounting guidance was sufficient in the field of financial instruments. The vast majority of respondents indicated that a specific Australian accounting standard was needed, or that regulators in Australia should introduce the same financial instrument accounting standards as are emerging internationally.

The survey, *Accounting for Financial Instruments Survey 2000*, was conducted by Deloitte Touche Tohmatsu and The Securities Industry Research Centre of Asia-Pacific on behalf of The Australian Financial Markets Association (AFMA). It explored current accounting practice and solicited views on a number of emerging issues arising from overseas developments in the same field.

Mr Stephen Gustafson, National Financial Services Industry Partner with Deloitte, says "The survey highlights the market's concern over the lack of clear accounting guidance in a field that continues to become increasingly demanding, and is subject to increasing scrutiny. It sends a strong message to accounting standard setters and Government on the need to push forward with reforms in this area."

Financial instruments have long been a troubled topic for Australian accounting standard setters. After much criticism of the proposed accounting model developed for measurement and recognition of financial instruments in 1995, Australia followed the path of many overseas jurisdictions by encouraging greater transparency through higher levels of disclosure of such activities.

Measurement and recognition issues however continue to pose the greater challenge. Australia is currently participating in a joint working committee with other standard setters including the International Accounting Standards Committee, the United Kingdom Accounting Standards Committee and the United States Financial Accounting Standards Board to develop such a standard. An Australian exposure draft on the topic is expected within the next two years.

Without a mandatory standard, inconsistent accounting practices may develop. Ultimately this may reduce investors' ability to make decisions. It is arguable that consistency of accounting practice that may result from mandatory accounting standards is not the only issue. It is important that such standards are appropriate for financial markets so that the true economic picture is provided to investors.

This is highlighted by a recent Basel Committee report on its review of International Accounting Standards, including recognition and measurement of financial instruments ("IAS 39"). The Committee concluded that the piecemeal approach of IAS 39 is likely to increase the risk of volatility in reported earnings and equity, which may not reflect underlying risk management practices.

One thing that is very clear is that the way forward will not be simple. Views on fundamental issues such as the appropriateness of fair value accounting (ie marking to market all financial instruments), how to measure fair value in certain circumstances, and when transactions should be considered a hedge, all showed a disparity of market views. Many of these views, and existing accounting practice, differ significantly from the emerging requirements in overseas markets. This means that big changes may be in store, and these changes may impact the way in which Australian financial market participants report profits in the future.

As Mr Gustafson explains "The hedging rules are a good illustration of this point. Emerging US and International Accounting Standards provide strict rules as to what constitutes a hedge. These rules extend the limited guidance provided in Australia. The survey highlights that many financial market participants may need to significantly change their hedging policies and procedures or else face changes in the way they measure the value of such transactions, and hence the profits they report."

AFMA is the industry body, which represents Australia's "over the counter" wholesale financial markets covering physical, currency and derivative products. This is one in a series of surveys on accounting practices commissioned by AFMA over the last 10 years. The last survey was conducted in 1995.

A copy of the survey can be obtained from www.deloitte.com.au or www.afma.com.au

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