

Financial Services: 'Regulatory Issues and the Common Good'

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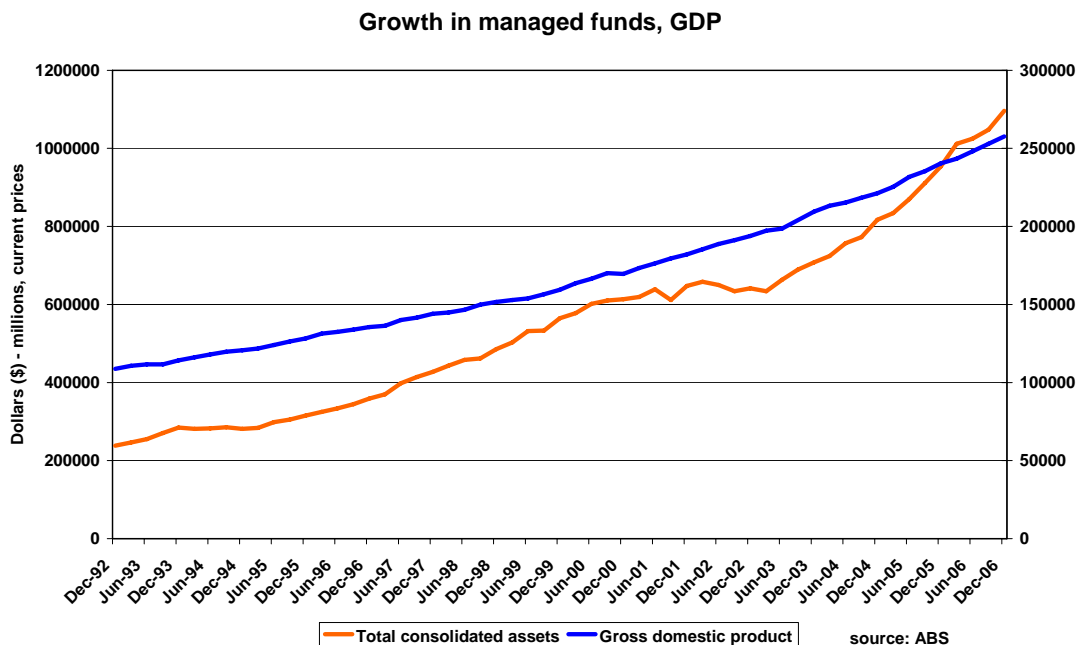
Investment and Financial Services Association Ltd (IFSA)

Good morning and thank you for providing me with the opportunity to address the 12th Melbourne Money and Finance Conference. IFSA represents the retail and wholesale superannuation, managed funds and life insurance industries. We have grown since foundation in 1997 to a membership of more than 140 of Australia's largest financial services providers who manage more than \$950 billion on behalf of almost 10 million Australian investors. As an industry, we contribute around 7.2% of GDP, which according to AXISS in 2006, is about the same as mining, agriculture, forestry and fishing combined.

In this paper I will touch on the challenge both Government and industry faces in achieving best outcomes for the 'common good' of Australians and provide examples of three industry proposals, recommended to Government, covering operational , investment, and tax that IFSA considers will address certain of the existing impediments to the financial services industry by our current law.

The financial services industry has come from a long way in the last 50 years "from one that operated entirely under the regulatory radar in 1954, to one of the most significant and intensely regulated parts of the Australian financial sector "¹. Over the last 20 years consolidated assets in the funds management industry have grown 606.1% from the September quarter 1988 (in current prices). The following table charts the growth in assets under management in funds management industry since 1988. According to the ABS, total consolidated assets of managed funds institutions was \$1042.1b at 30 September 2006. We have grown into a mature and very experienced industry where we are looking beyond our domestic shores and actively competing in the global markets.

¹ Mees BT, Wehner MS, Hanrahan PF, Fifty Years of Managed Funds in Australia - Preliminary Research Report, Centre of Corporate Law and Securities Regulation (available at www.ifsa.com.au)

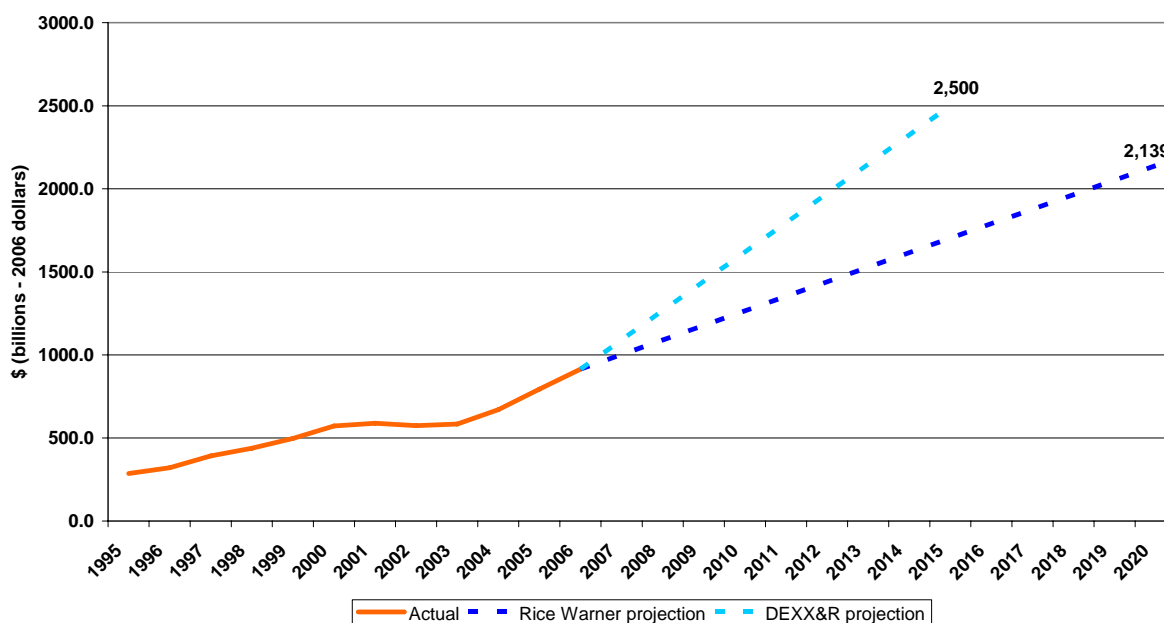


A significant factor in this increase in funds under management was the introduction of the super guarantee levy on 1 July 1992. Of the total consolidated assets under management of \$1042.1 billion at 30 September 2006, \$558,761 billion or 53.6% was in superannuation funds. This rapid growth is expected to continue. Actuaries, Rice Warner has projected that total assets under management for super funds alone will rise to \$2,139 billion in 2020 (in 2006 dollars). Of this increase, \$404 billion, or approximately 23%, is projected to be due to the Government's superannuation changes introduced in the last Budget.

Research consultants DEXX&R's projection is more bullish, with total superannuation assets predicted to reach \$2,500 billion in 2015 (see chart below).

Actual and projected total superannuation assets 1995-2020

source: APRA, ABS, Rice Warner, DEXX&R



Regulation and the 'common good'

Defining the 'common good' is a complex task in an age where regulatory and investment issues are becoming more and more global. Achieving the 'common good' involves trust, safety, growth, opportunity, and mutual benefit that is underpinned by vision and a willingness to adopt change.

IFSA has a deep and abiding interest in how this industry is regulated and of course for the 'common good' of our ten million investors, in both an investment and regulatory sense. We see ourselves very much as partners in public policy development with Government and regulators. We, therefore, have a vested interest in supporting a culture of cooperation that will result in better and more responsive regulatory system. Our challenge is to seek to ensure that both legislation and the administration of the law do not operate to stifle innovation and productive activity. As an industry, we are innovative and inevitably push the boundaries. This often presents significant challenges to our regulatory system.

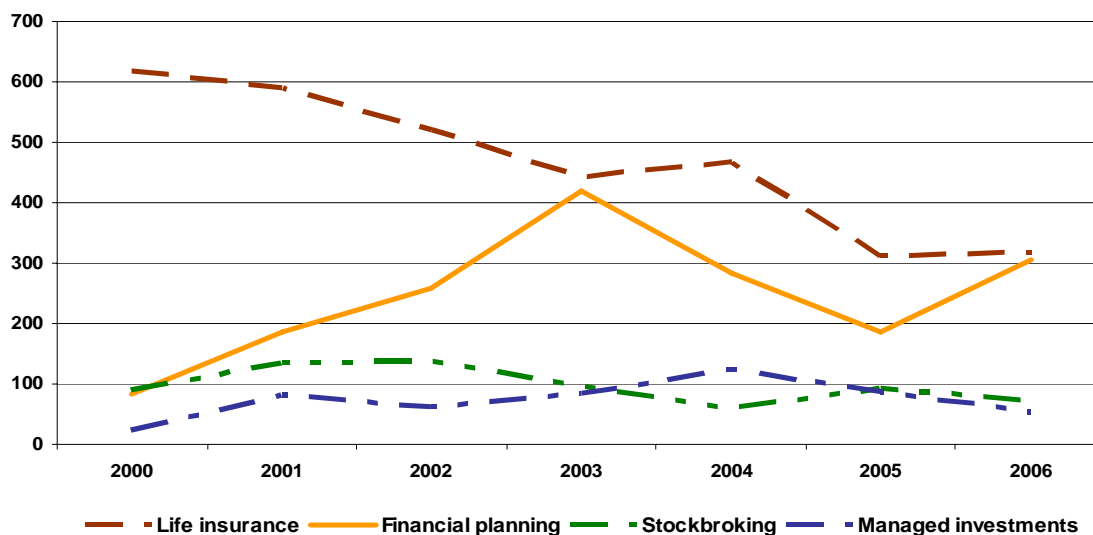
We believe that it has been a Government/Business partnership - or engagement – that has helped to deliver a regulatory system widely regarded as being amongst the best in the world.

It is certainly fair to say that our retirement savings system is widely regarded internationally as being perhaps *the* best in the world. Australia's financial services regulatory regime has few peers amongst OECD countries. We would challenge the critics of the Financial Services Reforms (**FSR**) initiated in 2002 to find a regime which has the regulatory quintuplet of:

- A single product licensing regime;
- A single regime for regulating advice;
- A national disputes resolution system at no cost to customers;
- Disclosure of all fees charges and commissions across all financial products under the FSR umbrella; and
- Finally and most importantly – low levels of customer disputation and high levels of customer satisfaction.

When compared with other comparable overseas jurisdictions, customer complaints in Australia are relatively low. FSR is working. While the UK recorded a leap from just over 40,000 complaints in 2003 to 100,000 in 2005, FICS complaints ranged from the high 500s in 2003 to the high 400s in 2005 and, written complaints to the SCT went from less than 1300 in 2003 to around 1100 in 2005. The following charts FICS complaints from 2000 -2006.

FICS Complaints* 2000 - 2006



The reality is that we are increasingly competing with the rest of the world as a funds management and financial services hub. I note that in November of this year that IFSA will host the 21st International Investment Funds Association (IIFA) Annual Meeting. IIFA meetings are an invaluable opportunity for the representative associations of mutual fund members to share information and increase the collective knowledge of international funds industries. We share a primary objective of promoting the ongoing development of high professional ethical industry standards and guidelines and, more efficient and globally competitive markets.

There is a growing awareness of the opportunities for the Australian financial services industry offshore, as witnessed by both Government and Opposition recently warming to our message that we are the 4th largest in terms of funds under management in the world. Australia has considerable expertise in both funds management and regulation which can be demonstrated by the number of regulators and investment experts who have moved offshore, as part of the Australian diaspora, in recent years. Indeed, a recent article in the Australian Financial Review (17 May 2007), headed 'Taxing times for local funds industry' made reference to a major Australian Funds Manager "taking Australian expertise and creating new funds in Germany or Singapore for foreign investors".

Australia has maintained its ranking as having the fourth largest pool of funds under management as at June 2006:

	\$trillion
United States	11.97
Luxembourg	2.45
France	2.04
Australia	0.97
United Kingdom	0.86

Regulatory responsibility

We believe that Australia has, through the financial **system** reforms of the 1990s and the financial **services** reforms over the last 5 years, set up an integrated structure that provides a solid platform for financial services operations and consumer protection. Regulation is **not** the sole responsibility of Government and our immediate regulators – ASIC, APRA, ACCC and AUSTRAC.

I am not sure if you are aware of IFSA's current structure, but we have well over 30 active Board Committees, Sub-Committees and Working Groups. We have also expanded our policy and research capacity to bring our staff numbers at the Secretariat to almost 20 and we regularly commission studies and surveys to ensure that we are at the forefront of policy development. We use the best consulting and actuarial firms and market research people that we can, so that when our people come wearing tracks in the carpet around Capital Hill and in the Commonwealth Departments, we can be sure that we are providing the best regulatory and policy advice that we possibly can. IFSA also commissions research to ensure that we have a sound understanding of both consumer preferences and of course, consumer sentiment.

It is largely due to the recognition that regulatory changes affecting our industry are for the 'common good' that has led to such a high level of engagement in the regulatory process on the part of IFSA members. I should point out that we have our own IFSA Standards and Guidelines as an additional layer of governance for member companies. Voluntary industry standards are recognised in many sectors as a key part of the regulatory tool kit - financial services is no different. Over and above the requirements of regulation, IFSA members must comply with the IFSA's 15 operational Standards². The Standards outline the guiding

² The current IFSA Standards are:

- No 1 - Code of Ethics and Conduct
- No 2 - Equity Trusts
- No 5 - Operational Capability
- No 6: Fund Performance, calculation of returns

principles by which members are expected to operate, set service or communication benchmarks and help members interpret their legal or regulatory obligations. By adhering to these Standards, member companies have undertaken to develop processes and products that provide investors with a quality assurance that goes well beyond the base line regulatory framework.

There is, of course, some degree of self-interest in ensuring that we operate under a regulatory regime that is easily understood, workable and cost efficient - and that any perceived benefits to consumers give full consideration to weighing the costs of a measure against the benefits. Any change - be it regulatory or other - is not without its costs and will lead to changes in operational systems that are eventually passed on to consumers. Industry estimates of compliance costs range from 10% to 15% of total operating costs³.

Regulation of our industry, and self regulation of industry, is something to which we devote a lot of time and energy. I know that the notion of self-regulation is probably viewed with some cynicism by some in the audience, but it *does* work. I can tell you that in a highly contested financial services marketplace like Australia, perhaps the one thing our members fear most after the regulators is each other. It is no secret that members can and do draw perceived breaches of IFSA Standards by competitors to our attention.

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- No 7 - Use of IFSA logo
 - No 8 - Scheme Pricing
 - No 9: -Valuation of Scheme assets & liabilities
 - No 10 - Promotional Statements
 - No 11 - Genetic Testing Policy
 - No 12 - ASIC fee template
 - No 13 - Proxy Voting
 - No 14 - Alternative forms of remuneration
 - No 15 - Rebates & related payments
 - No 16 - Family Medical History Policy
 - No 17 - Incorrect Pricing of Scheme Units - Correction and Compensation

³ IFSA 'Towards Better Regulation – Policy on Future Regulation of Financial Services Industry in Australia' February 2006 (available at www.ifsa.com.au)

To provide a focus for the discussion of overarching issues affecting providers of financial services in Australia, IFSA is a member of the Finance Industry Council of Australia (**FICA**), which comprises the Australian Bankers' Association (**ABA**), the Australian Finance Conference (**AFC**), the Australian Financial Markets Association (**AFMA**), the Insurance Council of Australia (**ICA**), and the Financial Planning Association of Australia (**FPA**). IFSA's CEO, Richard Gilbert, is the current FICA Chair.

FICA was established to provide higher level responses to regulatory and market developments affecting the financial services sector overall, building upon the work done by the FICA constituents. FICA's members have financial assets under management, including banks and other depositories and both the general and life insurance industries, which generate around 7.2% of Australia's GDP.

The Challenge and the Common Good

The Australian financial services industry has been subject to considerable regulatory reforms. Fundamental structural changes were brought about by the *Financial Services Reform Act 2002* which progressed many of the Wallis Inquiry proposals. We are still transitioning that Act with refinements to our legislative system. Indeed, both industry and regulators have been suffering more than a little from 'reform fatigue' as we struggle to keep up and implement changes to legislation and, subsequently, to our operating systems. However, there is still work to be done.

IFSA has made submissions to Government calling for legislative reform in a number of areas and identified a range of issues where there is a need for greater industry awareness. Three significant areas that I wish to touch on where we are calling for legislative reform are the need for: financial product rationalisation; a managed investment tax regime; and, environmental and sustainability related issues in investments that are likely to feature more prominently as consumers increasingly exercise choices in where they invest their money.

1. Product Rationalisation

The financial services industry in Australia has, particularly since the early 1980s, been subject to significant legislative reforms and technological changes in both administration and delivery of investment services to customers. A legacy of the changes to legislation, regulation, and taxation has been an increase in the number of financial products that are closed to new clients and that operate on old computer systems that are increasingly difficult to support. Inevitably, the numbers of technical staff most familiar with these products are dwindling and, the cost of maintaining an increasing number of products and systems, is becoming a drain on the industry. This increases both costs and product risk to industry and customers. It should be noted that product disclosure requirements, post the transition to the Financial Services Reform, are centred on contemporary products and do not take into account the older style products, particularly life insurance products. As a result, there are substantial costs associated with modifying existing technology systems (where this is possible) to comply with the disclosure requirements because:

1. the products are old and many have product features that do not fit well within the current disclosure compliance requirements; and
2. the systems supporting the products are likewise old and reconfiguring them to meet the compliance reporting regime is a significant task.

In the meantime, product providers are faced with the challenge of technology skills shortages for older style technology systems and diminishing product knowledge necessary to administer these older products. These factors pose serious operational risks to the organisations, and consequent risks for customers, which could be mitigated by product rationalisation.

In 2005, IFSA proposed to the Government the introduction of a single system for rationalising superannuation, managed investment and life insurance products which includes a three tier consumer 'safety net'. The 'safety net' includes independent validation, financial compensation and a 'no cost' to consumer complaints system.

A third of the approximately 6,000 financial products in the funds management, superannuation and life insurance industries are closed to new investment. Efficiency gains from product rationalisation should result in economic benefits to customers, a reduction in product and systems risk, and consequent regulatory savings. At the time of preparing the 2005 submission, IFSA estimated efficiency gains to industry⁴ from the removal of existing legal barriers to product rationalisation at between \$1 billion (conservative estimate) to \$3 billion (optimistic estimate), representing more than \$100 in value per client or more than \$300 in value for clients in legacy products.

While existing laws do enable managed investment schemes to be wound up, and contain mechanisms enabling the rationalisation of superannuation products and life insurance business, the respective regimes⁵ tend to involve lengthy and costly processes that, in fact, inhibit product rationalisation.

What is product rationalisation? Rationalisation of financial products⁶ is a process of merging or consolidating investments of a similar nature to provide a single product that allows a single structure, with features and benefits across a single pool of investments. The aim of product rationalisation is to enable a product provider to remove economically inefficient financial products, and to provide customers with the opportunity to roll-over their investment into another more efficient product or be compensated for the termination of an economically inefficient product. Product rationalisation can provide a range of benefits to both financial product providers and customers. It will allow customers to be moved from out-of-date financial products to more suitable financial products with similar or improved benefits.

The need for product rationalisation has general support and the industry is looking forward to developing a solution with Government that facilitates a positive result for customers and the industry. A fundamental object of the proposed product rationalisation regime is to enable customers to continue their existing investment in a more efficient and effective financial product. The rationalisation proposal is consistent with the broad policy of Government to

⁴ IFSA survey of members (November 2004)

⁵ Part 5C.9 of the *Corporations Act 2001*; Successor Fund Regime under Part 18 of the *Superannuation Industry Supervision Act 1993*; and, Part 9 of the *Life Insurance Act 1995*.

⁶ See section 9 of the *Corporations Act 2001*

create a regulatory framework that will seek to enable investors the best possible choice of investment products.

2. Managed Investment Tax Regime

The current trust taxation laws are unnecessarily complex, archaic and have not kept pace with the changing nature of the funds management industry. To address the compliance burdens and uncertainties in relation to the application of the *Income Tax Assessment Act* (ITAA) to the managed investment industry, IFSA has proposed reform of the income tax law to introduce a simplified and self-contained taxation system for managed investment products, whilst maintaining current tax treatment.

The idea of a self-contained tax regime is not unusual in the Australian context.

Superannuation and life insurance companies, which are also collective investment vehicles, have their own tax regimes:

- Superannuation funds - Part IX of the *Income Tax Assessment Act 1936*;
- Life insurance companies - Division 320 of the *Income Tax Assessment Act 1997*.

Similarly, the most powerful mutual funds nation, the USA, has its own managed investment tax regime in the form of Subchapter M of the Internal Revenue Code 1986 (US).

It is clear that there is a need for the tax laws applying to the funds management industry to be simplified. Tax simplicity will drive greater efficiency in terms of reducing costs, improving accuracy and also minimising the likelihood of delays in reporting results. It is acknowledged that there are many operational issues currently faced by the funds management industry, but these can be overcome by establishing a simple and efficient system for the industry to operate in.

What is IFSA proposing?

IFSA has called for the introduction of a separate tax regime to apply to the managed investments industry that will ensure that:

- 1 Complete flow through of taxable income to investors in managed investment schemes that retains its character for taxation purposes;
- 2 CGT be the primary taxation code for shares, property and units in unit trusts held by a managed investment scheme;
- 3 Managed investment scheme taxable income be:
 - fully distributed by the managed investment scheme to investors each year;
 - assessed to investors for taxation purposes by reference to their economic interest in the managed investment scheme. This should be determined by reference to each investor's unit holdings as a proportion of total units issued by the managed investment scheme so that the concept of present entitlement will no longer be relevant for tax purposes;
 - calculated by reference to the best information available at the time of distribution; and
 - adjusted, by way of tax deduction or inclusion of additional assessable income, for any under or over distribution in the prior year where that under / over distribution occurred as a consequence of imperfect information available at year end; and
- 4 Non-resident withholding tax be simplified so that it is imposed and collected by reference to the distribution components known and made at the time liability to withholding tax arises.

In relation to non-resident withholding tax, IFSA believes that Australia needs a flat and final rate that is competitive and removes the need for complex tax administration. We are concerned at the introduction of a 30% withholding rate on distributions to non-residents.

The proposed 30% rate is non-final and permits the investor to offset it with deductions. — which may produce the same net Australian tax cost as a reduced flat rate. Importantly, what matters to foreign investors is the headline rate, minimising the compliance costs of lodging

an Australian tax return, as well as the time that it takes to obtain a refund. Investors consider that the present system, if not changed, will be a major deterrent to foreign investment in Australian managed funds.

IFSA has recommended a flat and final non-resident withholding rate of 12.5%. On the basis of independent research this should initially result in a relatively small cost to the revenue and be revenue positive in a few years⁷. Certainly, our regional competitors for capital have far more competitive rates of withholding than the proposed 30% rate. Japan has a withholding tax rate of 7% (and 0% for super funds), Singapore imposes 0% for individuals and 10% for other investors and Hong Kong has an effective rate of 15%.

IFSA believes that if Australia does not adopt an international system with a more competitive tax rate, the immediate scenario will be an adverse effect on the market with foreign investors choosing to invest elsewhere in the region — followed by difficulties for Australian funds managers in raising new capital.

3. Environmental and Sustainability Related Issues

Environmental and sustainability related issues are increasingly entering the mainstream investment management and superannuation industries. There is increasingly a commercial expectation from beneficial owners that risks in these areas are being properly assessed and managed by investors and the entities that they invest in.

What are they?

Environmental and sustainability related issues can cover a broad range of social and economic issues. Many acronyms, often used interchangeably, have been developed over time to describe various approaches to these issues, including:

- CSR – Corporate Social Responsibility: typically relates to how a company takes account of its various stakeholder interests and is usually understood by reference to

⁷ Econtech Pty Ltd, 'Budget Costing of a Proposal to reform Withholding Tax on Property Income Distributed by Listed property Trusts to Non-Residents' report prepared for Speed and Stracey Lawyers, (18 April 2006) – available at www.ifsa.com.au

a company's social/philanthropic activities arguably designed to improve its image in the community/among its various stakeholders.

- ESG – Environmental and Social Corporate Governance: Is typically a more refined notion of CSR that is focussed on corporate governance and how these issues are being addressed from that perspective.
- SRI – Socially Responsible Investment: Relates to a form of investment which seeks to take account of ESG issues when making investment related decisions.

How can we respond?

While there are a large variety of ways companies and institutions are seeking to incorporate these issues into their operations, the more contemporary approach seems to be to integrate ESG considerations across the entire organisation through monitoring and responding to matters such as:

- the organisation's impact on the environment;
- being aware of the implications of climate change for that organisation; and
- actively managing the organisation's human capital (both recruitment and retention).

What impact?

Environmental and sustainability related issues have the potential to affect all categories of IFSA members and, therefore, the activities of IFSA itself. More specifically, these issues are of relevance to IFSA as they potentially impact on members' fiduciary obligations; can be viewed as an extension of good corporate governance; have consequences for market efficiency and transparency; and, impact the level of disclosure required to be provided to retail investors.

Fiduciary obligations of members

There has been considerable national and international debate about to what extent, if at all, entities that owe a fiduciary duty to their members (fiduciaries) are able to take environmental, social and sustainability related issues into consideration in performing their investment and custodial roles. On this point, the 2006 report of the Parliamentary Joint Committee on Corporations and Financial Services 'Corporate Responsibility: Managing risk and creating value' stated:

Superannuation funds, perhaps more than any other group of investors, are placed to take advantage of long term opportunities, and are most exposed to long term risks. In the committee's view, consideration of social and environmental responsibility is in fact so far bound up in long term financial success that a superannuation trustee would be closer to breaching the sole purpose test by ignoring corporate responsibility.⁸

Environment/sustainability

Since its inception, IFSA has taken a leading position on corporate governance matters. IFSA's Blue Book has long been seen as a landmark publication in this area. We have supported the view that environmental and sustainability matters are capable of falling within corporate governance policy. According to the ASX Corporate Governance Council (of which IFSA is a member), corporate governance is:

the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised.⁹

⁸ See pages 73 – 74 of Chapter 5: Institutional Investors.

⁹ ASX Corporate Governance Council Principles of Good Corporate Governance and Best Practice Recommendations March 2003, page 3.

It follows, therefore, that how a company goes about identifying, assessing and managing environmental and sustainability issues/risks is an element of good corporate governance.

Disclosure of environmental/sustainability related issues

At present, there is no requirement for listed companies to disclose information, other than voluntarily, on environmental and sustainability matters. However, while mandatory disclosure may not be required at present, voluntary disclosure initiatives are beginning to significantly increase to the point where there may be a time where standardisation of such requests is desirable.

More consistent and widespread disclosure in this area may be needed to ensure investors are in a position to analyse the full breadth of risks and opportunities facing companies and, therefore, to more accurately assess each company's true financial position/exposures and competitive advantage going forward.

Disclosure to retail investors

Product issuers that claim labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of an investment are required under section 1013DA of the *Corporations Act 2001* to comply with ASIC Guidelines in this area.

One question for IFSA is whether we should broaden the scope for members to report outside these strict legal requirements by developing standardised disclosure to facilitate more meaningful comparisons and greater clarity for investors. These are matters which are yet to be developed but which will likely be the subject of further consideration.

CONCLUSION

Any dynamic business environment is subject to continual reassessment. IFSA represents the views and aspirations of its members in the retail and wholesale superannuation, funds management and life insurance industries. All of the foregoing discussion assumes market

imperfections that are either not addressed, or are an outcome of imperfections, in the current regulatory framework and system of making laws and regulations.

Government has taken steps in seeking to address issues associated with poor regulatory proposals and the establishment of the Office of Best Practice Regulation, within the Productivity Commission, is a positive step. However, it is too early to evaluate its impact from an industry perspective.

What we would like to see is an approach similar to some of our global competitors. One where Government and the Regulator will work with industry to create a “responsive regulatory system that facilitates innovation, competitiveness and growth” both domestically and internationally¹⁰.

¹⁰ Building on Success, International Financial Services Industry in Ireland, September 2006