

Developing a Globally- Competitive Financial Services Sector: Managing the Tension between Innovation and Regulation through Self Regulation

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**Financial Regulation: Costs, Benefits and the
Process of Regulatory Change
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1 Introduction

The Australian government has a policy to develop and maintain the Australian financial services industry as a leader within the Asia-Pacific region. To realize this policy, the Australian industry needs to keep pace with the high level of change that has characterized the global financial and capital markets in the recent past and is likely to continue in the future.

A successful sector needs to be internationally competitive but, critically, must also meet local requirements. Chief among these local requirements is for the sector to develop as a coherent, efficient, transparent and fair market while reducing its levels of systemic risk.

In this paper we explore how Australian Financial Services legislation and regulation have coped with the fundamental tension between these two opposing forces: encouraging continuous innovation to establish and maintain global competitiveness while ensuring a regulated market that meets local requirements.

The paper builds on research undertaken by Pearson and Elliot over the past 10 years on innovation in the banking and financial services industry and the Financial Services Reform Act with its legal and regulatory requirements. Particular focus is given to the role and impact of self regulatory schemes.

In addition to prior research, in July and August 2007, the authors conducted interviews with key industry and regulatory groups and with a diversity of Ombudsman schemes. All interviews were conducted on the basis of strict confidentiality with no details attributable to any individual or organisation.

Senior representatives of the following organisations were interviewed:

- Abacus Australian Mutuals,
- Australian Bankers' Association,
- Australian Finance Conference,
- Australian Securities and Investments Commission,
- Banking and Financial Services Ombudsman,
- Credit Ombudsman Service,
- Financial Industry Complaints Service,
- Investment and Financial Services Association,
- Insurance Ombudsmen Service.

2 Global and national context

Globally, the financial services industry in the last decade has been subject to a high level of transformation and change. The primary drivers of this change include: market deregulation and integration of world economies, bi-lateral and multi-lateral trade agreements, rapid movement of goods, services and capital across borders, technology and telecommunications advances and information and communication developments.

For financial markets, the benefits of a more integrated global economy include economic growth and the potential for risk-sharing. However, these benefits are associated with risks of greater volatility in capital and investment flows and exposure to contagion in financial crises. In this increasingly global economy, national markets will be less open to national prudential and regulatory intervention.

“Full financial globalisation will result in real returns on financial assets with similar maturity and risk being equalised across countries. For the small open economy that is unable to affect global financial conditions, this means that monetary policy will not be able to influence domestic real interest rates”.¹

Institutions within the financial services industry are changing as they become more global and as national markets are increasingly interdependent and exposed to international competitors. Traditional practises for creating local value through growth and efficiency may no longer be adequate and local institutions themselves may be under threat.

“While the big banks are expanding and will continue to take market share globally, medium-sized banks without the economies of scale will be squeezed out of the market, mainly through acquisitions and continued consolidation.”²

The future does, however, appear more favourable for smaller, specialist, niche operations and innovative non-banks, such as GE Money, PayPal³, Tesco, Volkswagen and Zopa.

At a transactions level, innovations in mobile and pre-paid payments and in online peer-to-peer banking are combining to transform the market and may disintermediate banks. For example, in 2004, an alliance between Japan’s NTT and Sony established a simple mobile payment solution using a contactless chip for a mobile phone⁴. Within 18 months the FeliCa system had more than 10 million users. A separate mobile payments approach was implemented in 2007 by London’s taxis. Devised by non-banks, JourneyPay BuyVoice supports credit card payments using the taxi driver’s mobile phone.

The UK launch of the social lending network Zopa in 2005 has been followed by Prosper in the USA, Boober in the Netherlands and Smaya in Germany. These online peer-to-peer deposit and lending models for customers are new competitive challenges for banking practice and regulatory challenges for governments and authorities since banks and other financial institutions play no role in borrowing or lending funds.

¹ Már Gudmundsson, Deputy Head of the Monetary and Economic Department of the Bank for International Settlements, Reykjavik, Iceland, 18 May 2007, “Financial globalisation and challenges for prudential policies and macroeconomic management”

² http://www.thebanker.com/news/fullstory.php/aid/4809/...coming_soon_to_a_bank_near_you.html, 050307 p96

³ PayPal, for example, enables individuals and businesses with an e-mail address to send and receive payments online. Although PayPal does require the use of bank accounts, it creates another move away from cash, cuts banks out of part of the payment process and has attracted 145 million accounts in 190 countries in less than 10 years. S.Timewell, The Banker, July 02, 2007, p120.

⁴ http://www.thebanker.com/news/fullstory.php/aid/4755/Mobiles_begin_calling_shots_on_banking_and_payments.html

“For banks, survival and growth in the future will depend not only on reacting to the new competing technologies but also on transforming their operating models.”⁵

Confronted by the impact of global market transformation and threats from non-bank competitors, banks have been challenged to make a greater commitment to innovation. Eric von Hippel, head of the Innovation and Entrepreneurship Group at MIT’s Sloan School of Management is concerned by “the fact that banks don’t have R&D departments”. Unusually in a global industry, few banks (with the notable exception of Citigroup and Deutsche Bank) have a research and development department. He calls on banks to make a formal commitment to an organisation-wide, proactive approach to innovation⁶.

Calls for banks to improve their approach to innovation apply also to Australian banks competing in a global market where a rapid response to technology and market developments is essential. The recent launch by a consortium of Australian companies of an application using “cutting edge technology” illustrates the issue. In August 2007, a trial of a new “smart mobile phone” was announced that contains a contactless payment chip in the phone. Customers can pay for purchases by waving the phone over a merchant’s reader. The trial is aimed at keeping “our customers at the forefront of easy and secure banking technology”⁷. But this raises questions about, how close to the forefront this may be, is it close enough and could we be doing better?

The Australian trial comes some three years after the highly successful Japanese launch by NTT and Sony of a contactless payment chip in a mobile phone. Contactless payment cards have been used successfully for more than ten years, since the launch of Hong Kong’s Oyster card in 1997. A proactive R&D department in an Australian bank might well have seen the global opportunity to link contactless payment technologies with mobile phones ten years ago. Especially since an Australian company, ERG, supplied the Oyster card’s payment system. Even at a reactive level, is a response taking three years sufficient to establish Australia as a leader in the global financial services industry?

Australia’s economy is predominantly a service-based economy, with service industries accounting for 70 per cent of total gross value added. The finance and insurance sector is the third-largest, generating 7.5 per cent or \$60 billion of GDP.⁸ This contrasts with the time when Australia was a goods-based economy, relying on the resources, mining and agriculture sectors for economic growth.

The Wallis Inquiry’s (Financial System Inquiry, 1997) predictions of heightened competition from specialist lenders and overseas financial service providers as well as an increased trend towards disintermediation have proved accurate. Developments in applications of technology have created opportunities for efficiencies in access and delivery of financial services, but lowered barriers to entry for non-traditional players. Product innovation is focusing on new distribution channels, expansion of existing

⁵ http://www.thebanker.com/news/fullstory.php/aid/4941/Putting_a_face_to_the_online_banking_revolution_.html, 070507, p156

⁶ http://www.thebanker.com/news/fullstory.php/aid/4734/INNOVATION:_HOW_TO_IMPROVE.html

⁷ http://www.visa-asia.com/ap/au/mediacenter/pressrelease/NR-300807_telstra_nab_visas.html

⁸ Axiss, 2006 Australia: A global financial services centre, August

product and service offerings and development of new concepts for existing channels, e.g. branches.⁹

Compulsory savings for superannuation has resulted in a massive pool of national savings. With a total value of \$1,040 billion in 2006, Australia's managed investments are the largest in Asia and the fourth largest in the world, which represents ample opportunity for improvement in prudentially sound, sustainable international earnings.

Success in Australia's financial services industry needs to be considered in the context of the national economy. National foreign debt is more than \$540 billion with a balance of payments deficit of \$16.5 billion in 2006. While the financial services industry generates some \$60 billion in revenues domestically, its contribution to export earnings does not match its domestic significance. Exports of financial services and insurance at \$1,700 million in 2006 exceeded their imports by \$200 million but this is a modest contribution to reducing foreign debt and the balance of payments deficit. Greater focus and attention as a national priority coupled with strategic innovation in financial services could lead to greater international contribution.

John Stewart CEO of NAB captured both the challenge and the opportunity:

“Are we happy to allow Australia to turn into a branch economy ... or can we take the same focus and determination that we show in sport and other areas to turn an already successful industry into the financial services powerhouse of Asia?¹⁰”

In considering these questions, there is no place for complacency.

Dr Zhu Min, executive vice-president of the Bank of China, predicted at the recent APEC meeting in Sydney that within ten years China will become the next global financial centre. Those sceptical about this prediction should remember that 10 years ago the possibility of China rapidly developing to its current position as the world's manufacturing centre may have seemed equally remote.¹¹

3 Current legislative and regulatory context

There are unique characteristics of Australian financial services regulation (FSR) that stem from the Wallis Report.¹² FSR can mean financial services reform or financial services regulation. The latter can mean a limited number of legislative reforms¹³ or it can encompass the full panoply of financial services regulation.¹⁴ In its more restricted meaning it introduced two new legal concepts – a “financial product”¹⁵ and a “financial service.”¹⁶ These concepts are defined in two pieces of legislation and are

⁹ IBIS National and Regional Commercial Banks in Australia K7325 17 June 2005, p8

¹⁰ John Stewart “What is the future of Australia's Financial Services Industry.” Address to Australia-Israel Chamber of Commerce, 28 August 2007

¹¹ J. Irvine, SMH, 080907, p10

¹² For an account of Australian financial services regulation see Pearson, G “Risk and the Consumer in Australian Financial Services Reform” 2006 (26 (1) *The Sydney Law Review*

¹³ Eg Corporations Act 2001 (Cth) Chapter 7; Australian Securities and Investments Commission Act 2001 (Cth) Part 2

¹⁴ It should be noted that the definition of financial services law in the Corporations Act s761A includes any other . . . legislation that covers conduct relating to the provision of financial services, whether or not it also covers other conduct

¹⁵ Corporations Act 2001 (Cth) Chapter 7 Division 3; Australian Securities and Investments Commission Act 2001 (Cth) s12BAA

¹⁶ Corporations Act 2001 (Cth) Chapter 7 Division 4; Australian Securities and Investments Commission Act 2001 (Cth) s12BAB

not identical.¹⁷ They include what would be regarded as both wholesale and retail products. It also introduced the concept of the “retail client”¹⁸, a synonym for consumer. FSR in its restricted sense does have a strong consumer focus but is not limited to this.¹⁹ The trigger for regulation of who can provide or sell, how a product can be sold and what people who contemplate acquiring a product must be told is whether there is a “financial product”.²⁰ The content of the obligations depends on whether or not the acquirer is a “retail client”.²¹

Although the concept of a “financial product” is key, there is no or limited product regulation in the sense of how the product must be constructed.²² Advice, and sales of products and services are regulated, and where relevant the delivery of the product is regulated. This contrasts with other sectors of the economy where there is intense regulation of the product, such as the scope, quality and grade of its component parts.²³

The aim of FSR was to avoid generic regulation based on existing categories of financial services products and create a product neutral regime to encourage product and service development. This is reflected in the general definition of a financial product centred on three concepts: making an investment, managing risk and making non-cash payments.²⁴ The purpose of this functional based regulation was to capitalise on processes such as convergence, consolidation and technological change that were already occurring in the market and create a regulatory environment in which the market could innovate, respond readily to change, and become even more nationally and globally competitive.

FSR is not a Code. Despite the forward looking aims of regulatory reform, FSR in the broad sense built on and integrated existing legislation much of which remains product based. Following the Wallis Report the prudential regulator is separate from the corporate regulator.²⁵ Prudential regulation rests on a series of different product or sector based Acts.²⁶ There is separate legislation for payments systems.²⁷ Market regulation is in the Corporations Act.²⁸ The prime FSR legislation, Chapter 7 of the Corporations Act is complemented by a further series of product based Acts²⁹ and by additional generic consumer protection legislation.³⁰ Credit³¹ is in an unusual position

¹⁷ In particular note the different treatment of a “credit facility”. Arguments may be raised about other products eg superannuation. .

¹⁸ Corporations Act 2001 (Cth) s761G. But note that there are exceptions for certain types of products ie insurance and superannuation

¹⁹ For instance financial market licensing is located in Corporations Act 2001 (Cth) Chapter 7

²⁰ This refers to the extensive licensing, conduct and disclosure rules.

²¹ Contrast Corporations Act 2001 (Cth) Chapter 7, Part 7.7 and Part 7.9

²² Exceptions might be interest rate caps on credit products.

²³ See for instance Product Safety Standards and Product Information Standards associated with the state based Fair Trading Acts and the Trade Practices Act 1974 (Cth). Consider also Food Standards and Australian Standards for building and other manufactured products..

²⁴ Corporations Act 2001 (Cth) s763A

²⁵ Australian Prudential Regulation Authority; Australian Securities and Investments Commission

²⁶ Eg Insurance Act 1973 (Cth)

²⁷ Payment Systems (Regulation) Act 1998 (Cth); Payment Systems and Netting Act 1998 (Cth) Note that this is complemented by self regulatory systems. See *Visa International Service Association v RBA* [2003] FCA 977; *Australian Retailers Association v Reserve Bank of Australia* [2005] FCA 1707,

²⁸ Corporations Act 2001 (Cth)

²⁹ Eg Managed Investments Act 1998 (Cth) (Corporations Act 2001 (Cth) chapter 5C; Insurance Contracts Act 1984 (Cth); Superannuation Industry (Supervision) Act 1993

³⁰ Australian Securities and Investments Commission Act 2001 (Cth)

³¹ Credit has its own disclosure regime, and some states have no licensing while others do have positive licensing. The generic FSR licensing and disclosure obligations do not apply to credit. There are strongly held views as to whether this is or is not the appropriate location for credit regulation.

as it is regulated by state based somewhat uniform legislation³², included as a financial product in the generic consumer legislation³³ and excluded as a financial product in the Corporations Act.³⁴

This framework is concerned with maintaining stability by minimising systemic risk and guarding prudential standards, and with fostering an efficient market for products and services that is “fair, orderly and transparent”.³⁵ The prudential regulator is to “balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality”³⁶ The market regulator is to “maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy.”³⁷ There can be a keen tension between safety and performance.

FSR in its narrow sense is concerned primarily with the protection of retail investors. Without retail clients there is no market or at least a very different market. Product innovation is a matter for both markets and in the regulatory objectives clearly linked to consumer choice and confidence in the market. The first of the main objects of Chapter 7 is “confident and informed decision making by consumers of financial products and services while facilitating **efficiency, flexibility and innovation** in the provision of those products and services.”³⁸ This is also stated a little differently as: “promote the confident and informed participation of investors and consumers in the financial system”³⁹

The regulatory scheme is based on a blend of high level principles based rules, cascading through detailed statutory rules to highly prescriptive regulations. This mixture of principle and prescription is complemented by informal industry based rules that have their own combination of principle and detail. Principles based regulation can be a challenge to financial services providers that desire rules to be certain and predictable. Legislation, principled or prescriptive, may be inappropriate at the level of operation dealt with by some self regulatory rules.

FSR has had an uneven impact on different areas of the financial services market. In terms of product, the biggest impact has probably been on banking and insurance products, which have been drawn closer into the regulatory matrix. The weight of regulation has also borne heavily on the market for advice, particularly as it disentangles advice from sales and delivers financial advice in a manner which is meaningful for, and expected by, consumers.

The retention and persistence of the underlying product based approach is evident in the self regulatory schemes. FSR rests on an amalgam of statute and self or co regulatory rules. The self or co regulatory system encompasses both wholesale and retail markets. It includes clearing bodies⁴⁰, market bodies⁴¹ and industry bodies⁴².

³² Uniform Consumer Credit Code

³³ Australian Securities and Investments Commission Act 2001 (Cth) s12BAA(7)(k)

³⁴ Corporations Act 2001 (Cth) s765A(1)(h);

³⁵ Corporations Act 2001 (Cth) s760A(c)

³⁶ Australian Prudential Regulation Authority Act 1998 (Cth) s8(2)

³⁷ Australian Securities and Investments Commission Act 2001 (Cth) s1(2)(a)

³⁸ Corporations Act 2001 (Cth) s760A(a)

³⁹ Australian Securities and Investments Commission Act 2001 (Cth) s1(2)(b)

⁴⁰ Eg APCS, CSI, BECS

There are a series of product based industry associations which promulgate voluntary codes of conduct for their members. Primarily, these code rules set standards for the interaction of the industry member with the customer/client/consumer. In addition to the codes of practice, there is a series of product based dispute resolution schemes which now are formally independent from the industry associations but which nevertheless retain close ties with them.⁴³ The formation of the dispute resolution schemes is voluntary though membership may be mandatory.⁴⁴ This approach is so well entrenched that new codes of practice in particular market segments continue to be promulgated, for instance the SEQUAL Senior Australian Equity Release Association of Lenders, code for reverse equity products.

The following lists the major codes of conduct and the major self product based, retail client focused EDR schemes.

Code of Banking Practice,
Credit Union Code of Practice⁴⁵
Electronic Funds Transfer Code of Practice,
General Insurance Code of Practice,
General Insurance Brokers' Code of Practice,
Financial Planners Code of Ethics and Rules of Professional Conduct,
Mortgage and Finance Association of Australia Code of Practice (February 1 2007)
Investment and Financial Services Association Standard Number 1 Code of Ethics and Code of Conduct (A total of 17 Standards)

Financial Industry Complaints Service (FICS)
Banking and Financial Services Ombudsman (BFSO)
Insurance Ombudsman Service Limited (IOS)
Insurance Brokers Disputes Limited (IBD)
Credit Union Dispute Resolution Centre (CUDRC)
Financial Co-operative Dispute Resolution Scheme (FCDRS)
Credit Ombudsman Service Ltd (COSL)

An additional statutory body, the Superannuation Complaints Tribunal (SCT) should be noted.

The importance of self or co-regulation in Australian financial services regulation is no accident. It was debated through the Wallis inquiry and subsequently.⁴⁶ The arguments for a self or co regulatory approach to regulation are well known and include:

- Accepted by industry to forestall legislation and the fear of what such legislation may bring.⁴⁷

⁴¹ Eg ASX

⁴² Finance Industry Council of Australia includes membership of the following industry bodies: ABA, AFMA, IFSA, FPA, AFC and Insurance Council. <http://www.fica.com.au/>

⁴³ For an assessment of the dispute resolution schemes see O'Shea, P & Rickett, C "In Defence of Consumer Law: The Resolution of Consumer Disputes" 2006 28 (1) *The Sydney Law Review*

⁴⁴ See the position of AFSL licensees below.

⁴⁵ Abacus is currently developing a new mutuals code of practice. A consultation draft on a new code of practice for credit unions and mutual building societies will be available on www.abacus.org.au in October 2008.

⁴⁶ Financial System Inquiry Final Report 1997 (Wallis Report) at p 260

⁴⁷ This was the case in the 1990s with the initial Insurance and Banking Codes

- Industry acceptance of standards that it might otherwise oppose and argue should be watered down, e.g., EFT Code
- A way of enrolling financial services providers into the regulatory conversation.⁴⁸
- A way in which the financial services industry absorbs the values inherent in the regulatory framework.⁴⁹
- An ideal of “responsibilised autonomy”.⁵⁰
- Improves compliance and reduces potential disputes.⁵¹
- Is cost effective and leaves the regulator with more resources for other issues
- May simply be a way of avoiding conflict and exposing regulatory shortcomings and information imbalances⁵²
- A form of risk shifting from the regulator to the governed⁵³
- Promotes enforcement and market integrity⁵⁴
- Uses industry resources and expertise “to enhance market dynamism”⁵⁵

The place of self regulation in FSR is explicitly supported by legislative requirements. First, the regulator, ASIC has the power to approve codes of conduct, thus changing their status and giving added legitimacy to code rules.⁵⁶ ASIC itself has been on a journey in its approach to codes of conduct.⁵⁷ It has approved codes in the past. Currently there are no approved codes though arguably the presence of certain codes on the ASIC website conveys an aura of respect. ASIC’s failure to approve any Codes has been raised as a source of concern. In the context of risk regulation practiced by regulators it could be interpreted as risk aversion. Alternatively it could be that ASIC has such confidence in the codes that it is willing to see them develop autonomously.

The ASIC criteria for codes of conduct and code approval are contained in ASIC Policy Statement 183 *Approval of Financial Services Codes*. The key is that code rules should not embroider or amplify the law. ASIC has indicated that code rules should establish standards that are higher than that required by law. Thus the regulatory system asks industry to engage in a responsive process to constantly improve and lift market practices and seek evolving best practice. This is a potentially powerful approach to integrate “**efficiency, flexibility and innovation**” in the provision of products and services with continuously enhanced market practices.

Secondly, effective self regulation of a particular kind is a barrier to entry into the market for financial services for retail clients. To carry on a financial services business a person must have an AFSL.⁵⁸ To provide financial services to retail clients

⁴⁸ Black J “Regulatory Conversations” (2002) 29 *Journal of Law and Society* 163; Black, J ‘Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation’ (2003) *Public Law* SPR 63.

⁴⁹ Parker, C *The Open Corporation*, Cambridge University Press. 2002

⁵⁰ Vincent Jones P, “Values and purpose in government control – local relations in regulatory perspective,” *Journal of Law and Society*

⁵¹ Productivity Commission Review of the Consumer Protection Framework Submission Consumer Credit Legal Centre (NSW) June 2007 p45

⁵² Gunningham N “Negotiated Non Compliance: A Case Study of Regulatory Failure” 1987 9 (1) *Law and Policy*

⁵³ Pearson, G “The Place of Codes of conduct in Regulating Financial Services in Australia” 2006 15 (2) *Griffith Law Review*

⁵⁴ Commerton- Forde, C & Rydge, J “Self Regulation and Securities Markets”

⁵⁵ Productivity Commission Review of Australia’s consumer policy framework Submission by the Australian Securities and Investments Commission August 2007 3.51

⁵⁶ Corporations Act 2001 (Cth) s1101A. Note that the power of approval extends to codes that relate to “any aspect of the activities” of financial services licensees; authorized representatives of financial services licensees, and the issuers of financial products.

⁵⁷ Pearson, G “The Place of Codes of conduct in Regulating Financial Services in Australia” 2006 15 (2) *Griffith Law Review*

⁵⁸ Corporations Act 2001 (Cth) s 911A

and obtain an AFSL a person must be a member of one or more approved external dispute resolution systems.⁵⁹ These EDR memberships must cover disputes for all services included in the licence. Thus retail client dispute resolution is the province of industry.

The criteria for ASIC approval of dispute resolution schemes is set out in ASIC Policy Statement 139 *Approval of External Complaints Resolution Schemes*. There are further requirements in ASIC Policy Statement 165 *Licensing: Internal and external dispute resolution*. The key principles are accessibility, independence, fairness, accountability, efficiency, effectiveness. In contrast with the codes, ASIC has approved seven dispute resolution schemes.

The self regulatory schemes are regularly monitored and reviewed. This process should promote the potential for the schemes to act as an agent of change. Valuable suggestions come out of the review procedure. For instance the review of the BFSO and greater transparency⁶⁰, a reconsideration of loss allocation rules in the EFT Code, and better case management in FICS.⁶¹

4 Complexity of requirements

To be successful, the Australian Financial Services industry needs to be internationally competitive as well as meeting local requirements. The over-arching requirement is for the sector to develop as a coherent, efficient, transparent, fair and internationally competitive market while reducing its levels of systemic risk and meeting the needs of consumers.

This over-arching requirement is made up of two major elements:

1. The necessity to promote appropriate innovation in the Australian market to:
 - (a) respond to exposure to global competitors & market developments eg new forms of mobile payments, and social lending;
 - (b) enable innovative activities by smaller, specialist, niche operations and non-banks since these bodies are more likely to implement market transforming innovation than established market leaders;
 - (c) support economic growth and the potential for risk-sharing (associated with risks of more volatility in capital flows and exposure to contagion in financial crises);
 - (d) address the perilous positioning of medium-sized banks without global efficiencies and economies of scale;
 - (e) provide greater focus on international contributions to national wealth

⁵⁹ Corporations Act 2001 (Cth) s912A(1)(g); s912A(2)(b)

⁶⁰ Phil Khoury, Debra Russell, Fiona Guthrie, *Independent Review Banking and Financial Services Ombudsman*, November 2004. Available online at [http://www.bfso.org.au/ABIOWeb/ABIOWebSite.nsf/0/E28FD200B7ECEF5DCA256FF600203DE5/\\$file/BFSO+Review+2004.pdf](http://www.bfso.org.au/ABIOWeb/ABIOWebSite.nsf/0/E28FD200B7ECEF5DCA256FF600203DE5/$file/BFSO+Review+2004.pdf); The Board's response to the report and the steps taken to implement the recommendations are outlined in: Banking and Financial Services Ombudsman, *Board Response to Review Recommendations*. Available online at <http://www.bfso.org.au/ABIOWeb/abiowebSite.nsf>; and Banking and Financial Services Ombudsman, *Review of the Banking and Financial Services Ombudsman Recommendations and Implementation*. Available online at <http://www.bfso.org.au/ABIOWeb/abiowebSite.nsf>

⁶¹ *Review of the Financial Industry Complaints Service 2002 – Final Report*. Available online at <http://www.fics.asn.au/IndependentReview.asp>. The FICS Board has since prepared an implementation plan: Financial Industry Complaints Service, *Review of the Financial Industry Complaints Service 2002 – Implementation Plan*. Available online at <http://www.fics.asn.au/IndependentReview.asp>

- (f) ensure compliance with the regulatory system that asks industry to engage in a responsive process to constantly improve market practices.

2. The necessity to protect consumers:

- (a) by enabling confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services;
- (b) consistently and coherently even though customer protection is fragmented across legislation including FSR, Corporations Act, the ASIC Act and state legislation, particularly the UCCC;
- (c) by ensuring that any organisation seeking to supply financial services to retail clients is suitably licensed. To obtain an AFSL, a person must be a member of one or more approved external dispute resolution systems providing accessibility, independence, fairness, accountability, efficiency and effectiveness.
- (d) by maintaining accessible and low cost dispute resolution for all financial services complaints

While the necessity to protect consumers is an important part of FSR, the assumptions on which FSR relies may not be realistic. FSR focuses on disclosure as a key element for assuring consumer protection. This assumes a clarity of information transfer, efficiency in the market and capacity for optimal choice that may not be achievable given the growing knowledge of irrational decision-making.

The objective in promoting innovation is to establish and maintain a globally competitive financial services market that is committed to continuous improvement and responsive to international developments. The essential objective of the consumer protection requirements is to maintain consumer confidence in the financial markets and to protect the major source of funds for the industry. While both objectives are essential, commitment to either in isolation would be to the detriment of the other. The tension between each objective can be resolved through compromise and agreement on a middle ground. Internal conflicts are also present within the existing system, for example in the requirement for an industry external disputes resolution structure to be both accessible (low cost) and independent, while remaining part of the industry. Costs of innovation are born directly by institutions while costs of consumer protection are born jointly by tax-payers, industry participants in a dispute resolution scheme, and consumers.

5 Analysis of how well current regime meets requirements

This section examines regulatory structures and considers their impact on innovation.

5.1 Principles-based legislation

Principles based regulation as opposed to detailed prescription should support innovation. There is strong support for light touch regulation. This is premised on the risk being manageable. But there is tension in some industry sectors between the desire for certainty and predictability provided by prescriptive legislation and more open ended principles that encourage participants to behave in the “spirit of the law”. The extent of industry buy in may be unique to the Australian system and there is a

considerable degree of consultation and interaction at top levels. This is a true strength of the Australian system and the positive engagement and ownership should be preserved even as its particular features might change.⁶²

The tensions inherent in principles, self regulation, manageable risk and prescription may become more manifest in a market downturn. For example, due to the importance of superannuation and retirement incomes public policy, it is predicted that if there is a market downturn and investment losses, especially in superannuation funds, this may result in a change in regulation as a reaction. Industry leaders have suggested the possibility of more prudential control of superannuation and quasi-prudential regulation of significant investment products as well as restrictions on the types of products that retail clients can acquire from brokers. If this were to be the case this would have a significant impact and reduce the capacity to innovate in seeking out returns.

5.2 Ombudsman schemes and industry bodies

Yet despite the potential inherent in the self regulatory system for innovation, overall the structures do not support change. The dispute resolution systems do not and perhaps cannot drive innovation. Indeed the Ombudsmen schemes, while important for consumers, may be seen as an inhibitor rather than an agent of change. Some Ombudsmen do look at improving business practice and have the support of industry. Others focus just on dispute resolution and improving practices is not on their agenda. And for some there is resistance to engaging with the fringe or rogue elements of industry where greatest change in practices may be required.

The transparency requirements of the EDR schemes can result in change. For example, the BFSO Bulletins and ABA Code may influence the market and an example might be the approach to financial hardship in the UCCC.

There is a national agenda for the financial services industry. Some industry bodies are concentrated on their own requirements and protecting their own members interests with limited focus on national issues or global issues of competition and change. In some sectors, global competitiveness is not even on the horizon. Yet the system has achieved a level of success in meeting local objectives as international players in the market are encouraged to comply with local practices and standards.

This lack of focus is not assisted by the fragmentary nature of the self regulatory structure with its gaps and overlaps. This requires further and detailed mapping. For instance there is some overlap between the BFSO, SCT and FICS. Examples might be a superannuation product with an associated life insurance product or financial planning and banking products. This is being addressed for these three schemes only.⁶³

While some industry bodies are active in influencing members conduct through codes and standards, some parts of the financial services industry are not active contributors to the regulatory system through self regulatory initiatives. Some industry bodies have in place voluntary codes, whereas other industry bodies mandate compliance with the

⁶² A number of interviewees compared the Australian system very favourably with the UK system.

⁶³ See below

code as a pre-condition of membership. There are consequences of both approaches. For example, not all ABA members have adopted the ABA Code of Banking Practice.⁶⁴ Some IFSA members have ceased being members due to a reluctance to comply with industry standards.⁶⁵ It has been suggested that ASIC should monitor this to ensure that regulatory arbitrage does not undermine consumer protection.

The Ombudsmen and industry associations may have an almost impossible task to develop and motivate change where there is limited regulatory enforcement or limited regulatory interest in a particular industry segment. And to do so may put the relationship with industry at risk. This is particularly so if there is a requirement to discipline members⁶⁶. Schemes that emphasise the relationship between self regulation and innovation stress compliance and correction rather than punishment as characteristic of the scheme.

5.3 Gaps in coverage

Another challenge for effectiveness and efficiency of the current regime is that of fragmented legislation across Commonwealth and state statutes. This can contribute to increased costs for industry and increased risks for consumers.

Not all credit providers are subject to financial services and prudential regulation in the same way as ADIs. The position of credit compared with other financial services products impacts on the efficiency of self regulation. Since credit is excluded from Chapter 7, there is a fragmented regulatory system as different states have taken different approaches even though the Uniform Consumer Credit Code (UCCC) generally applies. Since credit providers do not have to hold an AFSL, like financial product issuers, they do not have to be members of an EDR scheme.⁶⁷ Many are voluntarily members of schemes.⁶⁸ Despite four schemes potentially covering credit, some small finance companies and fringe credit providers are not in schemes.⁶⁹ There is industry resistance both to being in a scheme and to having some players as members of schemes.

Intimately linked to the credit problem are finance and mortgage brokers. The urgent need for national broker legislation is widely acknowledged. The hiatus here may be linked to resolving the regulation of credit. Generally finance brokers are not required to join an industry association, subscribe to a code or be a member of an EDR scheme.⁷⁰ Other issues are the regulatory location of property investment advice and

⁶⁴ <http://www.bankers.asn.au/Default.aspx?ArticleID=460>

⁶⁵ Some organizations (3-4) in 10 years have left IFSA because of reluctance to comply with standards eg. Soft dollar, unit pricing, performance calculations, proxy voting.

⁶⁶ This has been an issue for FICS. See for instance *Financial Industry Complaints Service Ltd v Deakin Financial Services Ltd* [2006] FCA 1805

⁶⁷ There are state based Tribunals for consumer credit matters

⁶⁸ The majority of Australian Finance Conference membership by volume of business are mandated or have volunteered to be in an EDR scheme.

⁶⁹ Productivity Commission Review of Australia's consumer policy framework Submission by the Australian Securities and Investments Commission August 2007 3.59

⁷⁰ There is some indirect federal regulation of mortgage brokers who provide a financial product along side home loans. An ASIC Class Order provides relief from licensing provided the broker is a member of a dispute resolution scheme such as the Credit Ombudsman.

innovative services to consumers such as comparison services which are not captured in the regulatory structure.⁷¹

The fragmentary character of the self regulatory system is exacerbated by inconsistencies within the dispute resolution schemes. There are inconsistent monetary limits on the compensation payable by schemes. Some schemes have quite low dollar value for the market/product segment they serve. This may mean some complaints do not come to the scheme and enter the feed back loop to industry to enable it to improve practices. But it also means that if a complaint does come in that it may be resolved with a less cost to the industry member of a scheme than if the consumer had gone to Court. There are also inconsistencies in the approach to reporting complaints/cases/decisions.

5.4 Innovation

The current regulatory regime has resulted in a level of innovation, e.g., in continuing changes to the payments system, new credit products and providers such as reverse mortgages and mortgage brokers, and developments in platforms for managed funds. According to Richard Gilbert of IFSA self regulation has been a major contributor to “innovation without failure” although this may come at the risk of limiting change to incremental improvements.

In considering how the current regulatory regime balances requirements for innovation and consumer protection, there is no indication that regulation created barriers to innovation. However, this does not mean that consumers were disadvantaged. Not all innovation is necessarily directed in the interest of consumers. Innovation can seek to deliver benefits for industry. However, perceived regulatory gaps can drive change, for instance investment through debenture products linked to the provision of unsecured mezzanine finance. In some cases regulation may drive regressive change or encourage unscrupulous players to find ways to get around regulatory requirements and intervention to the detriment of consumer protection, such as UCCC restrictions driving business models through imposition of high fees from payday lenders. Other examples would be the post FSR reluctance to give insurance travel advice and state based credit provisions in the ACT setting out requirements for increasing card credit limits.

In other cases, potential industry responses to a changing regulatory environment may be detrimental to consumers as with the increase in cyber crime and a possible response of shunting home more liability to consumers for unauthorised transactions. Other unfavourable innovations may be honeymoon rates on credit cards or low interest rates for transfers of credit.

Given the nature of the product, in some instances there may be limited scope for product innovation or differentiation in simple financial products, such as with general insurance products. In other cases, products that look new may be merely a new marketing ploy. This practice of re-packaging is not exclusive to the Australian market. Internationally, the financial services industry has been criticised for focusing

⁷¹ Productivity Commission Review of Australia’s consumer policy framework Submission by the Australian Securities and Investments Commission August 2007 3.16

on incremental improvements of existing practices while ground breaking innovative financial products and services have been implemented by organisations from outside the industry such as CSC, PayPal, Sony, Zopa and a range of telecommunications companies.

Consumer protection (and indeed an efficient market) is predicated on consumer choice and acquisition of appropriate products and services. When there is innovation in the development of completely new products or enhancement of existing types of products, consumers may not understand the new product. There are particular issues if consumers acquire what appears to them to be a traditional well understood product and it has unexpected features or risks. This can be the case with shared equity loans, reverse mortgages or products that are offered as “bank like”. Enabling consumers to understand and assess the true nature of the product is a joint responsibility of regulation, advisers and providers and consumers. It has been suggested that unless this responsibility is met the alternative of paternalistic product regulation would stifle innovation.

It should be noted that the self regulatory system has little influence on the cost of products and services and of associated charges – other than through formal disclosure rules and ‘informal’ disclosure practices.

6 Potential options for future developments

There is strong industry confidence in the EDR schemes and an emphasis on the sense of industry ownership of the schemes. This is a positive argument in that it promotes industry involvement in the social and policy issues around consumer concerns and complaint resolution. Some industries see a well regarded EDR scheme as a plank in maintaining the good reputation of the industry and cost effective management of complaints without unnecessary court proceedings. However, currently the structure of the EDR schemes promotes a sectoral focus and a potential lack of appreciation of wider industry issues including the place of the sector and industry in the national picture. Self regulation risks becoming a means for focusing exclusively on market objectives rather than also supporting national policies.

6.1 Structure and membership of EDR schemes

The structure of external dispute could be enhanced through convergence of schemes. We note that on August 2 2007 Mr Chris Pearce, Parliamentary Secretary to the Treasurer announced the recommendation of a sector based report that the BFSO, FICS and the IOS merge.⁷² It is expected that the merged entity will be operating from July 2008.

Despite the pending merger of BFSO, Insurance Ombudsman and FICS, there will still be disparate EDR schemes across market sectors. Some enduring problems include:

- Smaller schemes lack of ability to influence industry practice

⁷² Mr Chris Pearce, Parliamentary Secretary to the Treasurer speech IFSA Annual Conference Breakthrough 2007. August 2 2007

- Consumer confusion as to where they can pursue complaints against certain participants
- Different limits for claims in different EDR schemes create difficulties where over-lapping responsibilities occur as it promotes a sense of regulatory arbitrage.
- Potential difficulties in convergence such as different cultures in different schemes and the requirements for specialised market knowledge exist.

Therefore, a review could be undertaken to determine a structure more supportive of national policies and objectives that would encompass all schemes. This review should strive for a more effective operation in terms of systems; be easier for consumers to identify where to take complaints; reduce forum shopping; provide quick and cost effective dispute resolution; and promote innovation across the industry as sectoral boundaries dissolve. It will need to take into account the differences in different parts of the industry; differences in the scale of the businesses, e.g., small financial planner, big insurance company and bigger bank.

Consistency and predictability on standards and compliance is required. An ideal body may be a private sector board with equal numbers of industry and consumers representatives and an independent Chair. Members should not be appointed by government and should not be political appointees. They would need long term expertise and should be paid enough to retain them. Particular care will be needed to maintain the feedback loop to industry to enhance practices.

The SCT does not appear to fit well within the FSR and perhaps could be rolled out of the statute. If there were a more consistent approach the SCT could be an industry scheme.

The potential role of an industry wide tribunal was examined. There was little support for such a tribunal among self regulatory or industry bodies. The cost and lead time necessary for a tribunal do not appear appropriate for small disputes. The experiences of the SCT are an example of the difficulties experienced by tribunals. This again raises the option that the SCT could be integrated with the dispute resolution system and become an EDR scheme rather than a Tribunal.

Membership of the EDR schemes could be supported by making it mandatory on all financial advertising to include details of membership of industry self regulating schemes. Currently ASL holders are required to include details of their international complaints systems, external dispute resolution schemes and compensation arrangements in disclosure documents provided to their retail clients.

Advertising will promote the schemes and provide further incentive for market behaviour to comply with industry codes of practice that endorse scheme membership and internal complaints handling mechanisms.

Several industry self regulatory bodies reported experiences with member companies unwilling to comply with high standards and those organisations leaving the voluntary industry bodies, with no apparent disadvantage. As the market transforms, other market sectors, such as small finance companies, fringe credit providers and ratings bodies which are not required to be part of any EDR scheme may see the commercial

benefits. Further embedding self regulatory schemes with high standards may overcome this problem.

6.2 ASIC support for self regulatory initiatives

A potential conflict arises with industry self regulatory bodies being required to work closely with voluntary members, but also expected to discipline those members. These conflicting requirements could act to reduce the effectiveness of self regulatory initiatives.

A more detailed examination could be undertaken of difficulties being experienced by industry bodies with a self regulatory role, with a view for ASIC to provide additional mechanisms for support, promotion and endorsement.

Currently, industry bodies rely on codes of conduct to promote standards of practice and market behaviour. There is a distinction between mature codes that have succeeded through various iterations and newer codes. The option of exploring ASIC's requirements for approval could be undertaken as this may assist implementation of voluntary codes.

6.3 Role of industry bodies

Overlaps and gaps in the responsibilities of industry bodies currently exist that could hinder their operations as self regulatory organisations. These gaps result from a commitment to have specialist industry bodies representing distinct interests within the financial services industry.

Currently, the Finance Industry Council of Australia provides an overarching framework for industry representation. Greater collaboration and cooperation using the FICA structure could enhance self regulatory initiatives.

6.4 Role of consumer education

The impact of a poor consumer or financial decision falls on the consumer. The importance of consumer education and financial literacy initiatives is paramount. This should not be a substitute for regulation and should recognize behavioural economics and irrational choice. The limits of financial literacy in balancing the risk as between industry and consumers should be acknowledged.

Currently, Government (via the Financial Literacy Foundation), regulators such as ASIC (via the FIDO website), industry bodies and industry participants all contribute important programs and resources to assist consumers broaden their financial understanding. Greater prominence and support for the expansion of these programs and resources, for all consumers including the disadvantaged could enhance participation and confidence of consumers in the mainstream financial system. There is scope for the self regulatory bodies through the codes and EDR schemes to support the financial literacy project.

6.5 Innovation

All of these options for future development should be considered in conjunction with the critical necessity for innovation in support of national policy objectives and calls by finance industry leaders for concerted action to avoid Australia's relegation to the status of a 'branch economy'⁷³. In moving from a reactive to a proactive approach to innovation, the level of these innovations needs to progress up the value chain from incremental improvements to current products and practice in the local market to world-class innovations that can be applied in a global market. The quality of Australian consumer protection practices are an integral part of our products and services and will provide a strong differentiation in a global market.

7 Conclusions, implications & discussion

This paper raises critical questions about national wealth and financial interests, levels and focus of industry innovation in support of national policy, mechanisms for consumer protection, complacency and the impact of FSR on all of these questions.

FSR and its self regulatory structures should be assessed in terms of its objectives:

- “confident and informed decision making by consumers of financial products and services while facilitating **efficiency, flexibility and innovation** in the provision of those products and services”.
- “financial safety and efficiency, competition, contestability and competitive neutrality”
- “to maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy.”

Arguably, FSR may be viewed as both support and hindrance to greater self and co-regulation by the Australian financial services industry.

1. Confident and informed decision making by consumers? FSR took a narrow view on how this could be achieved. Subsequent experience suggests that it is not solely determined by disclosure, but must be supported by higher levels of consumer education, robust regulation and sound industry practices.
2. Efficiency? Self regulation may be a less expensive option but the multiple schemes for each industry segment have led to gaps, overlaps, and, in the event of a dispute, forum shopping,
3. Flexibility? The industry has certainly experienced improvement and change. There has been no indication that market flexibility has been inhibited by regulation.
4. Innovation? The focus of self regulated industry segments appears at odds with the imperatives to develop the financial services industry at a national level. The current regime supports minor incremental change but the extent to which it supports fundamental ground breaking innovation remains unclear.

⁷³ John Stewart “What is the future of Australia’s Financial Services Industry.” Address to Australia-Israel Chamber of Commerce, 28 August 2007

5. Financial safety? This issue is outside the scope of this paper, though effective self regulation contributes to it.
6. Competition? There may be a competitive advantage in a multitude of different codes and dispute bodies but there is also a strong argument for convergence.
7. Competitive neutrality? The sector or product based codes and dispute bodies may hinder this.
8. Reducing business costs? This paper has not directly addressed the cost of self regulation. It is suggested that converged schemes should be less costly. It is recognised that there may be higher costs in ineffective and inefficient self regulation.

Self regulatory schemes should not be assessed solely against the efficiency of their operations, coverage, accessibility, independence and transparency. There needs to be more research on the impact of self regulation on product innovation and the self regulation of product characteristics. For consumer protection, self regulation should be assessed against the nature of products offered to the market and their comprehensibility, the risk to consumers in those products, and the balance of the risk between providers and consumers. For innovation, the self regulatory schemes should be assessed against meeting national objectives to ensure Australia becomes a regional centre for financial services.

The financial services industry is confronted by two conflicting challenges:

1. The necessity for continuous innovation to avoid falling behind developments in the global industry; and
2. The imperative to implement continuous improvement in consumer protection.

Success on either front should not be taken for granted as both will require high levels of sustained commitment. Simply, we cannot assume the transition from aspiration to success in Australia becoming a globally competitive financial services centre.