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Mr Gary Banks
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Regulation Taskforce
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Dear Mr Banks,

Thank you for the opportunity to make a submission to the Government's Regulation Taskforce ('Taskforce'). The Australian Bankers' Association ('ABA') strongly supports the Taskforce's inquiry and the announcement in October by the Prime Minister and Treasurer.

The ABA has also recently made submissions to the Government's Financial Services Advisory Council ('FSAC') on regulation and our submission to the Taskforce is consistent with our submissions to FSAC.

1. Background

The ABA represents 26 Australian and overseas banks and has wide representative coverage of the banking as well as the broader financial services sector. Our governing body is the ABA Council comprising 12 bank chief executives. The Council has set as one of the ABA's key priorities an objective to "Ensure that regulation meets the principles of sound regulation." As a result many of the matters that are identified in this submission are the subject of separate representations to the relevant areas of Government.

With the ABA Council priority in mind the ABA, as part of its membership of the Finance Industry Council of Australia ('FICA')[1], commissioned an extensive review of regulation in the financial services sector by CRA International ('FICA Report')

[1] FICA comprises: Australian Bankers' Association, Australian Finance Conference ('AFC'), Australian Financial Market Association ('AFMA'), Investment and Financial Services Association ('IFSA') & Insurance Council of Australia ('ICA'). International Banks & Securities Association of Australia ('IBSA') joined the FICA group for the purposes of commissioning the Report.

– *Enclosure 2*.[2] The ABA commends the FICA Report for its excellent analysis and representation of the impact of regulation on the financial services sector though we do not support all its recommendations.

The ABA will also prepare and send later this year a separate document on payments system reform, for consideration by the Taskforce. We have prepared a separate report because of the relatively discrete nature of the payments system issues and believe that the content is of direct relevance to Taskforce's inquiries.

Similarly, in light of the recent announcement that the Government will consider the introduction of a deposit insurance scheme, the ABA will prepare a separate submission to the Taskforce on this issue. In our view, the introduction of such a system would present a new and unnecessary regulatory overlay.

The Taskforce will be aware that banks (and other Approved Deposit-Taking Institutions ['ADIs']) and the card schemes have been subjected to a number of waves of significant payments system changes both actual and proposed. This has occurred through regulation, and follows the publication of the Reserve Bank of Australia ('RBA') and the Australian Competition and Consumer Commission's ('ACCC') joint study in October 2000 of interchange arrangements for credit cards, EFTPOS, Visa debit card and ATMs.[3] The catalyst for this study was the Wallis report.[4] The ABA believes that five years on, it is time to review the impact of the regulation of the payments system.

The ABA provides, on behalf of our member banks, to the Taskforce for its consideration, some general observations and specific comments on the particular questions posed to the ABA about financial services regulation.

2. General observations: The ABA's overall view on regulation

The ABA believes effective regulation is important. It assists confidence in our markets and helps protect consumers.

The ABA also agrees with the views laid down in the Wallis Report. The Wallis Report provided that the three primary purposes of regulation are to:

- Ensure that markets work efficiently and competitively;
- Prescribe particular standards or qualities of service; and
- Achieve social objectives.

The Wallis Report set down five key principles of regulation that should be observed to achieve these primary purposes:

- Competitive neutrality;

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2 "Review of Business Regulation in Australia", CRA International, November 2005.

3 "Debit and Credit Card Schemes in Australia – A study of Interchange Fees and Access", Reserve Bank of Australia & Australian Competition and Consumer Commission, October 2000.

4 Report of the Financial System Inquiry, March 1997.

- Cost effectiveness;
- Transparency;
- Flexibility; and
- Accountability.

It is the ABA's view that nothing has fundamentally altered since the Wallis Inquiry (despite the recent cases of corporate malfeasance such as HIH and One.Tel) to undermine the importance and desirability of principles-based legislation and financial services regulation as advocated by the Wallis Inquiry.

The ABA also understands and accepts that banks hold a unique position in the market both by virtue of the size of the sector and the special function banks perform within the economy. This necessarily impacts on the regulation of the banking sector.

The ABA believes that "good regulation" requires coordination and cooperation between legislators, government, regulators and industry. In this context it is important to get the balance right between the cost and benefit of regulation; clarity/certainty and flexibility of regulation; and that subsequent interpretation and enforcement correctly reflects original intent. If the balance is wrong it can lead to costly and less customer-friendly outcomes for consumers. The Financial Services Reform Act ('FSRA') process is an example of how an unbalanced approach can lead to a costly regime that has many unfriendly outcomes for consumers.

There are many challenges for all the participants in the regulatory process. The challenge for banks in implementing good regulation is understanding the myriad of obligations (which at times may overlap between regimes or are inconsistent across regimes, not just domestically but internationally), e.g. some of the Australian Prudential Regulation Authority's ('APRA') proposals in its draft *Fit and Proper and Governance Standards*. Whilst APRA has acknowledged the industry's concerns, banks will still have to undergo an exhaustive process to meet the standards in APRA's policy.

The challenge for legislators and governments in introducing good regulation is to balance the public interest with the realities of the compliance burden for banks. The cost of compliance is inevitably passed to customers, either in whole or in part, thereby increasing the cost of banking, e.g. FSRA.

The challenge for regulators in administering regulation is balancing the need to be consultative with industry (in order to develop sound policy) and the reality of their enforcement role.

It is also worth mentioning the growing impact of international regulation which has been significant for banks. To a degree, the significant amount of regulatory change reflects Australia's commitment to implementing business regulatory rules consistent with international standards. The key examples that come to mind are: Sarbanes-Oxley ('SOX'), international financial reporting standards ('IFRS'),

Basel II, the Financial Action Task Force ('FATF') *Forty Recommendation*s into anti-money laundering legislation ('AML'), the flow-on effects of the U.S.A. Patriot Act, and the recently proposed outsourcing policy by the Reserve Bank of New Zealand.

Acknowledging these observations above, it is the ABA's view that the regulatory burden faced by banks has increased markedly in recent years. This has lead to a substantial rise in compliance costs and affected the way financial products are offered to customers. Has it all been bad? No, we don't think so.

The FSRA regime provides a legal basis for the Australian Securities and Investments Commission ('ASIC') to ensure that standards for financial services providers across the industry are of an appropriate and professional level. Similarly, APRA administers that law so that consumers can have confidence in a robust banking system. However, the dominant view of our members is that the balance between the costs and the benefits has not been favourable for banks, and most importantly for bank customers.

Therefore, the purpose of the ABA response to Taskforce's inquiry is to highlight how addressing unnecessary complexity and uncertainty can reduce compliance costs for banks and other financial institutions.

3. Specific comments

3.1 Regulatory challenges

In summary, and in thematic form, we believe that there are a number of significant factors that have contributed to the challenging regulatory regime for banking and financial services:

- Incrementalism and "reform fatigue";
- Increased prescription versus principles-based guidance;
- Consultation and transparency when implementing regulation;
- Cooperation between regulators;
- Lack of national uniformity; and
- Creation of a "compliance culture".

3.1.1 Incrementalism and "Reform Fatigue"

Over recent years there has been considerable legislative and regulatory change for corporations and financial services providers. ABA members report that each new piece of regulation, be it large or small, adds to the already considerable burden of regulation.

In some cases complex regulation leads to an increased compliance burden, which in turn creates higher financial sector levies (under recent changes to the methodology for calculating levies), which all adds to the cost base of banks.

Appendix A of the FICA Report shows the increasing costs of funding regulators both in actual terms and as a proportion of total financial assets of financial institutions. The cumulative effect of a range of regulatory obligations and the interplay between regulatory requirements is of significant concern for our members.

The corollary of incrementalism is compliance or reform fatigue. In particular, corporate and financial services regulation has been substantial through the CLERP reforms, most recently being the CLERP 6 (FSRA) and CLERP 9 reforms. Procedural and systems changes have had a significant and ongoing impact on business. For example, every change made to the Product Disclosure Statement ('PDS') requirements results in substantial cost due to legal/advisory fees, technology scripts, staff resources and printing and distribution costs associated with implementing the change.

Significantly, there appears to be more in the pipeline despite the Government's post-election commitment to slow legislative and regulatory reform down. The Government's Corporations and Markets Advisory Committee ('CAMAC') and the Parliamentary Joint Committee on Corporations and Financial Services inquiries are looking at very complex and significant corporate law matters, including personal liability for corporate fault, corporate duties below board level, "long-tail" liabilities and corporate responsibility. All these matters are likely to have a substantial impact on the business of banking.

It is the ABA's view that governments, legislators and regulators need to be mindful of the impact of each additional piece of regulation, however small, as the cumulative effect of legislative and regulatory change can have much wider ramifications for the efficiency of our financial and capital markets.

3.1.2 Increased prescription vs principles-based guidance

In the spirit of principles-based legislation, the ABA believes that business regulation should be focused on guiding behaviour towards desired outcomes. Notwithstanding, regulatory policy and guidance should be able to be interpreted with reasonable levels of certainty as to their meaning and effect without requiring undue resources.

Many areas of core concern to business currently require very high resourcing to achieve reasonable levels of assurance as to legal and operational compliance. In part this is due to the fact that regulators in their administration of the law appear, at times, unwilling to rely on broad principles, but rather issue substantial and detailed policy and guidance. This approach means that the notion of principles-based is lost in the translation from regulatory formation to administration. While intended to aid certainty, it can often create the opposite effect when applied in practice.

It is acknowledged that some guidance is necessary, and that the objectives of simplicity and certainty are at times contradictory, but it is the ABA's view that the pendulum has swung too far, particularly when regulatory policy that has been developed as guidance or interpretation of the law, is used in a prescriptive

manner as part of a surveillance campaign or an enforcement proceeding. The ABA recognises the need for regulators to enforce the law; however, there is a tension between the "spirit of the law" and the black letter of the law approach. This can often lead to legislators and regulators saying things that are at times inconsistent with surveillance and enforcement practice.

The ABA supports Recommendation 1 in the FICA Report, which encourages the Government to adopt light-handed or outcomes focused model of regulation following the policy framework articulated in the Wallis reforms.

3.1.3 Consultation and transparency when implementing regulation

On occasion, regulation is implemented with inadequate consultation and a lack of commercial pragmatism. A recent example is the Anti Terrorism Bill 2005 ('ATB') which has the potential to conflict with mooted provisions of the yet to be released Anti-Money Laundering Bill. The ABA had to determine its first response to the Bill on the basis of reading the unofficial version of the Bill on the ACT Government website and in an unrealistically short time frame. This has now been corrected, and the second ATB Bill is currently the subject of further consultation with a Senate Committee and directly with the Government.

There are also concerns about the level of experience and commercial pragmatism of some staff within Australian regulators, especially when compared to their peers overseas. For example, there were difficulties for banks in explaining to ASIC some of their financial services operations and arrangements during the FSRA licensing process and ABA members felt that they were more educating ASIC as to these matters, rather than making an application for a licence. To some degree the implementation of the FSRA regime can be acknowledged as a difficult time for both the regulator and industry because the FSRA requires the application of both the law and considerations of business efficacy to deliver the right outcome; however, some concerns remain with regulatory staff ability and insight into the business implications of a particular policy approach which may impact on the timeliness and quality of decisions on applications for relief.

The ABA acknowledges some of the challenges that regulators face in attracting and retaining staff and resources, and in particular we recognise ASIC's efforts in recently consulting with industry regarding its strategic plan and resource deployment. However, inefficiencies can have a significant impact as, for example, applications for relief can be time consuming and therefore costly, both for the regulator and industry. This is causing frustration and additional and unnecessary risk as post-FSRA implementation requirements, ongoing administration and management of regulatory compliance issues are compromised by the necessity to quickly address the latest new issue.

In addition, recently there have been instances where there have been ambiguous statements made by regulators in their administration of the legislation. For example, ASIC's recent surveillance campaign on ''super switching" contained statements regarding the need for some industry participants to give closer consideration as to how they manage conflicts.

However, in public statements, some ASIC staff have made comments regarding systemic concerns with industry practices in the superannuation industry and their lack of trust in professional financial advisers. Unfortunately, ambiguous or inconsistent statements made by the regulator can be confusing for consumers and industry, and can have unnecessary and adverse consequences for consumer confidence.

Having said that, we believe that overall the banking industry has a positive and cooperative relationship with our key government and regulatory stakeholders. In recent times we have noticed a better level of consultation from Government and regulators. For example, Treasury staff have consulted widely with the banking industry as part of the FSRA refinement process.

In addition, the ABA welcomes APRA's revamp of its prudential regulations, by replacing the current system of prudential guidance notes with what will be known as 'Prudential Practice Guides' ('PPG'). The initiative is welcome because PPG's will give institutions more flexibility in meeting prudential standards, but still outline best-practice and provide a benchmark to which specific institutional arrangements can be assessed. APRA's recognition that an overly prescriptive approach to prudential regulation, as inherent in the guidance note system is a good step in reducing unnecessary business costs.

The ABA supports Recommendation 2 of the FICA Report about improving consultation. In addition to Recommendation 2, we also suggest that to enhance the commercial acumen and pragmatism of regulatory staff, that it may be worthwhile considering the following:

1. Introducing an "industry advisory panel" model to assist ASIC in its general policy formulation in much the same way as ASIC is assisted by its consumer advisory panel. An industry advisory panel could also provide a consulting mechanism for ASIC's Regulatory Policy Group ('RPG') in assessing and determining precedent applications for relief. The Panel could consist of a number of industry experts that could advise ASIC on the implications of a particular policy proposal and attend RPG meetings and provide industry input on particular RPG matters for consideration.

2. Introducing a regular information session program. The sessions would allow key industry participants to discuss with regulatory staff important emerging issues and assist in the development of more practical policy and standards.

3. Introducing a formal secondment program. The program could encourage greater interaction between regulatory staff and industry to assist in building a better understanding of, on the one hand, industry practice, and the other, government and regulatory process.

4. Reviewing the myriad of regulatory policy documents issued under the FSRA regime, including policy statements, guides, class orders

and other relief instruments, FAQs, etc, with the view to developing a consolidated regulatory and policy reference framework that will facilitate simpler and more efficient decision-making by financial services providers and their advisers.

3.1.4 Cooperation between regulators

The banking and finance sector is arguably the most heavily regulated sector of the Australian economy, as it is affected by the activities of the RBA, APRA, Australian Transaction Reports and Analysis Centre ('AUSTRAC'), ASIC, ACCC, ATO and the Federal Privacy Commissioner at a Federal level and many other agencies at a State level (note: credit is regulated by the State Governments). Many banks and financial institutions operate across more than one state and as a result are also subject to additional regulation imposed by State and Territory governments.

The ABA accepts the need for effective regulation of the financial services sector. However, there have been instances of overlapping and competing legislation and regulation. The clearest example is corporate governance which has attracted the intervention of ASIC, APRA and the ASX, and which we refer to in more detail below.

The ABA supports the principle (though not necessarily the specific solution) of Recommendation 10 made in the FICA report, which aims to reduce the incidence of duplication and inconsistency between regulators.

3.1.5 Lack of national uniformity

Banks are subject to a myriad of laws at the Commonwealth, State and Territory level. While it may be unreasonable to assume that there can be absolute consistency across corporate and financial services laws, the lack of consistency generates unnecessary complexity and compliance costs.

State to state overlaps and inconsistencies can significantly affect banks, e.g. States are beginning to develop laws in connection with workplace privacy and while NSW has recently legislated to regulate surveillance in the workplace, Victoria has recently released a different set of proposals to regulate workplace privacy.

Some further examples of lack of national uniformity are:

<u>Business Names</u>

A company name must be registered under the national Corporations Act 2001 administered by ASIC. If a company wishes to trade using a name other than its registered company name, the trading name must be registered as a business name.

A business name is a name under which a business operates. Business name registration is compulsory and must be completed before the business starts

trading. Registration is obtained under State or Territory legislation, so businesses trading in more than one state or territory must register their name under the laws of each one.

As with Personal Properties Securities ('PPS') discussed in 3.4.9 below, there is an important opportunity for reform and co-operation between the Commonwealth and States and Territories as currently each State and Territory has responsibility for maintaining a register of business names. A single national register would complement PPS law reform and help to reduce confusion and unintentional duplication of business names. Searching for a business name in a single register would be an advantage for businesses wanting to start-up.

Administration of Deceased Estates

Nationally the rules for applying for a grant of probate or administration of deceased are not uniform. Also the rules as to when a legal personal representative of a deceased is able to withdraw monies from bank accounts of the deceased are not uniform. This makes the processes for compliance with different individual State and Territory requirements more difficult necessitating differing training programs for bank staff depending upon the jurisdiction in which they are engaged. There are also varying protections between the States and Territories for banks and other deposit taking institutions when the trustee is administering an estate.

Equal Opportunity and Anti-discrimination

There is no national uniformity in these laws making national compliance problematic for nationally operating companies like banks. Credit providers and life insurers have some exemptions under the State and Commonwealth age discrimination acts which are reasonably uniform and are appropriate. However, in other respects the laws are different in content and degree. The administration of these laws is also fragmented in that complainants may complain to both Commonwealth and State and Territory tribunals or commissions in respect of the same matter.

The interests of both the community and business would benefit from a more harmonised national regime of these laws.

Garnishment of Debts

The procedures for enforcing judgment on debts through garnishee proceedings vary from jurisdiction to jurisdiction making debt collection through these means complex for organisations such as banks that have to recover debts on a national scale. National harmonisation of garnishment procedures and rules would reduce procedural inefficiencies for banks in the debt recovery process.

Powers of Attorney and Guardianship

With an ageing population and the focus of getting people with disabilities back into the community there is a need to harmonise the rules relating to powers of attorney particularly enduring powers of attorney. Also formal guardianship

appointments vary from jurisdiction to jurisdiction adding costs and complexity to ensuring banks' employees know and understand the law in any particular jurisdiction.

It is the ABA's view that greater national harmonisation of regulation will reduce unnecessary complexity, uncertainty and compliance costs. Therefore, the ABA encourages the Commonwealth to take a leadership role in urging the State Governments to reduce the incidence of a lack of uniformity in the regulation of banks and the financial services sector.

3.1.6 Creation of a "Compliance Culture"

The significant regulatory reform within the financial services and corporate sector over recent years has resulted in not just reform fatigue, but the creation of a "compliance culture". In particular, new or amended regulation has resulted in changes to the role and structure of the compliance function as well as wide ranging cultural impacts related to the everyday management of compliance as part of the business. The increase in legal and compliance staff within banks has created a focus for compliance consideration, input and direction in projects.

The ABA makes the following observations:

- Directors' duties and responsibilities are now more onerous. Not only have liabilities increased as a result of corporate law reform but directors and officers now also face increased derived liabilities due to various other statutes, e.g. environmental protection, occupational health and safety, fair trading, etc. Personal derivative liability is a potential disincentive for qualified and competent individuals to take up senior positions in companies. Increased personal accountability is also driving up remuneration and adding wages pressure to senior positions. Directors' duties and responsibilities may also have the effect of increasing an unhealthy level of risk aversion and stifling innovation.

- Training requirements for all staff in some particular areas, such as simple and well understood products, are unnecessarily onerous. Basic training is required for all customer-facing staff. In addition, organisations must have appropriate systems in place to monitor and record training. Policy Statement 146: Licensing: Training of financial product advisers [PS146] has had a number of adverse impacts on the industry, such as the emergence of the "no-advice" model.

- Customer's perceptions of a helpful culture supporting enquiries have changed to an over-regulated industry where "advice" and other enquiries are routinely directed to professional financial planners, or alternatively a "no-advice" model is adopted. Disclosure documents have been criticised for being too compliance driven and not providing the information sought by consumers.

The ABA also observes that since a number of recent high-profile cases of corporate malfeasance and the subsequent pressure on regulators, there has been additional pressure flowing through and placed on industry.

The ABA considers that there is a need to redress the apparent aversion to risk-taking by both the regulator and industry. Such an adjustment would allow greater application of the "spirit of the law". Flexibility will also enhance how principles-based legislation can be applied across the industry, regardless of the nature and complexity of the business. It would also ensure that legislative or regulatory changes are based on inherent deficiencies within the law, and not just reactionary to particular isolated cases.

3.2 Compliance costs

The FICA Report surveyed ABA members on their estimate of compliance and implementation costs and how this had changed over the past five to ten years.

It was reported that overall compliance costs had increased dramatically over the past five to ten years.

Ongoing compliance costs for the largest banks amounted to $30-40M per annum, representing 0.5% of operating income. These costs included compliance with various requirements including annual recurring costs for IFRS, Basel II and Sarbanes-Oxley Act ('SOX').

One bank reported that since 1994/95, compliance expenditure levels had almost doubled every five years, accompanied by growth in staff resources engaged in compliance-related activities.

Larger banks reported project costs associated with FSRA and APRA changes at between $30M and $40M per bank over the past two years. One major bank indicated that the majority of implementation costs related to Basel II ($60M) and IFRS ($20M). Another major bank estimates that it has spent significant costs on FSRA ($30M) and estimates that it will spend a further $25M on AML. Another major bank indicates that in addition to ongoing compliance costs, it has incurred additional resources and costs implementing Basel II ($25M) and FSRA ($5M). [5]

In 2003 the ABA sought estimates from its member banks on the direct costs of implementing FSRA. Costs included training, obtaining external advice, documentation, updating computer systems and procedures. The total grossed up to over $200M. Annual re-occurring costs were estimated at $50M. If the lost opportunity costs of staff having to be taken away from their productive work to implement the FSRA (not to mention the opportunity cost of time spent training thousands of staff in FSRA procedures) are added, the costs would be significantly higher. This is a cost not often taken into account when regulatory costs are being considered.

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[5] The ANZ Bank has been reported (Weekend Australian 5 Nov 05, p. 35) as estimating that "… it will spend $20 million on the introduction of international financial reporting standards, and a further $60 million on the Basel II project …".

Similar to FSRA, the implementation of the Consumer Credit Code ('UCCC') from its enactment in 1994 saw one-off implementation compliance costs for banks of approximately $200M with ongoing annual recurring costs of approximately $50M.

The ABA believes that in formulating regulation there should be proportionality between the regulation and the consequences of non-compliance. The relationship between strict application of the law and the consequences of non-compliance with the law bears directly on the compliance costs and customer experience. It has been the case with the UCCC. There is a civil penalty regime where, if a key provision of the UCCC is breached by a credit provider, they face imposition of a civil penalty of up to $500,000.

There is a direct correlation between the UCCC's civil penalty regime and the undue length and complexity of some UCCC disclosure and other documents. In other legislation such as the Trade Practices Act ('TPA') the imposition of civil penalties is reserved for breaches of the TPA's competition provisions and certain other matters but not in respect of a breach of a consumer protection provision. Under the UCCC, which is a consumer protection law, a credit provider can incur a civil penalty for a relatively minor breach of, for example, a disclosure provision. Because the provision of consumer credit by a bank is on a national basis, compliance systems and documentation are largely computer generated to reduce the risk of non-compliance. If a breach occurs this is likely to be on a national scale. Therefore, banks and their advisers have taken steps to ensure that their documentation is fully compliant to the finest of detail. The standard of proof in a civil penalty case is lower than for a criminal offence and arguably easier to establish a judgment favouring the regulator. Consequently, the civil penalty regime has added length and complexity to those documents. Customers have remarked on the length and complexity of UCCC credit contracts and this appears in some cases to have undermined the objective of disclosure by creating a disincentive for customers to read the documentation.

It is noted that recently a discussion paper has been issued by the Ministerial Council on Consumer Affairs through the Competition and Consumer Policy Division of Treasury inviting submissions on proposals to create a civil penalty regime for breaches of the consumer protection provisions of the TPA and related State and Territory fair trading acts. The ABA believes this would be a regressive move and the ABA will be responding citing the UCCC experience.

Banks also provided estimates of how much time that senior management and boards devote to compliance and how this has changed over the past five to ten years.

Estimates of proportions of Board time devoted to compliance issues from respondents with banking operations ranged from 5% to 25%. All reported that this has significantly increased over the last five to ten years.

One bank reported that time spent on compliance by Boards was 25% and Senior Management 20%, respectively; 5 years ago it was 7.5% & 7.5% and 10 years ago 5% & 5%.

One bank also predicted significant increases with the Executive Risk Committee and Board Risk Committee currently spending approximately 25% of time on compliance and regulatory matters. This is expected to increase to 40% with Basel II.

While some commentators may argue that this increase is justified, it highlights the increasing pressure on directors and those in senior executive positions to devote time to legal compliance matters at risk of distraction from strategic and operational matters.

3.3 Overlaps between regulatory regimes

3.3.1 Corporate governance and fitness & propriety of directors

Issue

Corporate governance practices and conduct of responsible officers have traditionally been regulated by ASIC and the ASX. Recently, APRA has issued revised draft prudential standards on corporate governance and fit and proper persons.

Discussion

To date, fitness and propriety of senior managers and governance of companies have been the primary responsibility of ASIC and the ASX. The proposed APRA Fit and Proper and Governance Standards impose a third layer of regulation. Without careful design, APRA's prudential standards may impose unnecessary additional compliance costs. For example, there may be differences in the definition of a "senior manager". The practical impact for regulated entities of maintaining a dual system of regulation for people who hold senior positions would be increased legal, administrative and compliance costs.

In addition, there is the matter of translating the ASX Principles, which adopt an "if-not, why-not" approach, into minimum prudential standards. For example, APRA is considering adopting the Principle in relation to "independence of directors"; however, APRA will have an expectation that banks would apply the concept as standard, rather than allowing banks to adopt an alternative approach more suitable to the nature and complexity of the business. Recently released statistics by the ASX on corporate governance reporting practices indicate a high level of compliance; however, this includes application of alternative approaches.

Conclusion

The ABA has made a detailed submission to APRA and continues to discuss with APRA regarding its draft prudential standards. The ABA has been given an indication that APRA is further amending its Fit and Proper and Governance Standards to remove unnecessary overlaps, and to improve flexibility by using PPGs rather than the legally enforceable Guidance Notes to foster best-practice prudential compliance in these areas.

3.3.2 Mutual Recognition

Increasingly as financial services are operated on a global basis the reach of international regulation is extending to the same degree. The ABA would like to see the Government continue its efforts to seek harmonisation or mutual recognition of these laws particularly given the robust regulation of the Australian regulatory and corporate governance systems.

The ABA believes that ASIC and Treasury should take a more active role in advocating a position of mutual recognition with US regulators. Further, we should ensure that the Department of Foreign Affairs and Trade are also kept across these issues in order to influence outcomes.

Two key examples are provided below.

Example 1: Extra-Territoriality of Sarbanes-Oxley Act

Issue

The Sarbanes-Oxley Act has extra-territorial reach affecting certain Australian companies' activities in Australia.

Discussion

There are no rules which allow foreign companies to be exempted from the Sarbanes-Oxley Act. To get the permission to be listed on an American exchange or to raise funds from U.S. capital markets, foreign companies need to be registered with the Securities and Exchange Commission ('SEC') and comply with the Sarbanes-Oxley Act.

This affects a number of Australian corporates including the four major banks. The ABA would like to see greater recognition by the SEC and the Public Companies Accounting Oversight Board ('PCAOB') of Australia's home corporate governance regime. Australia's regime is comparable to the US regime.

To illustrate the issue, section 404 and rules adopted by the SEC require companies that file annual reports with the SEC to report on management's responsibilities to establish and maintain adequate internal control over the company's financial reporting process, as well as management's assessment of the effectiveness of those internal controls. Compliance is onerous. The number of controls that big companies must test and document can run into the tens of thousands. The internal control provisions are basically a well-intentioned means of restoring trust in financial reporting. Auditors must report on the company's financial statements, management's assessment and the effectiveness of the company's controls.

Example 2: Investment Advisors Act 1940

Issue

The SEC has introduced a requirement for managers of US sourced investor money to register as an 'Investment Advisor.' The requirement to register extends to Australian banks which source investor funds from the U.S.

Discussion

The Investment Advisors Act 1940 was amended in December 2004. New regulations have been introduced requiring all managers of U.S. sourced investor money to register as an 'Investment Advisor' with the SEC from February 2006. Registration as an investment advisor results in ongoing compliance requirements, as set out in the SEC Rules, including:

- A compliance plan (extensive document referencing SEC rules to policies and procedures detailing internal controls, including filing/updating of SEC forms).
- Regular reviews of compliance plan.
- A designated compliance officer.
- A Code of Ethics (that meets the requirements of the SEC rules and includes conflicts of interest and policies regarding personal trading in securities, "soft dollar" arrangements, reporting to SEC of personal security trading, code violations, disclosure code to all employees).
- Proxy voting policies and procedures.
- Books and records with respect to U.S clients, and in some cases, for non-U.S. clients.
- Ongoing SEC examinations.

There are no rules which allow foreign companies to be exempted from the requirement to register as an Investment Advisor.

Some Australian banks and funds managers asked that ASIC approach the SEC to get relief from the requirement for Australian banks and funds managers. However, ASIC's response was that they were unable to assist.

The requirement to register will affect a number of Australian banks and fund managers. The ABA would like to see recognition by the SEC of Australia's own corporate governance regime, which is similar to the U.S. regime.

Conclusion (for both examples)

The ABA considers that a more harmonised approach to cross-jurisdictional regulation should be adopted. An alternative approach where Australian banks

either comply with Sarbanes-Oxley Act or explain why they should not comply could help to facilitate reciprocal recognition in individual cases.

3.3.3 Overlap in reporting requirements to regulators

Issue

Banks report data to the Government and regulators that seems to be for similar purposes, however, there are problems with the timing of information requests and formats for information.

Discussion

Banks are regulated by a number of regulators resulting in, at times, requests for information that are essentially seeking the same data. However, the request is made in such a manner that the bank is unable to provide the data once or in the same format. For example, there are differences between information required by super trustees applying for an APRA licence and information that is already reported to ASIC. In this instance, APRA requests the information in its own format, so trustees have to rework existing information. Similarly, the RBA gathers data from banks to complete its assets and liabilities of financial institutions statistics, whereas APRA gathers data from banks to complete its performance of financial institutions statistics. In this instance, the RBA and APRA are requesting similar data, and while the presentation of the data publicly may be different, the data provided is essentially the same.

Conclusion

The ABA considers that as far as reasonable and practical, information reported to Government or regulators should be streamlined to remove unnecessary duplication of reporting, particularly where this requires banks to rework or represent data differently.

3.3.4 FSRA – Dual Licensing of Banks

Issue

A fundamental systemic risk to the financial system persists with the requirement for banks to hold an Australian Financial Services Licence (AFSL) under the Corporations Act to conduct their deposit taking business, in effect a second licence in addition to a bank's requirement to hold an authorisation from APRA to conduct banking business in Australia.

Discussion

Prior to the FSRA, the essential protection to depositors was ensured under the Banking Act because a bank's licence or authority to carry on its banking business could only be placed in jeopardy by the Government of the day or regulatory authorities set up under Commonwealth legislation in the event of a prudential failure. For as long as a bank demonstrated it was prudentially sound, the

Commonwealth Government and its regulatory bodies set up under Commonwealth laws had no power to place at risk a person's savings held in the banking system.

Under the FSRA, banks are required to hold a second licence under the Corporations Act. This was never previously the case for banking business, although licensing applied for other activities of banks such as dealings in securities, futures, derivatives (which are not strictly speaking considered to be banking business). The provisions in the FSRA governing the AFSL permit the regulatory authority to threaten, restrict or ultimately terminate a bank's AFSL with effect that the authority of the bank to carry on its banking business would be revoked. The grounds for this revocation relate to "consumer protection" issues such as contractual disclosure, misrepresentation, matters that are at a level far below any threshold of a prudential concern.

Loss of confidence by the market, fuelled by media speculation or even the suggestion by a regulatory body that a bank's licence could be under investigation could adversely impact on confidence in the operations of the bank and subsequently generate undue market volatility in the share price in local or overseas markets.

Breaches of consumer protection types of legislation by banks should be dealt with by normal enforcement action through the courts and Commonwealth legislation should not permit bank licensing to be put in issue over consumer matters not raising prudential concerns.

When this issue was raised by the ABA and member banks prior to the FSR being enacted, a compromise provision was inserted into the legislation requiring that only the Treasurer could determine the future of a bank's AFSL. However, this is an inadequate protection for the financial system. Media comment surrounding such an elevation could be sufficient to result in a bank failure or the need to call on the Reserve Bank of Australia for liquidity funding due to panic withdrawals of deposits.

Conclusion

The ABA considers that removal of the requirement for a bank to hold an AFSL for its banking business would not otherwise affect the legislative intention of the FSRA regime, namely licensing by banks or their subsidiaries for dealing, financial advisory, broking, insurance and other activities which are not part of banking business.

In addition, breaches of consumer protection types of legislation by banks should be dealt with by normal enforcement action through the courts and Commonwealth legislation should not permit bank licensing to be put at issue over consumer matters which do not involve prudential concerns.

In the longer term, legislative change is essential. As a temporary measure, administrative action under the Act, as it presently stands, could be taken to remove the systemic risk by excluding bank deposits from the regime. Lending is already excluded.

ASIC could make a declaration under section 765A(2) of the Corporations Act that deposits with a bank holding an authority under the Banking Act are not financial products for the purposes of Chapter 7 of the Corporations Act. That declaration would be published by ASIC by notice in the Gazette.

By the operation of section 762A(3) such a declaration would override the specific inclusion of bank deposits in section 764(A) of the Act. In the longer term, the legislation could be amended to rectify the position.

Alternatively, a regulation to the same effect could be made by the Treasurer.

3.3.5 Annual Report

Issue

Since the CLERP 9 amendments, the requirement for a company to lodge an annual report has become convoluted. There are some requirements contained within the Corporations Act and some contained within the ASX Listing Rules.

Discussion

An annual report is now comprised of the following sections:

- The financial report (comprising the financial statements, notes to the financial statements and the directors' declaration);
- The directors' report (this report must contain the information required by sections 299, 299A, 300 and 300A);
- The remuneration report (the information required by section 300A(1) to be included in the directors' report must be included in a specific section under the heading "Remuneration Report"); and
- The annual report (which in addition to being the report as a whole means those sections not specifically required to be included in the other reports referred to above).

There are a range of provisions specifying the circumstances in which information must be included in a specific report or where it may be contained elsewhere in the annual report, including: ASIC Class Order 98/2395 (as amended) states that information required to be included in the directors' report under sections 299, 299A and 300 may be included in the annual report other than the financial report; section 300(2) states that certain information need not be included in the directors' report if it is included in the financial report; information required to be included in the "Remuneration Report" cannot be included in other sections but information otherwise required to be included in the financial report may in certain cases be included in the "Remuneration Report"; and amendments have been made to the provisions dealing with the annual report by adding additional sections but not necessarily integrating those sections in a cohesive manner with existing sections (e.g. sections 299(1)(a), 299(1)(e), 300(1)(a). In addition to the requirements under section 299, listed companies are also required to comply with LR 4.10.17.

Conclusion

The ABA considers that the Corporations Act requires simplification so that a company's obligations with respect to the preparation of an annual report are clear and unambiguous. The ABA also considers that the ASX Listing Rules should be reconciled to ensure no unnecessary overlap. This will ensure that companies have greater clarity and certainty regarding their disclosure obligations.

3.3.6 Regulation of superannuation

Issue

Regulation of superannuation is becoming increasingly complex and cumbersome. In terms of complexity and compliance cost, superannuation regulation is second only to taxation. In addition, there are potential inconsistencies, overlaps, duplications and gaps in the regulation of superannuation and wealth management.

Discussion

Firstly, superannuation trustees are regulated by both APRA and ASIC. APRA focuses on prudential regulation, whereas ASIC focuses on conduct of business regulation. ASIC administers both the *Corporations Act* and the *Superannuation Industry (Supervision) Act* ('SIS Act'), whereas APRA administers, amongst other statutes, the SIS Act. As both regulators administer elements of the SIS Act there is potential for inconsistent or overlapping policy.

The ABA recognises the challenges that APRA faces with regulating a broad superannuation industry. However, currently, industry is concerned with the manner in which APRA is considering administering the law in relation to obligations of superannuation trustees. For example, there may be tension between the *Corporations Act* and the manner in which APRA is interpreting section 52 of the *Superannuation Industry (Supervision) Act* ('SIS Act'). APRA seems to be interpreting the law in a manner that may require all superannuation trustees to impose asset concentration limits or asset diversification limits at the fund level.

This approach would restrict the ability for superannuation trustees to determine investment characteristics within their product offerings to maximise returns and diversify risks; restrict individual members (and their financial advisers) to match assets across portfolios within the superannuation and non-superannuation environment; and impede the ability for individual members (and their financial advisers) to tailor investment choices based on their own particular investment objectives, financial situation and needs.

Secondly, self-managed superannuation funds (SMSFs) are essentially regulated by the ATO. Currently, there are differences between how complying superannuation funds and SMSFs are licensed and regulated. This approach means that consumers may not be receiving professional financial advice,

creating concerns with consumer protection and market integrity in the retail superannuation industry.

Conclusion

The ABA believes that the Government and regulators should ensure that the policy objectives for the superannuation system as articulated in the law are reflected in the administration of the law across the various financial services regulators. In particular, the Government should ensure that the roles of superannuation trustees and professional financial advisers are not unintentionally restricted and that the regulatory treatment for SMSFs is product neutral and that savings are prudentially and safely invested in all superannuation vehicles.

3.3.7 Tax legislation

Issue

Currently tax legislation is extremely complex and cumbersome. Legislation should be principles-based rather than highly detailed and prescriptive. The design of the tax system should move to the alignment of tax and financial accounts, and be driven by simplification of the system as a whole.

Discussion

Tax law in Australia is very complex, with two Acts for income tax, and relatively new GST legislation. The approach to legislation has generally been detailed and prescriptive, with legislation supported by ATO rulings and other interpretative instruments.

Determination of a principle or point of law by a taxpayer usually requires interpretation of a number of legislative provisions and existing rulings, and frequently, requests for new rulings or testing in the courts.

For the policy-makers, changes to the law require detailed consideration of a large body of existing law, with significant risk of unintended consequences.

A principles-based approach would deliver higher levels of simplicity, fairness, efficiency and certainty in the tax system, improve tax administration and provide correlative benefits to taxpayers.

A principles-based approach would probably require further authority to be given to the Tax Commissioner, with the use of an appropriate review mechanism on ATO determinations, and process improvement on ATO interpretation.

Conclusion

The ABA considers that a principles-based approach to new tax legislation, where feasible, would significantly benefit policy-makers, the ATO and taxpayers.

3.3.8 ATO & Treasury

Issue

The tax policy function resides within Treasury. The intention was to provide a clear separation and delineation between policy and tax administration, which is the domain of the ATO.

In practice, however, the nature of the boundary is not clear to taxpayers, and there have been significant instances where banks have been caught in an apparent gap between ATO and Treasury – where neither agency takes full responsibility for resolution.

Discussion

For example, the ATO has raised the prospect that certain subordinated instruments may not be debt for tax purposes. The ATO has argued that this is because of the existence of solvency clauses which make payment of the amounts due contingent on the solvency of the issuer.

Another example relates to the Taxation of Financial Arrangements ('TOFA') proposals. The industry has been working with the ATO and Treasury on TOFA for some time. There is a resistance to aligning taxation rules with accounting rules – we need to ensure that the Government minimises duplication and maximises consistency with other reporting requirements.

Conclusion

If the ATO is constrained by their inability to interpret the legislation anything but literally, then a safety valve is needed through:

1. Powers granting the Commissioner discretion to apply a pragmatic or policy-based approach.

2. Fast-tracked system of having issues dealt with by Treasury.

Ultimately, the ABA considers that a thorough review of taxation is required to remove the unnecessary complexity.

3.3.9 State and Commonwealth Evidence Acts

Issue

Commonwealth and States' evidence acts are not uniform which means that nationally operating companies such as banks cannot adopt nationally uniform document retention procedures.

Discussion

The Commonwealth and NSW have amended their Evidence Acts to repeal the best evidence rule (requiring the retention of the original document) and other States have issued practice notes taking a range of approaches to the status and use of electronic copies of documents.

Conclusion

A national policy on the status of electronic records providing consistent principles across all jurisdictions is needed to enable documentary evidence to be retained and stored efficiently so as to satisfy national evidentiary requirements.

3.4 Inconsistencies between regulatory requirements

In addition to comment provided in section 3.3 regarding particular overlaps and inconsistencies, the ABA provides the following comments on inconsistencies between regulatory requirements.

3.4.1 Consumer Protection Laws

Issue

There is emerging inconsistency about how the nine Australian Governments use fair trading legislation (Trade Practices Act in the Commonwealth) to drive consumer protection initiatives. This leads to a national lack of uniformity in these laws and greater compliance burdens and costs for companies, such as banks that operate nationally.

Discussion

Commonwealth, State and Territory consumer affairs Ministers agreed in 1983 to adopt nationally uniform consumer protection legislation, with the objective of promoting efficiency and reducing compliance costs. The model chosen for the uniform scheme was the consumer protection provisions (Part V) of the TPA, which include general prohibitions against misleading or deceptive conduct in trade or commerce, as well as more specific prohibited practices. Each jurisdiction adopted these provisions in mirror legislation.

There is emerging inconsistency about how the nine Governments use their fair trading legislation (TPA in the Commonwealth) to drive consumer protection initiatives. Despite the original intent, when the legislation was passed, to have consistent national laws there is a trend away from this intention. An example occurred in 2004 when NSW and Victoria introduced similar but inconsistent amendments to their Fair Trading Acts regarding telemarketing. These provisions were not replicated in the TPA or in other State and Territory fair trading acts. The NSW and Victorian governments have since invited submissions on the harmonisation of some of the differences between the two pieces of legislation which has been welcomed by the ABA. However, the point is that had this been done before enactment, banks and other businesses would have been spared the need to develop different compliance arrangements and to later bring those compliance arrangements into line with the harmonised provisions once they are made known by NSW and Victoria.

Parliamentary Secretary Pearce has committed to work with the Ministerial Council on Consumer Affairs ('MCCA') to achieve a nationally uniform consistent consumer policy framework.

Conclusion

The ABA believes that a mechanism to achieve the original intent is to revisit the 1983 agreement between the nine Governments to include positive obligations to ensure consistency in consumer protection laws, using the template model that is applied to the Uniform Consumer Credit Code ('UCCC').

3.4.2 Credit Card Marketing

[Note: Also see comments under section 3.2 on compliance costs as they relate to the Uniform Consumer Credit Code.]

Issue

The UCCC was intended to be a nationally uniform law for the regulation of consumer credit (subject to some limited individual State and Territory discretions, for example the setting of maximum permissible interest rates for Code regulated lending). In 2002, the ACT Fair Trading Act 1992 was amended because the ACT Government decided to support a private member's bill concerning the marketing of credit on credit cards. The legislation was not subjected to a regulatory impact assessment nor was the assumed market failure researched beforehand.

Discussion

The amendment applies to restrict ACT credit providers from providing offers of credit cards and increased credit limits on credit cards to ACT residents unless certain procedures are followed. The effect of this amendment has been to require credit providers to adopt different procedures in the ACT than for the rest of Australia which undermines the principle of national uniformity for consumer credit regulation under the UCCC. Data available from the RBA shows that the overwhelming majority of credit card holders are managing their credit card facilities satisfactorily appropriately. The ACT amendment did not take account of the overall market situation.

In 2005 and in recognition of the importance of national uniformity of consumer credit law, the NSW Government decided (quite correctly and appropriately in the ABA's view) not to support a private member's bill in similar but not exact terms with the 2002 ACT Fair Trading Act amendment. Instead the NSW Government has provided a briefing paper for the consideration of MCCA.

Conclusion

The ABA considers that these examples highlight the need for clear regulatory protocols so that governments cannot by-pass uniformity agreements by supporting a bill not of their own making or because the legislation would not directly amend consumer credit law under the UCCC.

3.4.3 Mandatory comparison rate

Issue

There is emerging evidence that the mandatory disclosure of the comparison rate ('MCR') for fixed term UCCC regulated lending is failing its objective to inform consumers of the cost of their credit facilities.

Discussion

The UCCC mandates disclosure by credit providers of the MCR in all advertisements for fixed term credit and to have available in branches and other places, where credit is available, schedules of loan amounts and terms containing the MCR.

The MCR was legislated into the UCCC almost three years ago on the basis that its effectiveness would be reviewed at the end of three years. That review is currently in train and is expected to be followed by an examination of whether the MCR could be extended to continuous or revolving consumer credit products such as credit cards and overdrafts.

Consumer experience with the MCR indicates that the MCR requirement can mislead consumers into believing the MCR is the interest rate of another credit provider not the credit provider making the disclosure. Further, there have been instances of manipulation of the rate by some providers charging fees in a manner that has the effect of lowering the comparison rate they disclose. There is a lack of consistency in approach to the MCR by State Offices of Fair Trading and Consumer Affairs. New Zealand had a MCR for over a decade before deciding to repeal the requirement because they found that it misled customers and was of little informational use.

The MCR was introduced in Australia without research into its likely utility and application in an Australian context.

Conclusion

The task for the current MCR review is to assess the value of the MCR disclosure and it is hoped the review will be instructive on the future of the MCR. Any proposal to extend the MCR to continuous or revolving credit facilities must be preceded by appropriate research into a model and how it would impact on consumers and industry.

3.4.4 Regulation of finance brokers

Issue

There is an urgent need for nationally uniform regulation of finance brokers. There are two issues of concern to banks. Firstly, despite some progress towards nationally uniform legislation, it has not yet eventuated. Secondly, the proposed legislation is expected to contain a restriction on a mortgagee such as a bank from enforcing its mortgage after default by the customer where the origination of the loan involved a finance broker.

Discussion

The regulation of finance brokers varies across the States and Territories, particularly in relation to the provision of home lending products. Western Australia, Victoria, NSW and the ACT have legislated to regulate brokers. South Australia, Tasmania, Northern Territory and Queensland do not have specific legislation to regulate brokers. NSW, Victoria and ACT legislation is similar focusing on disclosure requirements for brokers.

The NSW Office of Fair Trading is expected to soon release draft provisions to develop nationally uniform finance broker legislation.

The ABA supports regulation of finance brokers. However, the ABA believes that it is inappropriate for the power of a bank to enforce a mortgage where the debtor has defaulted to be restrained simply because a finance broker was involved in the origination of the loan on behalf of the debtor. This proposal has prudential and other credit risk implication for banks.

Conclusion

The ABA considers that the MCCA should expedite the process towards nationally uniform legislation and not adopt the proposed restraint on the exercise of the power of sale by a mortgagee.

3.4.5 Regulatory concessions to accountants/tax agents

Issue

Under FSRA, accountants have a limited (incidental) exception available to them from the licensing regime. This has created a competitively uneven position in the provision of financial services advice.

Discussion

Advice given by a registered tax agent is not financial product advice if the advice is given in the ordinary course of activities and is reasonably regarded as a necessary part of those activities (section 766B(5)(c)). Accountants have a number of exemptions where they may not be required to hold an Australian financial services licence. This means that the promotion of self managed superannuation funds ('SMSFs') can be done through an accountant and not through a licensed financial services provider. This has ramifications for market integrity (as SMSFs are regulated in a different manner, e.g. ATO, not APRA and ASIC) and consumer protection (as SMSFs are being promoted by people that do not necessarily have ASIC Policy Statement 146 (PS 146) qualifications; PS 164 organisational capacities, including dispute mechanisms).

Conclusion

The industry is currently considering the concessions given to accountants and tax agents and contrasting behaviours with that of financial planners, and believes the Government should reverse the exemption on competitive neutrality grounds. This is particularly the case in relation to SMSFs, where retail investors

may be receiving information on superannuation from agents that do not meet professional financial adviser standards.

3.4.6 OH&S legislation

Issue

The nine Governments have separate and distinct occupational health and safety ('OH&S') legislation setting out minimum standards for employers across the Commonwealth, States and Territories.

Discussion

The myriad of OH&S statutes across Australia creates inconsistency which leads to additional costs and inefficiencies for national employers, such as banks. As the duties and responsibilities are inconsistent there is a risk to the health and safety of all employees and others in a workplace.

In particular, for example, NSW is different to the other States and Territories in a number of areas. Firstly, the Industrial Relations Commission (IRC) in Court Session determines cases. This means that the Supreme Court of NSW (except in relation to appeals against decisions for a death in a workplace pursuant to section 32A of the OH&S Act (NSW)) is not the arbitrator. It also means that the Court of Criminal Appeal is not at the apex of the criminal system, as the IRC also determines appeals.

Secondly, NSW is the only jurisdiction in Australia which permits unions to bring prosecutions for alleged breaches of occupational health and safety legislation. Unions are not required to demonstrate that the prosecutions are in the public interest.

Finally, the independence of prosecutors in NSW (whether WorkCover or union prosecutor) is bought into question by their ability to claim a moiety. No other jurisdiction permits the payment of fines to union or WorkCover prosecutors for OH&S prosecutions. There are no restrictions on the use of such payments.

Conclusion

In our submission to the NSW Government review of the OH&S Act (NSW), the ABA has made recommendations relating to procedural fairness as follows:

- OH&S matters should be returned to the jurisdiction of the courts, allowing the IRC to concentrate on industrial relations matters.
- OH&S matters should be taken by the Department of Public Prosecutions (DPP) to the Supreme Court of NSW. The Court of Criminal Appeal should be at the apex of the OH&S system.
- No moiety should be payable to a WorkCover prosecutor or union. These procedural issues potentially undermine the integrity of the OH&S system.

The ABA considers there should be national harmonisation of occupational health and safety legislation.

3.4.7 Workplace surveillance

Issue

There is an emerging trend to national disuniformity in workplace surveillance laws making compliance by industry more complex and costly. Such laws must strike an appropriate balance between the workplace and detection of fraud.

Discussion

NSW has introduced legislation strengthening the requirements on business around surveillance in the workplace. It is understood that NSW will be taking this to the next Standing Committee of Attorneys General ('SCAG') meeting to try to garner support for a national approach. Victoria has recently released a proposal from the Victorian Law Reform Commission for workplace privacy legislation. These kinds of measures could be counterproductive to banks' fraud prevention initiatives. The industry needs to be vigilant about fraud vs privacy issues, especially with increasing requirements at a Commonwealth level.

Conclusion

The ABA considers that SCAG should adopt a single model for workplace surveillance and privacy with appropriate recognition of the right of employers to protect their business investment against fraud and other loss.

3.4.8 Statutory trusts

Issue

There is a lack of national uniformity for the calculation and remittance of interest on business agency and trust accounts in Australia making compliance by banks more costly and complex.

Discussion

There are various statutes in the States and Territories that regulate the keeping of solicitors', real estate and other business agents' trust accounts. One of the common obligations is the requirement for solicitors and agents to pay client monies into trust accounts commonly maintained with banks and other ADIs.

The legislation which governs the calculation and treatment of interest earned on statutory trust funds is not uniform across the States and Territories. This imposes significant costs and compliance burdens on banks.

Conclusion

Costs and complexities could be alleviated by having one standard for the treatment of statutory trust interest imposed nationally.

3.4.9 Personal property securities

Issue

The taking of security over personal as distinct from real property is unnecessarily complex due to individual Commonwealth, State and Territory laws that regulate the classification, lodgement and priority of these securities. The result is complexity, cost and legal disputation creating avoidable inefficiencies.

Discussion

For over a decade Australian academics have been seeking reform of Australia's laws relating to personal property securities ('PPS') on the grounds of efficiency, lower cost and legal simplicity and certainty.

The Australian Law Reform Commission reported in 1993 that reform should be undertaken in Australia.

The ABA notes that the Australian Finance Conference has been a strong supporter of law reform in this area.

The ABA has opposed law reform on the grounds that wholesale reform is unnecessary, would be costly to implement, would add to regulatory burdens and disadvantage banks in their business lending and security arrangements.

Recently, in 2005 the Commonwealth Attorney General has taken an interest in reforming the law of PPS in Australia on the ground of efficiency because reform would harmonise the patchwork of State and Territory laws into a single cohesive and consistent regime.

There are overseas models that can be drawn upon to inform the reform agenda including the U.S. Commercial Code, Canadian provincial legislation and recently New Zealand's PPS regime.

The Attorney General has conferred with the general counsel of the four major Australian banks which have given "in principle" support to the notion of PPS reform.

The ABA now supports, in principle, support reform of the law relating to PPS and to identify the conditions that member banks consider must be applied in proceeding ahead with PPS reform.

The ABA agrees that PPS reform should create efficiencies in the taking, registration, management and enforcement of PPS, reduce costs and legal disputation and harmonise PPS rules within Australia and with some overseas countries, particularly New Zealand.

However, there are some important considerations and conditions that banks require to be taken into account in supporting PPS reform that include a scoping exercise by the Productivity Commission to asses the true costs, benefits and impacts of reform, full consultation and national consensus on a legislative model, preservation of existing priority rights and an incentive pricing structure by

governments for the registration process. The ABA notes that New Zealand has recently reformed its PPS laws.

Conclusion

The ABA considers that the Government, through SCAG, should consult with the finance and legal sectors to establish a plan for going forward with reform with particular focus on the New Zealand experience.

3.4.10 Conveyancing laws

Issue

There are inconsistent conveyancing laws across the States and Territories relating to:

- Stamp duty calculation;
- Mortgage registration; and
- The form of documents lodged with the relevant government agency.

This creates unnecessary costs and inefficiencies because there are eight different sets of requirements that nationally operating banks have to deal with. The effect is compounded when there are multi-jurisdictional transactions.

Discussion

The ABA is working to help implement a national electronic settlement and conveyancing system to standardise and make more efficient the current manual systems of conveyancing settlement and land titles lodgements. The Victorian government has developed an electronic system and will conduct a pilot of its system next year with the participation of five ABA member banks.

National facilitation of the development of an appropriate electronic conveyancing system has been enhanced with the establishment of a national office for the project. The project is also on the agenda of SCAG. The efficiency gain of electronic conveyancing cannot be achieved without a nationally applicable system and laws.

The inconsistency in calculation of stamp duty on mortgages creates costly inefficiencies. While harmonisation of the stamp duty legislation was a goal, and to some extent achieved, it has been eroded in recent times. The States' agreement to discard mortgage duty following the introduction of GST has been implemented in a haphazard and inconsistent manner, giving rise to internal operational issues for member banks.

Conclusion

The ABA considers that through SCAG or other national ministerial forums there needs to be continuing reinforcement of the notion of a nationally applicable

electronic conveyancing system. Electronic conveyancing will provide an opportunity to look at stamp duty harmonisation.

3.5 Regulation that is out-of-date due to industry trends

3.5.1 Fraud Detection

Issue

Fraud and anti-money laundering ('AML') detection is hampered by privacy issues. Prevention of crime, particularly in relation to electronic transactions requires rapid and effective verification of identity.

Discussion

Australia must meet its international obligations in relation to AML and the control of terrorist financing. Efforts in these areas require very robust Know-Your-Customer ('KYC') programs.

Verification of identity and KYC may require swift exchange of information between parties involved in a financial transaction, and strict application of privacy principles has the capacity to hinder processes in this area.

Conclusion

When a suspicion of criminal or terrorist activity is formed, action on that suspicion must not be obstructed by privacy considerations. Electronic payment mechanisms can move funds rapidly, and banks must be able to act swiftly to delay or block payments.

FSAC has indicated its interest in improving the regulatory framework to facilitate the adoption and use of technologies in the financial sector, and in relation to the prevention of crime, there is a clear public interest in facilitating the application of technology.

3.5.2 Review of Part III of the Privacy Act 1988

Issue

The credit reporting provisions of the Privacy Act (Part 111A) are preventing better credit default information being available for credit providers.

Discussion

There are some practical issues relating to the posting of credit default notices on credit reference agencies' credit reference files.

Under Part 111A of the Privacy Act credit providers cannot list an overdue payment with a credit reference agency (such as Baycorp) until it is 60 days old. It is common that when a demand is made for an overdue payment and the demand is not satisfied the credit provider will seek to list the debt together with the amount of interest and charges that have accrued since the demand, 60 days or more after the demand was issued.

The Banking & Financial Service Ombudsman and the Office of the Privacy Commissioner take the view that the credit provider must list only the amount demanded, and not subsequent interest and charges, because the interest and charges are not 60 days old at the date of listing. Credit reference files are relied on by credit providers to assess among other things any overdue amounts that a debtor may have incurred in relation to their credit provider(s). Unless all overdue amounts are able to be disclosed the credit reference file is incomplete which in turn impacts on the integrity of the file.

Conclusion

The ABA considers that the Privacy Act should be amended so that provided a credit provider makes it clear to the customer when the demand is made, interest and charges will keep accruing if the amount is not paid it should be permissible for the credit provider to list the amount actually owed at the date of listing.

3.5.3 Register of Shareholders

Issue

Sections 173 and 177 of the Corporations Act 2001 set out the rights of a person to inspect and to obtain a copy of the register of members of a company, and of the use that may be made of information on the share register respectively. The provisions are unclear from a legal perspective and do not allow for technology as an aid to compliance.

Discussion

Section 173(1) states that a company must allow any person to inspect its register of members. If the person is a member of the company, the member cannot be charged an inspection or other fee. A non-member may be required to pay a fee up to a prescribed amount. If the register is kept on a computer (which is now the normal practice for listed companies), the person has the right to inspect a hard copy of the information on the register. The company may only give the person access to a computer on which the information is available if the person agrees with the company to access the information by this means.

If a member of a company that may have hundreds of thousands of shareholders wishes to inspect a hard copy of the information on the company register. Practically speaking this can only be done by requesting the share registrar to print a copy of the register overnight (since it will take thousands of pages). The member may or may not keep any appointment for the inspection of the register. If the register is not inspected, it is almost immediately out of date and the expense involved is totally wasted.

A person has the right to request a copy of the register if they ask for a copy and pay the prescribed fee. Where the register is kept on a computer and the person asks for the data on "floppy disk", the company must give the data to the person on floppy disk, the data must be readable but the floppy disk need not be formatted for the person's preferred operating system. There is legal uncertainty

as to whether the word "readable" means readable in the ordinary English usage of that word or whether it has a meaning in terms of computer language meaning that the data must be able to be manipulated using a common software program.

Section 173 requires a company to provide a copy of its register upon request and payment of the prescribed fee. Section 177 imposes restrictions on the use of the information obtained from a register but it is not clear whether the right to inspect or to obtain a copy of the register is subject to these restrictions in 177.

Conclusion

The Corporations Act should be amended to clarify the relationship between sections 173 and 177 and to fully reflect the current technological means by which registers are kept. The present uncertainty increases compliance costs for listed companies.

3.6 Regulation hindering industry developments

The ABA makes some observations regarding the implementation of the Financial Services Reform Act ('FSRA').

Firstly, there was a delay in the decision as to whether banks would receive a streamlined licensing process.

Secondly, there was uncertainty as to the commencement of the new legislation and the transition period available for industry to apply for a new licence and comply with their new licensee obligations.

The original commencement date was 1 January 2001, reflecting a general lack of appreciation of the significant issues that industry was facing with introducing the legislation. Eventually the legislation was accented prior to the details of the regulations being issued for consultation and being finalised.

Therefore, while industry was supposed to be preparing for a new licence, they were in fact still making comment on regulations and other unintended consequences and operational implications of implementation. This resulted in changes being made to the legislation, contributing to ongoing uncertainty during the implementation and transition period.

3.6.1 Impact of FSRA

Issue

The FSRA, while streamlining licensing for financial products, has resulted in a ''one-size-fits-all'' approach to regulation across the spectrum of financial products, and to a certain degree, across the spectrum of consumers.

Discussion

Section 764A defines specific things that are a class of financial product. Furthermore, section 761G provides the meaning of a retail and wholesale client.

The various statutory tests are generally contained in regulations and apply to individuals and small companies.

The FSRA refinement project has, and is, going some way to address the restrictions of the "retail/wholesale distinction"; however, the arbitrary statutory tests have resulted in a contraction of the market for financial products for retail investors, or alternatively an increase in the cost of financial products for retail investors; for example, foreign exchange and other Treasury products being offered to retail customers - this includes risk management products for small business and over-the-counter (OTC) products being offered to individuals, both for the purposes of risk management or hedging exposures.

Other areas where FSRA is having an adverse impact on the bank-customer relationship is with disclosure and advice; for example, the disclosure regime is creating unnecessary compliance costs, particularly where there are changes made resulting in systems rebuild and additional printing and distribution costs. Another impact of the FSRA on the financial services industry is in relation to advice. Due to the compliance burden and administrative costs of providing advice, some banks have adopted a "no-advice" model for more simple products.

The ABA makes some further observations:

- Some employment agencies no longer supply staff for customer facing roles in financial institutions due to training obligations for more simple products.
- Low volume "legacy products" cannot continue to be supported due to high compliance costs, particularly due to systems rebuilds needed due to new requirements.
- Telephone call centre staff are required to make long disclosures to customers for basic products, increasing call time and ultimately cost.

Conclusion

The ABA is currently working with the Treasury and ASIC on the FSRA refinements project. While the ABA is pleased that many of the concerns expressed by industry since FSRA transition have been included in the project, some significant concerns remain to be addressed going forward.

In addition, the ABA is in the course of providing specific comments to ASIC on some outstanding dollar disclosure issues.

3.7 Regulation and Technology

The ABA was asked by FSAC to identify legislative barriers to the use of technology.

We found this a valuable exercise and have completed a table (Enclosure 2) identifying where Australia's current laws could be improved to facilitate better use of technology or remove uncertainties that may be inhibiting technology use.

3.8 Regulatory process and operations

The FICA Report makes twelve recommendations about improving regulatory processes. These are listed below, in short-form, along with ABA's views on each of the recommendations.

Recommendation 1

Government and regulators be encouraged to adopt light-handed models of regulation, following the policy framework adopted in the Wallis inquiry in the major reviews of regulations under way.

Supported

The ABA particularly supports the FICA Report's comments on implementation of regulation using the minimum level of market intrusion necessary to give effect to policy objectives.

Recommendation 2

Consultation should be comprehensively focused on ensuring the most cost-effective means to achieve the stated policy intent of any new or substantially modified financial sector regulations be undertaken at all stages of the development of the regulations i.e. when policy is designed, legislation is drafted, and the legislation is translated into specific regulations and procedures applied by the relevant regulator.

Supported

The ABA notes that the industry's major regulators have improved their consultative processes and do have their own consultative models in place already. However, the ABA believes that there can be improvements to consultative processes.

Recommendation 3

The business community continue to support a broad debate on the need for further microeconomic reform with the development of well-designed regulations being an essential element of that agenda.

Supported

The ABA notes the good work done by the Business Council of Australia ('BCA') report which canvasses economic reform agenda issues such as tax, regulation,

infrastructure and workplace relations, to ensure the economy remains globally competitive and can continue to support strong job growth and rising standards of living.

Recommendation 4

For major pieces of financial sector regulation, the Government should release a statement of policy intent, initially in the form of its 2nd reading speech and thereafter following a post implementation review that would be conducted within two years to measure whether the objectives were being achieved in the most cost effective manner.

Supported

It is critical to check whether regulation has achieved its desired outcome. If it has not then steps can be taken to change it.

Recommendation 5

A Bureau of Financial Regulation be established to oversee financial sector regulation.

We do not support in the first instance

Although the FICA Report advocates the establishment of a Bureau of Financial Regulation, this could be seen as an additional layer of bureaucracy. We believe that at first instance, the Office of Regulation Review should be tasked with the suggested functions - with additional accountability and review mechanisms, for example, by requiring the Productivity Commissioner to issue a regular report to Parliament on regulation.

However, if it is not possible to achieve this change in the ORR, other alternative models could be looked at including the Bureau model as proposed.

Recommendation 6

The Bureau of Financial Sector Regulation should be tasked with the development of common methodologies to calculate the costs of complying with financial sector regulation on a regular basis. The Bureau should work closely with FICA (or the different industry associations) to help to ensure that this effort is as cost-effective as possible.

We do not support in the first instance (see comments in recommendation 5)

As noted above, the ABA believes that the Office of Regulatory Review should be tasked with enhancing and promoting the Government's objective of effective and efficient legislation and regulation, and to do so from an economy-wide perspective. The Office of Regulatory Review should be given a mandate to assist policy makers and regulators give closer consideration to quantifying the costs and benefits as part of completing Regulatory Impact Statements ('RIS').

Recommendation 7

The Bureau of Financial Sector Regulation should be given a mandate to lift the standards of the cost-benefit analysis of financial sector regulation, and be resourced adequately for this task. The Bureau should encourage a deeper understanding of best practice regulation.

We do not support in the first instance (see comments in recommendation 5)

The ABA believes that the Office of Regulatory Review should have enhanced capacity to influence policy makes and regulators fulfilling their RIS obligations.

Recommendation 8

The Government recognise the potential usefulness of regulated entities being able to develop their own compliance models to achieve regulator-specified outcomes. APRA and ASIC in particular be encouraged to refine what is expected of regulated entities and to develop a framework for alternative compliance models for specified areas of regulation.

Supported

The ABA considers that a model of principles-based regulation should:

- Ensure accountability for outcomes remains with regulators; but
- Allow for regulated entities to apply measures commensurate with the nature and complexity of their business.

International standards provide a precedent for applying principles, e.g. Bank of International Settlements has issued guidance on capital adequacy; APRA has issued guidance on implementing capital adequacy requirements through a value-at-risk (VAR) model. This means that institutions can determine what risks are weighted as commensurate with their business.

Recommendation 9

The Reserve Bank should be encouraged to reconsider its current approach to the regulation of interchange and explore less constraining means to encourage appropriate competition.

Supported

The ABA will provide a separate submission to FSAC and the Government's Taskforce on payments system reforms.

Recommendation 10

The Bureau of Financial Sector Regulation should have a mandate to monitor areas of duplication and inconsistency across regulators.

We do not support in the first instance (see comments in recommendation 5)

As canvassed above, we believe that at first instance, the Office of Regulation Review should be tasked with the suggested function - with additional accountability and review mechanisms

Recommendation 11

The Government should continue taking a lead in the developing of outcomes-based models of regulation in international forums. It should also encourage the recognition that regulatory frameworks may need to evolve as specific regulations are made operational. In adoption of international standards, Australian legislators and regulators should take due regard to the impact on international competitiveness of being an early adopter.

Supported

The ABA notes the work already done by Government e.g. ASIC through IOSCO and AUSTRAC through FATF.

Recommendation 12

That an independent review of the Wallis Inquiry be conducted with an emphasis on the appropriateness of its underlying philosophy and the implementation of its recommendations.

Noted.

The ABA believes that the current Government reviews of regulation (FSAC and Taskforce) be completed and assessed for effectiveness before any review of the Wallis Inquiry.

Although the suggested terms of reference in the FICA report are useful, if there is to be a review of the Wallis Inquiry we would recommend a focus on specific matters which by way of outcome diverged from the original recommendations of the inquiry. A key example of this would be the changes that have taken place to

the payments system which, as already noted by this submission, will be the subject of a later submission to both the FSAC and Taskforce inquiries.

The ABA also notes that compliance and reform fatigue means there is little support to change the current regulatory framework, i.e. changing the "twin peaks" model of regulation and replace it with a 'super-regulator' like the Financial Services Authority in Britain.

3.9 Complaints or positive feedback

Anecdotally, the ABA has received feedback from industry participants and consumers about the impact of the FSRA, particularly regarding advice and disclosure. While some improvements have been noted, such as more consistent disclosure of conflicts and fees across industry, criticisms regarding the amount of disclosure now required to be provided to consumers continues to persist. The lack of recognition of applying product-risk across the spectrum of financial products is a contributing factor. It is not just industry that are finding the compliance burden untenable, but consumers are not tending to read all the material they receive, throwing into question the success of the FSRA. In addition, consumers have complained about the cost of professional financial advice. The lack of recognition of proportionality of advice in the law is a contributing factor.

However, the ABA notes that CPA Australia commissioned Investment Trends to conduct a survey of attitudes as to whether there have been improvements within the industry following the introduction of the FSR regime. The independent report indicates that consumers' views on the quality of advice offered, the clarity in which it is presented, and the effect of Statements of Advice ('SOA') are positive[6].

3.10 Experiences with regulators and Treasury

Generally, the experience of the ABA has been positive in terms of its dealings with regulators and the Treasury, and on matters of regulation. We have found the regulators and Treasury to be helpful, cooperative and generally consultative in their approach. Having said that, we still believe that it would help to improve consultation, as per the recommendation in the FICA Report, to ensure that emerging regulatory policy does not unnecessarily impede innovation and competition within the banking and finance sector.

The ABA acknowledges that building relationships is a two-way street. It is not satisfactory for an industry to complain about the approach of Government and regulators without making an effort to establish an effective working relationship.

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6 http://www.cpaaustralia.com.au/cps/rde/xchg

One area of concern that the ABA holds is in relation to the operation of the Ministerial Councils of Commonwealth, State and Territory Ministers. These bodies are not good at consulting with industry – it is often left to industry to try and work out what is on the agendas of these meetings, to attempt to make input to the matters being discussed and to find afterwards the substance of what occurred beyond the official communiqué.

The bodies we refer to are the meetings of gambling, fair trading and small business Ministers in particular.

The ABA would be happy to discuss any of the issues raised in this letter with you further.

Yours sincerely,

David Morgan

Enclosures:

1. Review of Business Regulation in Australia, November 2005, prepared by CRA International.
2. E-commerce issues for the banking industry

Enclosure 2

Australian Bankers' Association

E-commerce issues for the banking industry

	Relevant legislation, regulation or process	Issue	Proposal
1	**Uniform Consumer Credit Code** ("UCCC"). Relevant provisions include sections 12 (credit contract in writing), 31 (statement of account), 38 (written mortgage), 59 (notice of change to interest rate), 60 (notice of change to repayments), 61 (notice of change to credit fees and charges), 63 (notice of unilateral changes) and 65 (changes by agreement).	Credit contracts must be in writing and signed by the debtor. Notices required to be given to consumers in relation to credit products must all be given in writing. It is not clear whether "writing" includes electronically. Furthermore, although there is not a specific requirement for statements of account to be given in "writing", it is uncertain whether such statements can be given electronically.	Modify the UCCC to clarify that obligations of writing, and of providing statements of account, may be in electronic form consistently with the Electronic Transactions Acts that apply in each of the States and Territories. This might be achieved in the amendments currently proposed to be introduced into the Queensland parliament either late this year or early next year.
2	***Cheques Act (1986) (Cth)*, section 68**. The Electronic Transactions Act 1999 (Cth) does not apply to the Cheques Act.	A cheque or a copy of a cheque is required to be retained by an ADI for a period of 7 years after it is presented. It is not clear whether "copy" includes an electronic copy.	Modify the Cheques Act to clarify that the requirements to retain cheques or copies of cheques is satisfied if a copy is retained in electronic form.

	Relevant legislation, regulation or process	Issue	Proposal
		The *Acts Interpretation Act 1901* (Cth) suggests that a document could include an electronic copy.	
3	***Hague Conference: Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary***	There is uncertainty about the laws that apply to cross-border transactions involving securities held with an intermediary. Australia is a member of the Hague Conference, but has not yet adopted or ratified the Convention.	That legislation be implemented to give effect to the Convention in order to provide legal certainty to the law that applies to securities held with an intermediary in cross-border transactions.
4	***Electronic Transactions Act 1999*** **(Cth)** **Electronic Transactions Act 2001 (ACT)** ***Electronic Transactions (Victoria) Act 2000*** **(Vic)** ***Electronic Transactions Act 2000*** **(NSW)** ***Electronic Transactions (Northern Territory) Act 2000*** **(NT)** ***Electronic Transactions (Queensland) Act 2001*** **(Qld)**	There is inconsistency in the application of this legislation between the jurisdictions. For example: • wills, codicils and other testamentary dispositions are carved out in Victoria, the Northern Territory, Tasmania and Western Australia; • powers of attorney are carved out in the Northern Territory, Tasmania, and Western Australia; • the delivery of a document where a statute requires personal delivery is a transaction carved out in Victoria, the Northern Territory, Queensland, South	The legislation and transactions that are carved out from this legislation should be consistent across all of the jurisdictions. The fact that some transactions have not been expressly carved out in some jurisdictions may give rise to doubt as to whether the ETA in that jurisdiction applies to the transaction. State governments should either work towards a uniform system, or allow the Commonwealth to legislatively cover the field.

	Relevant legislation, regulation or process	Issue	Proposal
	Electronic Transactions Act 2000 **(SA)** ***Electronic Transactions Act 2000*** **(Tas)** ***Electronic Transactions Act 2003*** **(WA)** **(each an "ETA")**	Australia, Tasmania and Western Australia; • the Consumer Credit Code as it applies in New South Wales and South Australia; • documents requiring attestation, witnessing etc by another person is carved out in Queensland, South Australia and Western Australia; • the filing and retention of a document filed by a court etc is carved out in New South Wales and Queensland and the Commonwealth ETA generally does not apply to judicial processes; and • New South Wales has carved out its *Conveyancing Act 1919* (although presumably on the basis that this statute has it own provisions dealing with electronic transactions).	
5	***Bills of Exchange Act 1909*** **(Cth)**	Bills of exchange by definition are orders in writing with requirements of signatures. The Bills of Exchange Act is specifically excluded from the ambit of the Commonwealth ETA. Bills of Exchange are commonly used in trade and commerce as	Modify the Bills of Exchange Act to permit the dematerialisation of bills of exchange and promissory notes, and to provide for electronic clearing and settlement facilities.

	Relevant legislation, regulation or process	Issue	Proposal
		a means of funding and this process is impeded by the need for bills of exchange to be physically created to satisfy the requirements with respect to writing and signatures. In fact, the *"National Competition Policy Review of the Bills of Exchange Act 1909"* ("**Review**") paper released for comment in July 2003, noted that: *"The Bills of Exchange Act plays a significant role in Australia's financial markets, with bills of exchange and promissory notes constituting an important segment of the short-term money market."* Treasury did not follow up on the issue of dematerialisation raised in the Review.	
6	***Insurance Contracts Act 1984*** **(Cth)**, for example duties of disclosure under section 22 and 21A, notification of unusual terms under section 37.	Certain disclosure that must be made in respect of insurance contracts must be made in writing. It is not clear whether this disclosure would be permitted in an electronic document. To the extent that if it is not, this would be inconsistent with other disclosure material that must be	Apply the Commonwealth ETA to the Insurance Contracts Act. Alternatively, amend the Insurance Contracts Act so that disclosure of the relevant matters may be given in a document that is provided to the customer in electronic form.

	Relevant legislation, regulation or process	Issue	Proposal
		given to retail consumers under Chapter 7 of the *Corporations Act 2001* (Cth). We note that Treasury has made similar recommendations in its *"Review of the Insurance Contracts Act 1984 - Final Report on second stage: Provisions other than section 54"*. Recommendation 2.1 states: *"Amendments to the IC Act and other Acts and regulations should be made so that communications under the IC Act may be made electronically. They should be subject to the Electronic Transactions Act 1999", and subject to appropriate safeguards including:* • *clarity;* • *consent by the recipient to electronic communication and nomination by the recipient of the information system for that purpose;* • *ability to print and retain the communications; and* • *certainty of time and place of origin and receipt."*	

	Relevant legislation, regulation or process	Issue	Proposal
7	***Financial Transaction Reports Act 1988*** **(Cth) ("FTRA") , Part VIA**	Part VIA imposes an obligation on financial institutions to retain the original of a customer generated financial transaction document for a minimum period. Part VIA is not excluded from the Commonwealth ETA, however there is ambiguity as to whether "original" means the original form or whether an identical electronic copy of the original is adequate.	Amend the Financial Transaction Reports Act to clarify that the obligation to retain the original of a customer generated financial transaction document is satisfied if an identical copy of it is stored electronically such as may be reproduced or audited as needed.
8	**E-conveyancing**	Transfers of land and the taking of security over interests in land is handled manually in each State and Territory. This is a costly and inefficient process, the costs of which are ultimately borne by customers.	That a National e-conveyancing scheme be implemented, with common forms (for example, standardised mortgage and transfer forms etc.) and stamp duty requirements across all jurisdictions. We note that there has been some movement towards creating a national electronic conveyancing system and that an e-conveyancing pilot will be launched next year in Victoria, involving five of the ABA's member banks.
9	***Fair Trading Act 1992*** **(ACT)**	Credit card limit increases may only occur if the customer has either requested the increase in writing, or has accepted the credit provider's offer of a limit increase in	Modify the Fair Trading Act to clarify that obligations of writing may be in electronic form consistent with ACT ETA.

	Relevant legislation, regulation or process	Issue	Proposal
		writing. It is unclear whether "writing" includes electronically, although there may be an argument that the ACT ETA applies.	
10	***Australian Securities and Investment Commission Act 2001*** **(Cth) ("ASIC Act")**	Credit and debit cards may only be sent to a person if that person has requested the card in writing. It is not clear whether "writing" includes electronically.	Modify the ASIC Act to clarify that obligations of writing may be in electronic form consistent with the Commonwealth ETA. It might also be made clear that it is permissible to accept a recorded telephone request.
11	***Corporations Act 2001 (Cth)*** **("Corporations Act")**, for example section 173 (right to inspect and get copies of registers) and section 252Y (appointment of proxy).	Section 173 provides that if a register is kept on a computer, a person can inspect a "hard copy" of the information on the register, or if they agree, they can be given computer access to inspect the information. Where a corporation has a large number of shareholders, printing a hard copy share register is costly, time consuming and can be quickly out of date, depending on the number of shareholders. Section 173 also provides that a person can ask for the data to be provided on a	Modify the provisions of the Corporations Act regarding registers to reflect that most registers are kept on computer, (for example, clarify the meaning of "readable") and allow companies to provide computer access to such registers without requiring the positive consent of the person requesting access. Clarify whether a proxy can be appointed electronically, and if so, the procedure for such electronic appointments.

	Relevant legislation, regulation or process	Issue	Proposal
		floppy disk, if the information is kept on a computer. Such data must be "readable". It is unclear whether this means "readable" in the ordinary English usage or whether it means able to be manipulated using a common software program. Section 252Y states that an appointment of a proxy must be "signed by the member". It is not clear whether this would include an "electronic signature".	
12	**Code of Banking Practice ("CBP")** **Electronic Funds Transfer Code of Conduct ("EFT Code")**	Providing documents in electronic form to an email address, or publication of material on a website should be treated the same as if the information was provided "in writing" and should not require specific consent where contact details are provided. It is also important to clarify: • whether a notification email sent to a customer advising that relevant information/documents can be obtained from a particular website must contain a link to that website;	Both Codes require a "specific positive election" by the consumer to electronic communications. This should not be the case. Rather collection of email details should be adequate for customer consent, just as a postal address is adequate for this purpose. Both Codes should also provide clarification of the requirements relating to notification emails and for undelivered emails. That said, the EFT Code duplicates a large number of provisions contained in the CBP and arguably might be repealed if, where

	Relevant legislation, regulation or process	Issue	Proposal
		and • the process for dealing with "undelivered" electronic communications, which, for whatever reason, do not reach a customer's nominated electronic address.	the CBP does not mirror a specific consumer protection provision in the EFT Code, such provision was either incorporated into the CBP or included in Chapter 7 of the Corporations Act.

FINAL REPORT

Prepared For:

Finance Industry Council of Australia

Review of Financial Sector Regulation in Australia

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Level 7, 107 Pitt Street

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EXECUTIVE SUMMARY

The regulatory burden being faced by the financial sector has increased sharply in recent years as both the Australian and international authorities have instituted substantial change. Compliance costs have risen significantly and the products being offered to consumers affected.

A robust and safe financial sector supported by a sound regulatory system is crucial to the success of market economies. The damage that failure of significant financial institutions can inflict on economies and individuals has been clearly demonstrated in Australia and overseas over the past decade.

Equally, however, it needs to be recognised that the success of market economies is built on their ability to respond flexibly and in innovative ways to changing circumstances. Rigid regulations can harm this flexibility. Thus, the presumption should be to intervene only where there is a clear need and to do so in ways that minimise costs and distortions.

This philosophy was reflected in the Wallis Inquiry[1] which, in 1997, provided a thorough investigation into the regulation of the Australian financial sector. It advocated a principles-based approach to regulation emphasising competitive neutrality, cost effectiveness, transparency, flexibility and accountability.

The extent of intervention should be graded according to the nature of the contract involved and the consequences of market failure. This suggests that, in areas where the consequences of failure are not severe, what might be termed 'light-handed' regulation should be used. To be more precise, regulation can be viewed as light-handed where:

- The policy is circumspect as to the range of services and activities where explicit regulations are needed. As far as possible, reliance will be placed on market discipline;
- Where regulation is introduced, reliance is place on principles-based regulation rather than rules-based regulation; and
- In this regard, alternative compliance models are encouraged to meet stated principles.

The Government accepted Wallis' recommendations relating to regulatory principles. In fact, these basic principles remain appropriate although the experience of the past few years may indicate that further consideration as to how they may be made operational was warranted.

1 Financial System Inquiry, *Final Report*, 1997, available at www.fsi.treasury.gov.au.

Moreover, as it turned out, the light-handed approach advocated by Wallis was overtaken by events. The landscape was fundamentally altered by the infamous corporate collapses and the greater urgency given to checking the flow of finance to terrorist organisations. More interventionist regulation and regulators ensued.

Regulating well is inherently difficult. Very often the devil really is in the detail. The overarching principles may be well specified in legislation and in Second Reading speeches. But once this has occurred, regulators and regulated firms must ensure that the spirit and letter of any legislation and resulting regulation is met at the detailed operational level.

The nature of the difficulties that arise may fall under the banner of 'the politics of detail'. This is a particularly difficult challenge for the regulation of the financial sector where it is unrealistic for either legislators or officials in Canberra to be able to monitor and assess the appropriateness of how regulations are being implemented in detail. Alternative arrangements are needed in order to monitor and assess the practice of financial sector regulation and in turn support the existing accountability procedures for regulators.

More broadly, a multi-faceted approach is recommended to improve financial sector regulation directed at:

- Encouraging the **design** of less prescriptive regulation;
- Ensuring that a **culture** consistent with an emphasis on outcome-based regulation is maintained throughout each of the financial sector regulators;
- Developing a stronger **information** base of best practice regulation;
- Boosting the **monitoring and accountability** of regulators;
- Encouraging **regulated entities** to actively explore better ways of meeting the objectives of regulation; and
- Advocating similarly flexible approaches to regulation in **international** forums.

Ideally, the changes will institutionalise better informed and accountable systems of regulation that will be automatically refined over time.

RECOMMENDATIONS

The recognition that the imposition of a suite of new financial sector regulations threatened to add unreasonable costs to business (and their customers) has led to efforts to refine and moderate previous draft regulations, including those related to the Financial Services Reform ACT (FSRA), anti-money laundering (AML) and counter-terrorist financing (CTF) and prudential standards for general insurance. Given this ongoing work, this report does not address these regulations in detail. Nevertheless, the decisions taken in these re-examinations will set the tone for future agendas and it is important that balanced, cost effective solutions be found for the issues that have arisen.

Recommendation 1: Following the policy framework articulated in the Wallis Inquiry, the Government should be encouraged to adopt light-handed models of regulation in the major reviews of regulations currently under way. The implementation of these regulations, as for all regulation, should use the minimum level of market intrusion necessary to give effect to the identified policy objectives. It should be proportionate to the demonstrated market failure and applied efficiently.

Consultative processes have generally been set up for major changes to financial sector regulation. However, for some of the major changes in recent years, including FSRA and AML/CTF, the consultation processes were perfunctory. Problems with the original drafts were not identified and addressed at an early stage and opportunities to develop more cost-effective approaches to meet the basic policy objectives were not explored. There have been significant improvements in the consultation processes for tax matters in recent years and these improvements should be emulated for the development of financial sector regulation.

Recommendation 2: Consultation should be comprehensive focused on ensuring the most cost-effective means to achieve the stated policy intent of any new or substantially modified financial sector regulations be undertaken at all stages of the development of the regulations i.e. when policy is designed, legislation is drafted, and the legislation is translated into specific regulations and procedures applied by the relevant regulator.

The design and application of regulation does not occur in a vacuum. Developing a realistic understanding in the community of what can and should be expected of regulation will assist both legislators and regulators. Furthermore, the net benefits to flow from well-crafted regulation can be substantial and in fact of a scale to rival many of the major microeconomic reforms introduced over the past two decades. Better regulation should form a central part of the next wave of microeconomic reform.

Recommendation 3: The business community should continue to support a broad debate on the need for further microeconomic reform, with the development of well-designed regulations being an essential element of that agenda.

The challenge of converting policy principles and legislation into operational regulations and practice has been complicated in recent years by potentially conflicting pressures on what is expected of regulators. They should rely on light-handed approaches where feasible but adopt a sufficiently hands-on style to "be ahead of the game". Such tensions can be reconciled, especially if the expectations of Government are clearly spelt out. This is a function of 2nd reading speeches although the intentions specified in these speeches are frequently incomplete. This reflects the reality that the initial design of a regulation cannot appreciate all aspects of how the regulation will operate in practice and the 'regulatory craft' will be an evolving exercise. Thus, expectations articulated in 2nd reading speeches may need to be refined and elaborated at a future point.

Recommendation 4: For major pieces of financial sector regulation, the Government should release a statement of policy intent, initially in the form of its 2nd reading speech and thereafter conduct a post implementation review within two years to measure whether the objectives were being achieved in the most cost effective manner.

Unaided, legislators and officials in Canberra will always struggle to provide close oversight of financial sector regulators. Treasury has a traditional and structure that makes it very effective in advising on the design and objectives of policy. However, it is not well-tuned to support the implementation and subsequent monitoring of regulations at a detailed level. Even more so, Government and Parliament tend to struggle to cope with this 'politics of detail'.

The oversight of financial sector regulators would benefit from the establishment of a dedicated bureau with a mission to identify and filter systemic issues. It would provide advice to regulators and legislators as needed, and report to Parliament on an annual basis. As such, it would contribute to both a better informed debate about the regulatory performance – including minimising unhelpful distractions that frequently surface – and assist in progressively improving regulatory practice.

Recommendation 5: A Bureau of Financial Sector Regulation should be established to oversee financial sector regulation.

A stronger knowledge base and analytical capability than exists today would facilitate the development of well-crafted regulations. Being able to analyse and quantify the benefits of reform, and then use these results in public forums, proved to be of considerable value in driving the adoption and acceptance of earlier reforms such as the reduction of tariffs. Emulation of this experience would significantly benefit financial institutions, their customers and the economy more broadly.

Recommendation 6: The Bureau of Financial Sector Regulation should be tasked with the development of common methodologies to calculate the costs of complying with financial sector regulation. The Bureau should work closely with FICA (or the different industry associations) to help to ensure that this effort is as cost-effective as possible.

The development of a deeper understanding of both the direct and indirect costs and benefits of regulations requires both better understanding and the development of a stronger analytical capability.

Recommendation 7: The Bureau of Financial Sector Regulation should be given a mandate to lift the quality of the cost-benefit analysis of financial sector regulation, and be resourced adequately for this task. The Bureau should encourage a deeper understanding of best practice regulation.

Wallis emphasised the desirability of tailoring the extent of regulatory intervention to the 'intensity' of the financial promises involved. For most areas of financial sector regulation, there is scope for alternative procedures to be adopted by different institutions in order to meet a basic policy objective. Where feasible, the regulatory framework should be designed to allow alternative compliance models to be used and regulators should encourage their adoption as an option to the regulator's default model.

This approach should allow institutions to tailor their compliance to their particular circumstances and, in turn, encourage innovation and competition in the sector. In addition, the lessons learnt from alternative compliance models should contribute to progressive improvements in how regulation overall is conducted.

Recommendation 8: The Government should recognise the potential usefulness of regulated entities being able to develop their own compliance models to achieve regulator-specified outcomes. APRA and ASIC, in particular, should be encouraged to define what is expected of regulated entities and to develop a framework for alternative compliance models for specified areas of regulation.

One area where more interventionist regulation has occurred than had been anticipated by the Wallis Inquiry is in the payments system. The Payments System Board (PSB) has a mandate to ensure the stability and reliability of the payments system. It also needs to foster competition and efficiency in the system. However, as in other areas of the economy, the presumption should be to encourage competition through, *inter alia*, ensuring that barriers to entry are minimised rather than to directly intervene.

The RBA's decision to directly intervene in the setting of interchange has been taken without strong evidence of net benefits, at the risk of harming innovation and against the basic philosophy of light-handed regulation. This is one area of regulation not under active review by Government that could be revisited.

Recommendation 9: The Reserve Bank should be encouraged to reconsider its current approach to the regulation of interchange and explore less constraining means to encourage appropriate competition.

The cumulative impact of the raft of regulations introduced over recent years has been as much of a challenge for financial institutions as many of the individual measures themselves. Also, despite efforts to minimise overlap between the operations of different regulators and regulations, such overlap has inevitably arisen. Conflicts have occurred both from international obligations placed on many financial institutions – notably in the context of Sarbanes-Oxley – but also on the domestic front.

APRA and ASIC have been aware of potential issues of overlap and have taken steps to minimise them. The risk, however, will persist and thus there should be a means to regularly identify problems that may arise.

Recommendation 10: The Bureau of Financial Regulation should have a mandate to monitor areas of duplication and inconsistency across regulators.

Many of the pressures that have occurred in recent years have originated from international sources. In the case of Sarbanes-Oxley, there was little scope for Australia to influence the outcome at the time. However, this legislation is far from ideal and there is a growing chorus of voices, both in the United States and elsewhere, arguing for modification. Australia should explore opportunities to encourage refinement to the Sarbanes-Oxley legislation.

In other areas of regulation fostered by international bodies, Australia has often been in the lead advocating the development of outcomes-based models of regulation. This activity is supported. Nevertheless, problems have arisen where due regard has not be made at an early stage to the costs and complications involved in converting the policy principles into domestic regulatory practice (as was the case for AML/CTF). As noted above, the implementation of regulations will be an evolutionary process and thus some flexibility and scope for learning should be recognised throughout the consideration by the relevant international body. Another problem that has occurred in the case of the introduction of new accounting standards has been that the international competitiveness of early adopters has been affected for a period.

Recommendation 11: The Government should continue taking a lead in the developing of outcomes-based models of regulation in international forums. It should also encourage the recognition that regulatory frameworks may need to evolve as specific regulations are made operational. In adoption of international standards, Australian legislators and regulators should take due regard to the impact of early adoption on international competitiveness of domestic players.

Significant problems have been encountered in translating what still appears to be a sensible set of principles in Wallis into practice. Over the past year, legislators, advisors, regulators and industry have devoted considerable effort to ameliorating the worst of the problems that have occurred with various sets of regulations. But given this experience, and the desirability of learning from it, an independent review focusing on the implementation of policy principles into regulatory practice is warranted. A loose parallel can be drawn to the relationship between proposed review and Wallis and that of the Martin and Campbell Inquiries of the 1970s/1980s.

The terms of reference for such a review could include:

- Assessing whether the basic assumptions and philosophy underpinning Wallis' analysis should be modified in light of the corporate failures seen in recent years in the financial sector;
- Reviewing areas where a more outcomes-based approach to regulation could be implemented;
- Reviewing the extent of convergence in financial services and the extent to which a common approach should be applied to the regulation of financial services;
- Exploring criteria for developing more differentiated approaches to 'general market regulation' (including regulation involving licensing and the disclosure of information);
- Investigating the scope for 'alternative compliance' models where the regulated entity can demonstrate the effectiveness of its processes in meeting outcomes that are set by the regulator or legislator;

- Examining the scope for limiting regulatory overlap. This will include overlap both between jurisdictions and between national regulators, especially APRA and ASIC and possibly the ACCC; and

- In reviewing financial sector regulation, consideration should be given to the appropriate role to be performed by boards and senior management, and the level at which they should communicate with regulators.

Recommendation 12: An independent review of the Wallis Inquiry should be conducted with an emphasis on the appropriateness of its underlying philosophy and the implementation of its recommendations using terms of reference along the lines of those in the text.

1. INTRODUCTION

> *There are laws against fraud and misbehaviour of other kinds and they should be vigorously enforced. But it's important that we don't overreact. It's also important that we don't impose on ethical but nonetheless robust business operators in our country, a new layer of unproductive and ultimately self-defeating regulation.*
>
> *Prime Minister John Howard, 6 August 2002*

The Prime Minister made this statement at a time when the United States was adopting the onerous Sarbanes-Oxley legislation in response to the serious deficiencies in corporate governance that were exposed by the series of corporate failures. The Prime Minister was signalling that there was a danger of overreaction and that Australian policy-makers wanted to maintain a balanced and generally light-handed approach to business regulation.

Despite those intentions, the regulatory burden being faced by industry has increased markedly in recent years, especially in the financial sector. Business has been confronted with a succession of substantial regulatory changes instituted by both Australian and international authorities. Compliance costs have risen significantly and the products being offered to consumers affected.

Business regulations are directed at legitimate policy objectives. Unfettered, the market economy will not always deliver socially optimal outcomes. Accordingly, legislators will be required to make judgements about the need for, and design of, regulatory intervention.

In making these judgements, it needs to be recognised that the success of market economies is built on their ability to respond flexibly and in innovative ways to changing circumstances. Rigid regulations can harm this flexibility. Thus, the presumption should be to intervene only where there is a clear need and to do so in ways that minimise costs and distortions. Wherever feasible, policy-makers and regulators should aim to establish the objectives that the policy or regulations aim to achieve and then design regimes that allow these to be carried out in a flexible rather than prescriptive manner.

This report concentrates on business regulation that specifically applies to financial institutions. It will not examine the design and implementation of regulations that apply throughout the economy such as those related to tax, accounting standards, labour or workers' compensation.

Even excluding these areas of regulation, it is clear that financial institutions are heavily regulated – indeed, much more so than most sectors of the economy – and have become more so in recent years. This has implications for the entire economy because of the central place assumed by the financial sector. Any systemic problems in the financial sector can have a widespread impact on the economy and community while, equally, an efficient and dynamic financial sector will deliver widespread benefits.

All regulations lie on a continuum with prescriptive and outcomes-based regulation lying near either end. Simply put, outcomes- or principles-based regulation involves specifying a standard for the desired regulatory outcome without specifying how the compliance is to be achieved. Prescriptive regulation by contrast specifies how certain activities should be undertaken to achieve the desired regulatory outcome.

In 1997, the Wallis Inquiry[2] undertook a thorough investigation into financial sector regulation. It advocated a principles-based approach to regulation emphasising competitive neutrality, cost effectiveness, transparency, flexibility and accountability. The extent of intervention should be graded according to the nature of the contract involved and the consequences of market failure. For example, in the area of prudential regulation, Wallis states: [3]

> *As a general principle, financial safety regulation will be required where promises are judged to be very difficult to honour and assess, and produce highly adverse consequences if breached. … promises which rank highly on all three characteristics are referred to as having a high 'intensity'. The higher the intensity of a promise, the stronger the case for regulation to reduce the likelihood of breach.*

The Government accepted Wallis' recommendations relating to regulatory principles. However, as it turned out, the light-handed approach advocated by Wallis was overtaken by events. The landscape was fundamentally altered by the infamous corporate collapses in Australia and overseas as well as the greater urgency given to checking the flow of finance to terrorist organisations. More interventionist regulation and regulators ensued.

The result has been increased costs and reduced innovation and limited product choices. The implementation of a number of the regulatory changes that have been introduced in recent years or are now being introduced – including the Financial Services Reform Act (FSRA), prudential regulations for insurance, Basel II and anti-money laundering and counter-terrorist financing (AML/CTF) – individually have consumed considerable resources. The cumulative impact of these changes has then quite naturally elicited widespread frustration.

The issue for legislators, then, is whether the benefits of the new regulations justify these costs or whether the policy objectives could be adequately met by other means. This report that the pendulum has swung too far and the regulations are tending to add to the cost of financial services with few benefits for consumers.

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2 Financial System Inquiry, *Final Report*, 1997, available at www.fsi.treasury.gov.au. This is labelled FSI below.

3 FSI, p190.

Regulating well is an inherently difficult task. Very often the devil really is in the detail. The overarching principles may be well specified in legislation and in Second Reading speeches. But once this has occurred, regulators and regulated firms must ensure that the spirit and letter of any legislation and resulting regulation is met and, if necessary, can be demonstrated to have been met at the detailed operational level.

One of the founding principles of modern management is the impossibility of management specifying processes at a minute level – and the cognate imperative to empower employees to improve the processes and routines by which they do their work. It is often difficult enough to foster a culture of employee initiative within a firm's reporting, command and accountability structures. Adding a second quite different source of command – that of government regulation – can make such empowerment much more difficult again, often in ways that are poorly understood even by managers quite close to the process let alone senior management and policy makers.

Options that could lower operating costs or otherwise improve flexibility within a firm may no longer be considered. This can happen without policy makers or senior managers even being aware of the fact as resistance to new ways of doing things is strengthened by internal views – informed or otherwise – about what does and does not comply with the regulation. Where change is considered, lawyers will often have to be commissioned to advise on the compliance of alternative approaches. Moreover, neither policy makers, nor their advisers, will have the time, the inclination or the incentives to regularly address many of the problems thus caused.

The nature of the difficulties that arise may fall under the banner of **'the politics of detail'**. As argued below, this is a particularly difficult challenge for the regulation of the financial sector where it is unrealistic for either legislators – i.e. Cabinet Ministers or Parliament – or the Commonwealth Treasury to be able to monitor and assess the appropriateness of how regulations are being implemented in detail. Alternative accountability arrangements are warranted.

In addition, the quality of the administration of regulation will crucially depend upon the experience and skills of regulators themselves. The complexity of the activities of financial institutions – and the range of activity across different types of institutions – makes it extremely difficult for regulators to develop and maintain appropriate skills. The HIH Royal Commission highlighted this as an important issue for APRA as it became established. The difficulty that regulators face in understanding and keeping pace with details of the businesses they regulate is of continuing concern among many regulated entities and, subject to core standards being maintained, reinforces the desirability of exploring flexible, less intrusive forms of regulatory practice.

In response to these challenges, this report recommends a multi-faceted approach to developing a framework for regulation that will foster continual improvement. This will involve reconsideration of the **design** of some important pieces of financial sector regulation. Even more vital at this point is the need to improve the **accountability** of regulators and to change the **culture** within which regulations are enacted.

A series of steps to meet these objectives are developed and brought together in Section 5. The recommendations include two important elements:

- The establishment of new institutional arrangements to improve the accountability and monitoring of regulators. In particular, in light of the difficulties associated with the "politics of detail", it is recommended that responsibility for much of the oversight of financial sector regulation be devolved to a new body termed the Bureau of Financial Sector Regulation; and

- Conducting an independent review of the complications encountered in putting the Wallis principles into action and how greater reliance on principles-based regulation can be instituted in the financial sector.[4]

In making these recommendations, it is acknowledged that the Government is engaged on a number of exercises that will contribute to improving financial sector regulation. These include the re-examination of the proposed regulations for FSRA and AML as well as the recently announced Task Force on Reducing the Regulatory Burden on Business.[5] However, while helpful, it is unlikely that these processes will succeed in delivering lasting best practice regulation:

- As discussed below, the likely refinements to FSRA and AML should ameliorate some of the more severe aspects of the draft regulations without achieving what could be regarded as good principles-based regulation. But more fundamentally, the nature of the regulations inherent in FSRA and AML mean that their appropriateness will depend on the detail of how they are implemented as much as their basic design. Also, they potentially apply to a wide range of financial services in what is a rapidly evolving industry. Consequently, the application of the regulations will need to accommodate this evolution in a sensible fashion, and this is difficult for legislators or officials in Canberra to do.

- The Task Force has been charged with a substantial brief, covering, at least on paper, all areas of business regulation. One of its main aims will be to establish an effective system of regulatory review based on detailed cost-benefit analyses. The regulation of the financial sector, along with all parts of the economy, should gain from this effort (see Section 5). However, as argued in Section 5, effective oversight of financial sector regulators would benefit from solutions specifically targeted at the financial sector – the Task Force's brief is too broad for sector specific solutions to be forthcoming.

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4 The Financial Sector Advisory Council (FSAC) has conducted a review of Wallis, but that review was limited in scope. A thorough evaluation of the how the Wallis principles were implemented in detail, and the problems exposed by this exercise, is warranted.

5 See the joint press release issued by the Prime Minister and Treasurer at http://www.regulationtaskforce.gov.au/media/mr20051012.html.

Accordingly, this report sets out an approach to develop complementary action to improve the regulation of the financial sector. The report is structured as follows. Financial sector regulation has typically relied on a combination of market discipline assisted by effective disclosure, corporate governance and direct supervision. The balance in the reliance on each of these components, as well as the extent of direct intervention and rule-making by regulators, has varied across countries and across time. Section 2 reviews the state of knowledge as to what approach works best in practice, concluding that, while the empirical evidence is not as yet definitive, the weight of evidence lends support to light-handed regulation. Section 2 goes on to summarise the policy principles recommended by the Wallis Inquiry.

Section 3 reviews the reasons behind the increased regulatory burden confronting the financial sector in recent years. It examines both domestic and international forces at work and argues the need for better regulation to form a central plank in future microeconomic reform agendas.

Section 4 explores in more detail Australia's experience of four important aspects of financial sector regulation, namely the challenges that APRA faced in the early years of its operations, the introduction of the Financial Services Reform Act, measures directed at anti-money laundering and counter-terrorist financing, and the regulation of the payments system.

The main lessons from the experience of recent years are set down in Section 5. Policy-makers and regulators recognise that the increased regulatory burden has demanded modifications to the approaches that were being adopted and, over recent months, they have acted to ameliorate the impact of some of the most onerous regulations. The challenge now is how to ensure that this attitude is embedded into regulatory practice on an ongoing basis and to cultivate mechanisms that encourage continual improvement in regulatory practice. Accordingly, Section 5 develops a series of recommendations aimed at institutionalising better regulatory practice.

A short conclusion follows.

2. THE REGULATION OF THE FINANCIAL SECTOR

The regulation of financial markets around the world has been subject to intense challenges over the past decade. Convergence of financial products and institutions, the inexorable integration of international financial markets, the sophistication of financial instruments, infamous corporate failures and banking crises in a number of emerging markets have combined to confront the design and application of regulatory systems.

At the same time, policy-makers and regulators in numerous countries have substantially modified their regulatory systems in an effort to address these developments.[6] They have done so in what is a very uncertain environment, where understandings of best practice are informed by an imperfect and very fluid information base. However, among experts, as discussed below, a consensus in support of principles-based regulation rather than prescriptive and more interventionist approaches has emerged. This is certainly the approach recommended by the Wallis Inquiry in Australia and supported by the Government.

This section begins by reviewing some of the main theoretical and empirical messages to emerge from the academic literature. This is followed by a summary of the main conclusions and recommendations from the Wallis Inquiry. The basic approach advocated by Wallis has stood the test of time but, as argued in subsequent sections, refinement of this basic approach is needed in order for the basic policy principles to be translated into regulatory practice.

2.1. LESSONS FROM THE LITERATURE

The most appropriate means of influencing a particular economic or social policy objective will vary according to, *inter alia*, the nature of the risks, the consequences of failure and market structure. Djankov *et al* outline four basic strategies that societies have employed to meet their objectives.[7] Stated in order of increasing intervention by government, they are reliance on market discipline, private litigation, enforcement through regulatory agencies and state ownership. Most developed markets will rely on a combination of these four strategies.[8]

Consider, for example, the aim of having liquid, robust and transparent securities markets.[9] Four basic choices are available:

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6 The Bank for International Settlements has played a pivotal role in informing, influencing and coordinating this response.

7 Djankov *et al* (2003).

8 This is certainly the case for the regulation of the financial sector in Australia. The regulation of the payments system is the main area where the public sector directly participates.

9 This example is taken from Shleifer (2005).

- The fact that market participants will seek repeat business means that reputational concerns will impose a discipline for transparency and truthful market practice;
- This can be reinforced by the buyers of securities being able to litigate if they feel cheated;
- Alternatively, regulators can impose disclosure and other conduct provisions on market participants; or
- Governments could nationalise security issuance.

Note that there is an important overlap between the second and third approaches involving the private enforcement of public rules (i.e. through litigation or the threat of litigation rather than a regulator enforcing the rules). Also, there will be a gradation of public rules with some being mandatory, others not. For example, for issues where compulsion is not called for, regulation (or guidance) may be used to set aspirational standards. This can enable a plurality, and a degree of contestability, of approach. Innovation is not choked off.

The choice of approach for a particular concern will depend upon a trade-off between the extent to which 'market failure' and 'regulatory failure' apply in the circumstances at hand, and the costs associated with each. Each of the four options has advantages and disadvantages and the degree to which public intervention is appropriate will vary.

In developed market economies, the presumption is typically to rely as much as possible on establishing market conditions that are conducive to achieving desired outcomes and avoiding more interventionist regulations and supervision. This presumption reflects a strong belief that the success of market economies depends upon their ability to innovate and respond flexibly to change. Economic efficiency is thereby boosted and the market is best able to provide choice to consumers.

While this presumption in favour of light-handed regulation is widely held among policy-makers and many observers, it does not always carry the day. The rebukes that politicians or regulators face when a problem emerges typically greatly outweigh any plaudits they may receive for adopting a restrained approach to regulation. As UK Prime Minister Blair stated:[10]

> *A civil servant or regulator who fails to regulate a risk that materialises will be castigated. How many are rewarded when they refuse to regulate and take the risk?*

10 See Blair (2005).

The benefits from a sensible approach to regulation are diffuse but substantial while the costs of an unregulated risk materialising are concentrated and highly visible and, even though the actual costs may be limited, can lead to a vocal reaction. This situation is not unique. Similar considerations apply to most of the major microeconomic reforms of the past. For example, tariff reform affected particular groups in society quite acutely but the net benefits were significant.

Just as in the tariff debate, it is important in developing an appropriate approach to regulation to be able to quantitatively assess the merits of alternative strategies. At this point, the empirical basis for making these judgements is not strong and, accordingly, Section 5 discusses how the knowledge base for specific regulations may be strengthened.

However, it is of interest that there is a growing body of empirical evidence internationally that supports the presumption of light-handed regulation for, at least, the financial sector. Consider first the prudential regulation of banking. There has been an extensive literature on the causes and resolution of banking crises without, until recently, a consistent and comprehensive empirical base for this literature. However, this research has been assisted appreciably in recent years by the development of a large database at the World Bank on the nature of regulations and supervision in 107 economies around the globe.[11] While the results from the analysis of this database are still tentative, some useful evidence appears to be emerging and might be summarised in the following conclusion:[12]

> *The results … raise a cautionary flag regarding government policies that rely excessively on direct government supervision and regulation of bank activities. The findings instead suggest that policies that rely on guidelines that (1) force accurate information disclosure, (2) empower private-sector corporate control of banks, and (3) foster incentives for private agents to exert corporate control work best to promote bank development, performance and stability.*

Similar conclusions are emerging for the regulation of securities markets. In particular, La Porta *et al* (2004) in examining the operation of stock markets in 49 countries concluded that:[13]

11 Barth *et al* (2001).

12 Barth *et al* (2003).

13 La Porta *et al* (2004).

> *First, the answer to the question of whether securities laws 'matter' is a definite yes. Financial markets do not prosper when left to market forces alone. Second, our findings suggest that securities laws matter because they facilitate private contracting rather than provide for public regulatory enforcement. Specifically, we find that several aspects of public enforcement, such as having an independent and/or focused regulator or criminal sanctions, do not matter, and others matter only in some regressions. In contrast, both extensive disclosure requirements and standards of liability facilitating investor recovery of losses are associated with larger stock markets.*

This literature which is exploring regulatory and legal practice across countries is still in its infancy, but it does lend strong support to the presumption against excessive reliance on intervention and in favour of light-handed regulation. It is of some concern, then that the regulation of the financial sector has become more interventionist in recent years. Before reviewing these trends in Section 3, it is useful to review some of the main messages from the Wallis Inquiry.

2.2. WALLIS INQUIRY

The Wallis Inquiry identified three basic (and sometimes overlapping) reasons for regulating the financial sector:

- Regulation designed to promote competitive and efficient markets;
- Regulation involving the prescription of standards or quality of service, in this case related primarily to the promotion of financial safety; and
- Regulation for other social purposes.

Each of these types of regulations will be discussed in greater detail in the subsections that follow.

2.2.1. Regulation to Promote Competitive and Efficient Markets

Regulation to promote competitive and efficient markets, referred to in the Wallis Report as **'general market regulation'**, is found in all sectors of the economy. This category encompasses regulation to prevent fraud and deter anti-competitive behaviour such as collusion or monopolisation (**conduct regulation**) and regulation to promote adequate disclosure (**disclosure regulation)**. Three main areas of general market regulation were examined:

- Financial market integrity;
- Consumer protection; and
- Competition regulation.

The Wallis Report concluded that as a general principle, greater regulatory consistency and efficiency will result from economy-wide regulation and that, consequently, this should always be preferred unless a clear case for sector-specific arrangements can be demonstrated. In this context, Wallis noted that competition objectives are not unique to financial markets. The case for specialised arrangements in this area is therefore relatively weak.

In contrast, Wallis argued that there was a case for specific regulation related to both financial market integrity and consumer protection. In the case of market integrity, sound, orderly and transparent markets are essential if they are to operate efficiently:[14]

> *Financial market prices can be sensitive to information, and this raises the potential for misuse of information. For this reason, regulators around the world impose specific disclosure requirements (such as prospectus rules) and conduct rules (such as prohibitions on insider trading) on financial market participants. The complexity of financial products and markets, their intrinsic risks – including those due to limited information – and the detailed knowledge required to deliver efficient regulation in this area argue strongly for continued specialised regulatory arrangements.*

Similarly, Wallis maintained that there were two grounds that justified specialist consumer protection regulation for financial services:[15]

> *First, the complexity of financial products increases the probability that financially unsophisticated consumers can misunderstand or be misled about the nature of financial promises, particularly their obligations and risks. This, combined with the potential consequences of dishonour, has led most countries to establish a disclosure regime for financial products that is considerably more intense than disclosure rules for most non-financial products.*
>
> *Secondly, financial complexity also increases the incidence of misunderstanding and dispute. Given this, and the high cost of litigation, a number of countries have imposed specific regulation of financial sales and advice and established low-cost industry complaints schemes or tribunals for resolving disputes.*

What is important to note about general market regulation and will be relevant to evaluation of the principles of design for frameworks designed to attain their objectives is that they are not directed at prescribing a particular market **result**. Rather, they are directed at improving competitive and information transmission **processes** within the markets in question. The regulatory framework, then, should aim to harness the feedback mechanisms of market discipline as far as possible in principles-based or 'light handed regulation'.

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14 FSI, p188.

15 FSI, p189.

2.2.2. Regulating for Financial Safety

Wallis recognises the need for more intensive regulation to promote financial safety. Even here, Wallis stresses the desirability of managing risk, not eliminating risk:[16]

> *While in some other industries safety regulation aims to eliminate risk almost entirely (for example, to eliminate health risks in food preparation), this is not an appropriate aim for most areas of the financial system. One of the vital economic functions of the financial system is to manage, allocate and price risk.*

The motivation behind regulation for financial safety reflects two sets of characteristics of financial markets:

- The consequences of financial contracts not being honoured can be particularly severe by creating systemic risk external to the parties to that contract – hence the need for prudential regulation.

- The problem of information asymmetry facing most consumers can be so severe that they cannot reliably assess risk regardless of how much disclosure is mandated – thus, as a complement to disclosure regulation, licensing requirements such as stipulating that only 'fit and proper' persons can act as financial advisors are used.

A prevailing theme throughout Wallis is that the choice of regulatory arrangements for a particular concern should be graduated according to the risks and costs involved. This is reflected in the Report's consideration of financial safety:[17]

> *… the Inquiry considers that the intensity of financial safety regulation should be proportional to the intensity of financial promises.*

Wallis judged that the most "intense" financial promises involved payments services. This, in fact, is reflected in the regulation directed at ensuring the integrity of the payments system where the role of government includes its monopoly in the provision of cash and a very direct involvement in the running of other parts of the payments system.

In regard to prudential regulation, Wallis emphasised the trade-off between efficiency (because of the inherent problems of moral hazard and adverse selection) and financial stability. It recommended that a new prudential regulator be established which it labelled the Australian Prudential Regulation Commission (APRC):[18]

16 FSI, pp189-190.

17 FSI, p192.

18 FSI, p321.

> ***Recommendation 34: The intensity of prudential regulation needs to balance financial safety and efficiency.***
>
> *The APRC's charter should emphasise the need to approach prudential regulation in a way that balances the objective of promoting financial safety with the need to minimise the adverse effects on efficiency, competition, innovation and competitive neutrality. This balance should preserve a spectrum of market risk and return choices for retail investors, meeting their differing needs and preferences.*

Again, the intensity with which prudential regulation should be applied would vary with the nature of the financial promises involved. Wallis recommended that authorised deposit-taking institutions (ADIs) be regulated most intensively.

Furthermore, Wallis recognised the limitations of prudential supervision:[19]

> *… regulation cannot and should not ensure that all financial promises are kept … Primary responsibility should remain with those who make financial promises.*

Indeed, consistent with the principles set down by the Bank for International Settlements, Wallis argued that effective prudential regulation would involve elements of market discipline, corporate governance and regulatory supervision. The extent of supervision is limited by both the practicalities involved in monitoring numerous and varied institutions and, more fundamentally, the desirability of finding an appropriate balance to foster the efficiency of the financial system. (This judgement is supported by the international evidence on regulatory practice discussed briefly above.)

Finally, the notion that the intensity of regulation should vary applied equally in areas of consumer and investor protection. For example, Wallis argued this case in terms of investment products:[20]

> *Regulation should seek to ensure that, while risk remains, those making promises ensure that risks are appropriately managed in accordance with the reasonable expectations of their promises. This may involve varying degrees of regulatory intensity – greater regulatory intensity is appropriate for a life company annuity product involving both investment and mortality risks than for a market-linked investment.*

2.2.3. Regulation for Social Purposes

The third rationale for regulation outlined by Wallis is the desire to achieve other primarily non-economic social objectives. Wallis recommended that, generally, social objectives are better achieved by tax and transfer policies than by regulations (although this may not always be deemed to be practical).

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19 FSI, p192.

20 FSI, p193.

To an extent, social objectives in the financial sector have been addressed through some combination of self-regulation and industry codes. Government has exerted moral suasion with the implicit threat of direct intervention. This is the case, for example, with the provision of financial services for disadvantaged groups or regional centres.

The one area where social (or non-economic) objectives have been prominent in recent years has been with efforts to constrain **money laundering** and finance for terrorist activities. While Wallis did not address this issue directly, the principle balancing intervention with the costs and risks involved will also apply here. Indeed, just as in other areas of law enforcement, the objective is to develop cost effective means of minimising illegal practice rather than adopt onerous zero tolerance obligations on market participants.

2.2.4. Implications

The above discussion implies that regulations are likely to be more intensive and extensive in the financial sector than elsewhere in the economy. However, there is still a strong presumption in favour of a light-handed approach to the design and implementation of regulations.

To guide consideration of the development of particular regulations, Wallis set out five basic principles that should be followed:

- **Competitive neutrality** – a principle that has become especially relevant in the context of convergence of financial products and institutions. It implies that there should be:[21]

  > *… minimal barriers to entry and exit from markets and products, no undue restrictions on institutions or the products they offer and that markets should be open to the widest possible range of participants.*

- **Cost effectiveness** – while Wallis couched this principle in terms of cost effectiveness, it could be expressed in broader terms of economic efficiency. Wallis contended that among the implications of the principle are two beliefs that are central to the consideration of financial sector regulation in Australia:[22]

  > *… a presumption in favour of minimal regulation unless a higher level of intervention is justified.*
  >
  > *The allocation of functions among regulatory bodies should ideally also minimise overlaps, duplication and conflicts.*

21 FSI, p197.

22 FSI, p197.

- **Transparency** – so that all providers of financial services and all their customers are fully aware of their rights and responsibilities.

- **Flexibility** – given the fluidity of the financial sector, the regulatory framework needs to be able to accommodate – and indeed foster – change while maintaining the integrity of the regulations and the financial system.

- **Accountability** – regulatory agencies need to be both independent and skilled. Also, Wallis argued that:[23]

  > *… the regulatory structure must be accountable to its stakeholders and subject to regular reviews of its efficiency and effectiveness.*

These principles inform the recommendations developed below in Section 5.

2.3. LIGHT-HANDED REGULATION

As noted above, Wallis emphasised the desirability of matching the approach to regulation with the "intensity" of the need. This suggests that, in areas where the consequences of failure are not severe, what might be termed "light-handed" regulation should be used. To be more precise, regulation can be viewed as light-handed where:

- The policy is circumspect as to the range of services and activities where explicit regulations are needed. As far as possible, reliance will be placed on market discipline;

- Where regulation is introduced, reliance is place on principles-based regulation rather than rules-based regulation; and

- In this regard, alternative compliance models are promoted to meet stated principles.

Light-handed regulation is not without its difficulties, especially in that it can increase uncertainty for regulated entities. This uncertainty can lead to overly legalistic responses to new regulations as regulated entities try to account for all possible eventualities (a case of "liability anxiety"). As discussed in Section 4, this appears to have been a significant factor with the introduction of the FSRA. Possible mechanisms to alleviate the impact of this uncertainty include:

- Developing a set of rules that regulated entities can chose to adopt instead of developing their own response to the overarching principles. (The approach used for capital requirements under Basel II is an example of this); or

- The regulator providing detailed guidance on what actions would be expected in order for the regulated body to meet the principles.

23 FSI, p198.

3. THE GROWTH IN THE REGULATORY BURDEN

The Business Council of Australia (BCA) has summarised the inexorably increasing regulatory burden facing business throughout the economy.[24] As the BCA argues, while the specific policy objectives of the various regulations are typically understandable and indeed, laudable, the regulations are often poorly designed and their cumulative impact has become a significant inhibitor of an efficient economy. The issue is not one of being pro or anti regulation but rather one of balance and how to best design and implement regulations to efficiently meet legitimate policy objectives.

While the regulation of many aspects of the economy reflects largely domestic priorities, international pressures have heavily influenced regulation in the financial sector. Given its central place in modern economies and societies, the financial sector is among the most heavily regulated areas of all developed economies. Its central role means that both the costs of poor regulation and the benefits of sensible regulation are amplified.

The section briefly reviews some of the main international trends affecting financial sector regulation followed by a discussion of what is implied for the domestic agenda.

3.1. INTERNATIONAL ASPECTS

A range of forces have combined to test the regulatory systems in domestic and global financial markets over the past decade:

- Financial sector liberalisation in many developed economies has seen a reduction in the direct participation of government or its agencies in the operation of the financial system and an increased reliance on the private sector to meet policy objectives;
- The rapid development of new information technologies has facilitated the global integration of financial markets;
- The resultant international competition has spawned new products and new forms of institutions as financial companies endeavoured to focus on their areas of relative strength – convergence in products and institutions has seen a blurring of the characteristics of different financial services provided by different players;
- Prices in asset markets have surged in many markets (perhaps triggered by financial market liberalisation and the new technologies which have created new areas of economic activity and profit);
- This has occurred against the backdrop of often poor governance standards and disclosure laws which has been revealed in corporate failures such as Enron and WorldCom; and

24 Business Council of Australia (2005).

- In addition, the pace of change has severely tested the financial systems in a number of emerging markets resulting in a number of 'crises'.

Some of the responses to these developments have been oppressive. For example, the Sarbanes-Oxley Act (SOX) in the United States – with its global reach – was excessive and is adding to the regulatory burden throughout the world. This concern has been increasingly recognised by leaders around the world. For example, Prime Minister Blair was happy to put diplomacy to one side when he said:[25]

> *In 2002, the Sarbanes-Oxley Act was, in the words of The Economist, "designed in a panic and rushed through in a blinding fervour of moral indignation."*

Within the United States, the Sarbanes-Oxley legislation is viewed as of considerable economic significance, comparable with the Securities Acts of 1933 and 1934.[26] Yet, it was introduced with limited consideration of its overall impact and detailed design. It was criticised by most observers at the time for being both costly and likely to have limited effectiveness.[27] As it was being implemented, various surveys confirmed the substantial compliance costs involved.[28] In addition, as General Motors' chief accounting officer stated:[29]

> *The real cost isn't the incremental dollars, it is having people that should be focused on the business focused instead on complying with the detail of the rules.*

Furthermore, the academic evidence confirms that at least the private benefits of SOX do not match the costs. For example, Zhang (2005) looking at both the impact on stock prices and cross-sectional data finds that investors judged that the changes had a significantly negative net impact on values. This does not address potential social benefits, but given the questions as to the effectiveness of the particular legislation on the incidence of corporate fraud, the weight of evidence is compelling.

The challenges involved in developing a sensible regulatory framework should not be understated, but there is a clear imperative to re-examine the frameworks that are currently employed and the principles on which they are based. Prime Minister Blair in arguing the case for a rebalancing in the approach to regulation earlier this year advocated:[30]

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25 Blair (2005).

26 See the discussion in Zhang (2005).

27 See, for example, Ribstein (2002).

28 See discussion in Zhang (2005).

29 As reported in Zhang (2005).

30 Blair (2005).

> *… a serious debate about risk in public policy making. In my view, we are in danger of having a wholly disproportionate attitude to the risks we should expect to run as a normal part of life. This is putting pressure on policy-making, not just in Government but also in regulatory bodies … to act to eliminate risk in a way that is out of all proportion to the potential damage. The result is a plethora of rules, guidelines, and responses to 'scandals' of one nature or another that ends up having utterly perverse consequences.*

And

> *We cannot guarantee a risk free life.*

Blair went on to highlight the potential costs to the UK and European economies of poorly designed regulation including the damage it can inflict on an economy's competitiveness. He committed to making better regulation a central theme of the UK's term as President of the EU.

While Sarbanes-Oxley has been an overreaction to the pressures that have emerged, the approach adopted elsewhere has frequently been more measured. In particular, the work that has been carried out under the auspices of both the International Association of Insurance Supervisors (IAIS) and the Bank for International Settlements (BIS) has typically been aimed at establishing a consistent set of principles for different aspects of financial sector regulation. Legislators and regulators then have some flexibility as to how the basic principles can be best applied to their particular circumstances.

In addition, the approach pursued under Basel II for capital standards for banks provides scope for the regulated entities to determine how they can tailor their operations to meet the overarching standards as long as they can demonstrate the appropriateness of their systems and methods. Of course, not all banks may have the expertise and resources to develop their own regulatory systems. Accordingly, Basel II also allows them to choose to adopt a common set of prudential standards based on, *inter alia*, risk weights for different assets determined by the regulator.

Similarly flexible approaches to regulation could be applied in other areas of financial sector regulation as advocated in Section 5.

The other main area where international bodies have influenced financial sector regulation in recent times is anti-money laundering (AML) and counter-terrorist financing (CTF). The Financial Action Task Force (FATF) consists of 33 member countries. It was originally established to concentrate on anti-money laundering. There has been a greater urgency attached to these efforts over the past few years as governments act to find new means of combating terrorism. The danger has been that the focus on terrorism shifts what was a risk minimisation philosophy into a risk elimination one no matter what the costs involved. This is taken up in Section 4.

3.2. THE NEXT MICROECONOMIC REFORM AGENDA

The growing recognition of the desirability of developing a sensible balance in financial sector regulation is a welcome change following the initial excited response to the corporate failures of the late 1990s. Australia should try to take advantage of these changed attitudes and foster best practice regulation internationally.

But the starting point is to do so at home. Indeed, Australia has been an early and active advocate of many microeconomic reform agendas. The development of well-crafted regulation could form a centrepiece of the next wave of reform. The economic benefits of doing this well do appear to be of a scale to rival those derived from previous reforms.

In fact, well designed regulation has become more imperative over the past two decades as greater responsibility is imparted on individuals and the private sector for the delivery of public services and policy objectives. For example, individuals have been obliged to assume greater responsibility for their circumstances in areas such as providing for their retirement incomes or health. At the same time, through privatisations and other strategies, more services that were traditionally viewed as the responsibility of government are being delivered by the private sector.

These shifts, however, do not mean that the underlying policy objectives have become redundant. Rather, there is simply a different means of delivery supported, where necessary, by regulation.

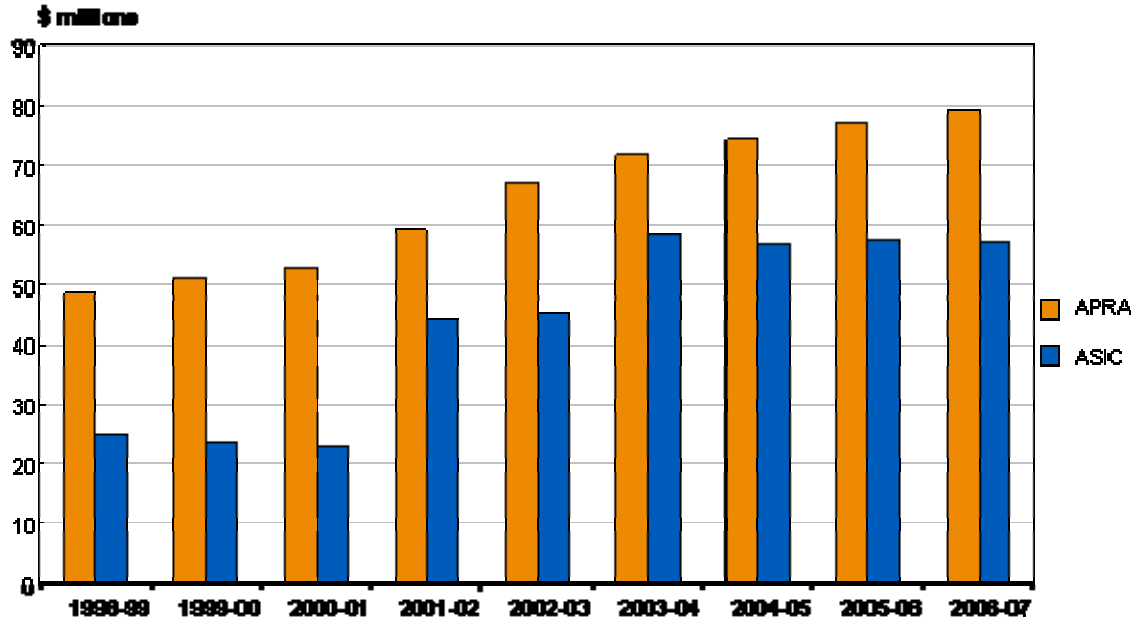
4. LESSONS FROM RECENT REGULATORY CHANGES IN AUSTRALIA

There is a strong perception within financial institutions and many observers that the regulation of the financial sector has been very onerous in recent years, and unnecessarily so. The view is that the underlying policy objectives could be met at lower cost and while allowing greater choice and flexibility in the financial services provided to customers.

It is difficult to categorically confirm such perceptions given the paucity of consistent data on the costs and benefits of regulation and, indeed, the inherent complexity of compiling them. The costs of regulation relate not only to the direct use of resources for compliance and administration but also, and perhaps more significantly, the costs of, in effect, restraining the choice of products and processes and inhibiting innovation. On the other hand, too little or ineffective regulation can lead to a loss in credibility and a heightened risk of policy objectives not being met.

Nevertheless, what evidence is available tends to support the perception of increasingly onerous regulation. From a narrow perspective this can be seen in the growing budgets of the regulators – Appendix A shows that the administrative costs for APRA and ASIC combined have risen by around 80 per cent over the past five years. Note that the increased budgets is not only a direct cost through the fees imposed on industry but, in practice, it has tended to lead to a significant expansion in 'initiatives' with unremitting requirements on financial institutions to provide supporting information and analysis.

Figure 1: Administrative costs of financial regulation



More broadly, as part of the current review, a selection of FICA members were asked to respond to a questionnaire of their experience. The questionnaire was directed at gathering existing information and views.[31] A detailed discussion of the results is provided in Appendix B, but some of the main findings were:

- Direct compliance costs have risen significantly over the past five years, often more than doubling;
- The expected costs of complying with two of the major changes – FSRA and AML/CTF[32] – were originally estimated to run into the hundreds of millions of dollars. The revisions to these regulations currently being developed will lower these costs, but they will still be very large;
- Compliance is accounting for between 5 and 20 per cent of senior management time and 25 per cent of board time;
- The range of financial services has been restricted by some of the regulations, notably under FSRA, while investment in new products has been inhibited; and
- While some institutions commented on the improvement in awareness of compliance matters among staff, the dominant impact on culture was negative. There was a particular concern that customers had become frustrated by the adding complications to service delivery.

In light of this evidence, the following examines four areas of regulation where significant change has occurred. These are the establishment of APRA as the principal prudential regulator across the financial sector; the introduction of the Financial Services Reform Act; the measures aimed at addressing AML/CTF; and the actions of the Payments Systems Board especially in the area of card networks.

4.1. APRA – A CHALLENGING START

APRA was established on 1 July 1998 in line with recommendations in the Wallis Inquiry. Convergence of financial services across the financial sector meant that greater consistency in, notably, prudential regulation would be desirable and APRA, after a short period, incorporated eleven Commonwealth and State regulators.

31 It was considered impractical and too resource intensive at this point to undertake a more substantive survey aimed at deriving estimates of the various costs of regulations on a fully consistent basis.

32 The impact of AML/CTF did not feature in the questionnaire since many institutions were still to come to terms with its possible impact.

Wallis had in mind a regulator that would develop a light-handed, outcomes-based approach to regulation. Given the range of institutions to be regulated, and the evolution occurring in the financial sector, it would not be sensible for APRA to rely on as close an understanding of each regulated entity as the Reserve Bank had traditionally done in its supervision of banks. Instead, prudential regulation would be based on a combination of:

- Market disciplines (supported by suitable disclosure requirements);
- Effective corporate governance delivered through clear (high-level) obligations placed on senior management and boards; and
- Light-handed supervision by APRA (although the extent of supervision could vary on a case-by-case basis).

There was an expectation that APRA's staff would include a significant proportion with experience in public policy and economics (including those formally employed by the RBA). The intention was that APRA not adopt an overly legalistic or prescriptive approach to its task.

APRA was still finding its feet when HIH failed. As the HIH Royal Commission found, the HIH failure highlighted two main issues with APRA's role:

- The lack of people with suitable experience and skills; and
- Questions over whether the *Insurance Act 1973* provided a suitable basis for APRA to perform its task, especially if early intervention were required.

The Royal Commission made a series of recommendations, the overall effect of which would be to strengthen APRA's monitoring and investigative capabilities and to encourage it to adopt a more intrusive approach to regulation. For example, Recommendation 26 proposed:[33]

> *APRA develop a more sceptical, questioning, and where necessary, aggressive approach to its prudential supervision of general insurers. Consultation, inquiry and constructive dialogue should be balanced by firmness in its requirements and a preparedness to enforce compliance with applicable standards. In particular, APRA should take a firm approach to ensuring regulated entities' timely compliance in the lodging of returns and provision of information.*

This recommendation is quite reasonable, especially as it pertained to the circumstance surrounding HIH. A lot, however, rests on how "where necessary" is interpreted and in the event APRA, at least until recently, did begin imposing more onerous regulatory requirements throughout.

33 See Costello (2003).

The Government accepted the thrust of the Royal Commission's recommendations. New governance arrangements were established for APRA, legislation was modified and APRA instituted significant organisational changes. APRA was in effect being told to develop a much more intimate understanding of the entities it was responsible for regulating. In turn, APRA has introduced significant modifications to its approach to implementing regulations.

Although APRA's changed approach was directly influenced by the Royal Commission's findings and the view adopted by Government, it also reflected widespread community expectations. As ex RBA Deputy Governor Phillips said at the time: [34]

> *The financial system is not well regarded by the general community. It is widely seen as rapacious and not particularly ethical. Its previous image of dependability has been damaged by a series of incidents over the past twenty years. To a substantial extent, the community has associated these with greed and insufficient regulation.*
>
> *In the circumstances, there has developed a strong push for more government intervention and less reliance on self-regulation. Governments need to respond to these pressures with caution. There is a limit to the curative properties of Government action.*

Not only does the community expect financial institutions to maintain high standards, the institutions themselves benefit from the credibility engendered by a sound regulatory system. The challenge is to find a cost effective manner to deliver an appropriate level of regulation.

There is no doubt that APRA has made considerable progress over the past few years. It has developed an approach to supervision that is:[35]

- Forward-looking;
- Primarily risk-based;
- Consultative; and
- Consistent and in line with international best practice.

Integral to its approach has been the development and use of its risk-based framework set out in its Probability and Impact Rating System (PAIRS) and Supervisory Oversight and Response System (SOARS). The regulatory framework that APRA has instituted and its stated approach to supervision is consistent with many of the principles advocated in this report.

34 Phillips (2002).

35 Somogyi (2005).

Introduced in October 2002, the PAIRS and SOARS systems combine to form a matrix which effectively embodies APRA's institutional mandate. The matrix describes the supervisory actions the regulator will undertake according to the PAIRS probability assigned and the impact rating.

The SOARS system explicitly recognises the possibility for a differentiated approach to supervision. For example, the 'oversight' regulatory response represents a greater level of APRA intrusion, but at the same time does not necessarily involve seeking 'remedy' toward ratings that would attract the lower APRA response of 'normal'. The approach recognises that some regulated entities may elect to accept more intrusive supervision in return for greater shareholder returns and underscores an appropriate balance in supervisory practices that are differentiated according to the entities regulated.

Despite these principles and framework, a strong perception by market participants and many independent observers has emerged that APRA has become very interventionist in how it relates to regulated entities on a regular basis. For example, this has been evident in APRA's initial proposals for the 'Stage 2 Reforms' for the prudential supervision of general insurance.[36] At this point APRA is considering responses to its proposals and the regulations have not been finalised. However, the proposals themselves illustrate some of the concerns about the prescriptiveness of APRA's recent actions. For example:[37]

- The detail and complexity of the proposed regulations is illustrated by the fact that they contain 583 paragraphs in six Prudential Standards and twelve Guidance Notes;

- The Guidance Notes make frequent use of terms such as "should" and "must" and, depending on legal advice, could require compliance under the law rather than acting purely as guidance to help the entities themselves determine how they can best meet the Prudential Standards;[38]

- APRA is placing considerable burdens on boards which risk their activities being dominated by compliance in matters of detail at the expense of their important roles in setting the overall directions in strategy and compliance; and

36 The Stage 2 reforms are intended to build on earlier changes to strengthen the regulation and supervision of general insurance, notably those introduced from June 2002 that included, *inter alia*, increased capital requirements and suitable risk management strategies and processes.

37 These examples are taken from Insurance Council of Australia (2005).

38 APRA has the power to create regulations that have the force of law and thus, where this applies, it is important that there be effective scrutiny.

- Also, APRA continues to argue that it needs to set explicit, mandatory standards on corporate governance in addition to those already in place for the broader economy. As outlined in Section 5, it would be desirable if a more flexible means of strengthening governance standards could be employed.

The current deliberations on the Stage 2 reforms for general insurance may see some of the more onerous aspects of the proposals pared back. In fact, the informal signals emerging from the discussions between APRA and the industry indicate that the more acute problems with the original drafts will be ameliorated. However, even if substantial modifications were to be enacted, this experience does illustrate how APRA's disposition to its mission has been quite interventionist.

4.2. THE FINANCIAL SERVICES REFORM ACT

The Financial Services Reform Act (2001), FSRA, sought to address the concern expressed by Wallis that inadequate disclosure was preventing consumers from making well-informed and efficient choices regarding financial services. Its key elements were to standardise information disclosure rules across financial products and services and to establish a single licensing regime of minimum standards for financial service providers. As such, the Act represented an ambitious attempt to introduce a comprehensive, "one-size-fits-all", system across the financial sector.

The introduction of the regulations was fraught from almost the outset. While Wallis had recommended the establishment of a consistent set of market rules to apply across different financial services, the Inquiry had also emphasised the desirability of moderating the intrusiveness of regulations to match the 'intensity' of the regulatory need. A fundamental difficulty with FSRA in its original form was that the one-size-fits-all model meant that many areas which were previously very light-handed or, indeed, had no explicit regulation were caught in what is an inflexible regime.

Furthermore, partly driven by a desire to inject precision and comprehensiveness into the regulations, the high-level policy principles were translated into costly and cumbersome draft legislation and, in turn, operational regulations and procedures. It appeared that the legislative drafters, the regulators and the compliance officers in regulated entities all had difficulty injecting the spirit of the law into practice.

In part, this reflected the difficulty in developing the experience and skills needed in both regulators – in this case, ASIC – and regulated entities to understand the complexities of the financial institutions and the services being provided, and appreciate how the proposed regulations would impact these. Such 'people issues' underline the desirability of not adopting overly ambitious timetables for change.

Numerous submissions have set out the nature of the difficulties that the original FSRA draft raised. For example:

- Onerous requirements as to what constitutes advice, and the licensing conditions on those who can provide advice, have meant that information provided to customers on, say, a minor general insurance where the "intensity" is low is significantly curtailed. While such requirements might be appropriate where the consequences of failure are severe – for example, where individuals' life savings are at stake – they have added unnecessary costs across the board and risk having the perverse effect of a poorer flow of information to customers;

- The distinction between retail and wholesale clients was poorly defined, relying largely on a characterisation of a sophisticated investor based on their wealth or the size of the transaction. The reach of the definition of retail clients was such that the original draft risked serious consequences for the efficient operation of wholesale markets.

The total implementation costs were likely to amount to many hundreds of millions of dollars. For example, the ABA estimated that its members alone would face implementation costs "conservatively" estimated at $200 million. The annual addition to compliance bills was likely to have been in the tens of millions of dollars.

In addition, as noted in the example above, it was often questionable whether the ultimate objectives related to better informed customers would be achieved. The licensing and disclosure requirements were cumbersome and complex, with the likely consequence being that compliance would become an exercise of ticking boxes. The material conveyed to customers risked being voluminous and complex and of no value.

In the event, these difficulties were recognised and the Government, through FSAC, embarked on an extensive consultation process to refine the legislation. The worst of the problems are likely to have been ameliorated when the revised legislation is announced in November.

However, given the nature of the FSAC deliberations, it appears that the changes will not address the fundamental difficulty with FSRA namely, this is one area of regulation where light-handed models of regulation should come to the fore including allowing regulated entities greater ability to determine how they address the ultimate policy objectives. This could include the use of alternative compliance models. This is discussed in Section 5.

4.2.1. The Inherent Tensions in ASIC's Dual Mission

ASIC has two main responsibilities:

- The enforcement of corporate law; and

- As Wallis recommended, being the main conduct and disclosure regulator for the financial sector.

Ideally, as indicated above in relation to FSRA, a principles-based approach should be adopted to conduct and disclosure regulation. In contrast, ASIC's enforcement role requires primarily rules-based regulation. The challenge for ASIC, then is to be able to develop a working culture that facilitates this inherent tension between different aspects of its mandate. Section 5 recommends that ASIC can be assisted in this endeavour by (i) clarity in what is expected of ASIC; and (ii) supportive accountability arrangements that understand how the mandate is being addressed at a quite detailed level.

In addition, the breadth of ASIC's activities and, especially, of the activities of the entities that are subject to ASIC oversight underlines the importance of developing regulatory frameworks that are inherently non-intensive. Outcomes-based regulation that makes use of, *inter alia*, alternative compliance models will tend to operate alongside more realistic staffing aspirations for the organisation.

4.3. ANTI-MONEY LAUNDERING (AML) AND COUNTER-TERRORIST FINANCING (CTF)

The Financial Action Task Force (FATF) was initiated in the early 1990s. It now consists of 33 member countries. Its *modus operandi* relies on developing agreements with recommended actions, review of performance and moral suasion. Point (i)(c) of its mandate to which members have agreed states:[39]

> *Ensure that FATF members have implemented the revised Forty and the Eight Recommendations in their entirety and in an effective manner.*

The basic objective has been to develop an international commitment to this area of law enforcement, and to do so in a cost effective manner. While its original aims related to anti-money laundering, the heightened focus on finance for terrorism has given the agenda a greater urgency with increasingly interventionist action being encouraged.

In this context, FATF reviewed its recommendations to governments and issued its revised 40 Recommendations on Anti-money Laundering and 9 Special Recommendations on Combating Terrorist Financing in late 2003. The Attorney-General's Department worked with FATF in developing the revised recommendations, with some limited input from the finance sector, and has the lead role in developing new AML law to update the Financial Transaction Reports Act to comply with the FATF requirements. Australia was selected as one of the first countries to be scrutinised on its actions to implement the revised recommendations. Quite reasonably, then, there was a desire to be seen to delivering on the recommendations.

39 See http://www.fatf-gafi.org/pages/0,2966,en_32250379_32236836_1_1_1_1_1,00.html.

However, the process of developing revised laws and regulations on AML/CTF has been fraught. In particular, the early stages of consultation with affected entities that would be subject to the new regulations were not effective. While the consultative *structure* established by the government was appropriate, the consultative *process* was flawed. There was a tendency in the initial consultations for AG's to ask for financial sector views on AML/CTF issues but not to share with the financial sector the government's policy proposals. The outcome of this approach was that draft legislation was presented to Cabinet without the financial sector being given an opportunity to comment on the draft or even to know what it contained.

When AG's Issues Paper for the financial services sector was released in January 2004, the extent and likely costs of the proposed scheme progressively became evident. For example:

- There were impractical proposals that would have imposed huge costs on the finance sector and public inconvenience for little off-setting policy benefit, for example verification of the identity of the entire customer base;

- Regulated entities would be required to closely monitor 'politically exposed persons' (PEPs) and it would be up to the entity itself to identify such PEPs despite their having no practical means to do so.

While it is difficult to precisely estimate the costs that would have been incurred in implementing the proposed AML/CTF rules without knowing the precise legislation and accompanying rules, it appears that the costs for banks would have been in the hundreds of millions of dollars. For the financial sector and related industries that would be caught in the net, the implementation costs would have been much larger.

In the event, it was recognised that such costs would be out of proportion with the likely benefits. Accordingly, a series of joint Government-industry roundtables – with the Federal Minister as co-chair – worked through each of the relevant FATF recommendations and reached in-principle agreement on Australia's response. Draft legislation is now due in November.

Even with a more sensible approach from Government, there remain many uncertainties about how new AML/CTF requirements will be applied and financial institutions are still contemplating very large implementation costs. This situation has been complicated by the need to rush anti-terrorist financing measures into place which will intersect the AML changes but on a different time frame, creating further implementation and cost issues.

This saga highlights the desirability of government investing resources and time *early* in the process in consultation with industry to ascertain the likely costs involved and to help design an appropriate system.[40] In this regard, there has been substantial improvement in recent years in industry consultation on changes to tax laws. This experience could be replicated for financial sector regulation.

In addition, the original proposals appeared to be developed without a clear assessment of additional compliance and adjustment costs, nor the incremental benefits to be delivered compared with the existing arrangements. While difficult, the magnitude of the costs involved highlight the desirability of a careful analysis beforehand on the likely costs and benefits as well as possible alternative means of achieving the basic objectives (which, in this case, involved detecting and preventing crime).

In particular, there appears to be a case for incremental change, concentrating first on institutions covered by the existing Financial Transactions Reports Act, modifying the regulations as needs be and progressively bringing other areas into the net. Options for technology-friendly means of expanding the reach of the identification systems could be explored. All along, decisions would be based on a careful assessment of the costs and benefits; the latter defined in terms of the ultimate policy objectives rather than a narrow interpretation of the FATF recommendations.[41]

4.4. REGULATING THE PAYMENTS SYSTEM

Wallis recommended that the RBA be responsible for regulating the payments system consistent with its responsibilities for system stability. This recommendation was incorporated into the Payments System (Regulation) Act 1998, the main objectives of which related to the integrity and stability of the payments system. The Act also states that the RBA should seek to ensure that the system is competitive and efficient.

The payments system has been subject to considerable change as new technologies and market strategies have created considerable innovation. Major change has been seen with electronic systems – especially the card networks but more recently internet-based systems – expanding at the expense of paper-based mechanisms. The RBA has expressed concern that the outcomes being produced were not in some senses efficient and decided to use its designation powers under the Act to influence outcomes by:

- Influencing market structure by introducing a new access regime;
- Affecting market conduct through prohibiting the 'no surcharge' rules that the card networks operated and encouraging greater disclosure; and

40 This is not to say that there was no consultation on FSR and AML/CTF, but rather that it tended to be token and ineffective.

41 Indeed, lessons learnt as Australia tries to find cost effective means of meeting the basic objectives could inform the FATF group as other countries confront similar issues.

- Directly intervening in the market to restrict a key charge, namely interchange fees on the basis of selected costs that support part of the card networks.

In most areas of the economy, competition and efficiency are promoted through means such as:

- Measures to improve transparency; or
- Reducing barriers to entry.

Only as a last resort – and only after it is demonstrated that the net benefits (in terms of allocative efficiency and the impact on innovation and market development) of intervention are clear and material – is direct intervention used. Yet the RBA has pursued such a course in the regulation of credit and debit cards even though many commentators and market participants argue that these conditions have not been met. Indeed, at this point, academic research into card networks does not support the RBA's position.[42]

Given the uncertainty surrounding the net benefits of the regulations, a light-handed approach based on disclosure and possibly market structure, and not on direct intervention on prices or costs, would have been preferable. This seems to have been the sentiment expressed by some Members of Parliament when the RBA appeared before the House of Representatives Standing Committee on Economics, Finance and Public Administration in August.

In summary, one of the clearest examples of the derailment of high principle in practice has been the designation power incorporated into the Payments System Act. Such sweeping powers were never envisaged by Wallis and, we understand, policy-makers and their advisers in Canberra did not envisage their routine use. They are an example of reserve powers being used summarily when the intention was that they be used sparingly, if at all.

42 A summary of the current theoretical and empirical understandings of card networks is provided in Harper *et al* (2005).

5. THE WAY FORWARD

The above argues for a rebalancing of the design and implementation of financial sector regulation away from an increasing reliance on quite intrusive supervision and directives to a more outcomes-based regulatory system. No single, simple action will deliver such a result.

The Wallis Inquiry laid out a basic structure and principles by which financial sector regulation could be conducted. While some aspects of the Wallis recommendations may benefit from review, the basic ideas appear to have lasted well. Rather, the problems relate to the translation of policy principles into practice.

Also, as the earlier quotes from Prime Minister Blair emphasise, the fault does not lie solely or even principally with the regulators. They are responding to the all too often one-sided incentives that push in the direction of trying to eliminate failure rather than apply a balanced approach to regulation. What is needed is an environment that is more supportive of balanced, well-designed regulation as well as more direct accountability arrangements for regulators.

A multi-faceted approach is needed, directed at:

- Encouraging the **design** of less prescriptive regulation;
- Ensuring that a **culture** consistent with an emphasis on outcome-based regulation is maintained within each of the financial sector regulators;
- Developing a stronger **information** base of best practice regulation;
- Boosting the **accountability** of regulators;
- Encouraging **regulated entities** to actively explore better ways of meeting the objectives of regulation; and
- Advocating similarly flexible approaches to regulation in **international** forums.

Ideally, the changes will institutionalise better-informed and accountable systems of regulation that will refine themselves automatically over time.

5.1. POLICY DESIGN – REGULATIONS CURRENTLY UNDER REVIEW

It has not been the purpose of this report to identify specific issues that require a change in government policy or specific legislation. Indeed, the continuing development and review that is underway in a number of areas of regulation (for example, anti-money laundering, Basel II, FSRA, APRA's Stage 2 prudential regulations for general insurance) may well lead to some refinements in not only the implementation of regulations but also the basic policy approach. This is to be welcomed and encouraged.

In addressing these issues, it is likely that legislators will face some questions of basic policy. This is certainly the case in the area of AML/CTF where the original draft proposals were overly legalistic and were unable to achieve a suitable balance between the compliance costs imposed and the extent to which the policy objectives could be met.

Also, the 'intensity' associated with the risk of regulatory failure for the set of regulations under review does vary although, in each case, there appears to be considerable scope for the use of a light-handed approach (as defined in Section 3). This would seem to be entirely consistent with the policy approach recommended by Wallis.

In addition, the reviews into a number of these regulations are yet to be finalised because it became evident that the initial draft regulations were poorly designed and likely to be very costly to implement and too frequently did not meet their original objectives. It is thus incumbent on all parties engaged in reviewing the regulations to contribute towards the development of less interventionist models of regulation.

Recommendation 1: Following the policy framework articulated in the Wallis Inquiry, the Government should be encouraged to adopt light-handed models of regulation in the major reviews of regulations currently under way. The implementation of these regulations, as for all regulation, should use the minimum level of market intrusion necessary to give effect to the identified policy objectives. It should be proportionate to the demonstrated market failure and applied efficiently.

5.2. CONSULTATION

The reviews and refinements that have been conducted over recent months emphasise the desirability of effective consultative arrangements with industry. The consultation in the early stages of the development of FSRA and AML/CTF (as discussed above) were ineffective, the result being considerable effort and angst as policy-makers, regulators and the industry struggle to find more cost effective solutions to the basic policy objectives.

The imposition of unrealistic deadlines appears to have contributed to these problems. Also, at times, there was a perception that the positions of either the legislators or regulators had been determined in advance of the "consultation" and these sessions were more in the nature of information dissemination exercises.[43]

There is no doubt that the refinements that are currently nearing finalisation will yield improvements to the previous proposed regulations. In addition, the close involvement of the Parliamentary Secretary to the Treasurer and, in the case of AML/CTF, the Minister for Justice and Customs has contributed positively to this process. However, it is unrealistic to expect such close involvement of senior parliamentarians on all aspects of regulation going forward. Also, as noted in Section 4, despite the refinements, it is far from clear that the resultant regulations will be designed as well as they could be.

43 Such a perception was conveyed to the authors by both public sector and industry representatives.

The lesson from this experience is the desirability of achieving a meaningful dialogue with industry as regulations are being developed. This entails:

- More resources may need to be devoted to the initial design stages of regulations and, if necessary, more time be taken to ensure that the likely impact of any changes is well understood before the laws and/or regulations are finalised;

- A well-designed regulatory system will be tuned to the particular market place and structure of the firms and industry involved. It will always be difficult for legislators and their advisers, or even regulators, to craft such regulations without support. Thus, it is imperative that industry be properly engaged early in these deliberations, and before positions of legislators or regulators become entrenched; and

- There will of course be vested interests represented in any consultative process. Nevertheless, meaningful dialogue occurring over time can see a considerable degree of trust built and the problems associated with vested interests minimised.

Accordingly, effective consultation with those in industry who will be charged with carrying out the regulations should be of considerable value. The development of changes to many tax laws has benefited from improved consultative procedures in recent years and similar arrangements could be established for financial sector regulations. In fact, done well, such consultation will lead to a more ready acceptance of changed regulations by industry.

Recommendation 2: Consultation should be comprehensive focused on ensuring the most cost-effective means to achieve the stated policy intent of any new or substantially modified financial sector regulations be undertaken at all stages of the development of the regulations i.e. when policy is designed, legislation is drafted, and the legislation is translated into specific regulations and procedures applied by the relevant regulator.

5.3. ESTABLISHING A SUITABLE POLICY CONTEXT FOR REGULATORS

Inquiries into business regulation and most of the submissions prepared for such inquiries almost invariably advocate light-handed systems of regulation. Such systems, if feasible, provide the potential for the efficient meeting of policy objectives while allowing the regulated bodies the flexibility to innovate and grow.

The perennial challenge is to translate the goal of light-handed regulation into practice and to do so in a manner that is preserved well beyond the point that the inquiries have been completed and the politicians move onto their next agenda. Two elements that appear to be essential in achieving such an outcome are the accountability of regulators and the culture in which regulation is implemented.

Indeed, perhaps the most important immediate steps to be taken to wind back what have become overly costly and often ineffective regulations relate to changing the culture within the regulators themselves. In turn, the focus of the regulators' engagement with regulated entities may be affected.

5.3.1. Providing a Supportive Environment for Regulators

There is a clear perception that financial sector regulators have become more prescriptive in their actions in recent years. However, this trend has not occurred in a vacuum. Rather, at least in part, it reflects a reaction by politicians and the broader community to the uncertainties flowing from rapid change in the nature of financial services – including policies requiring individuals to assume greater responsibility for their finances and particularly their retirement incomes – and the fall out from corporate failures including that of HIH. Regulators, especially APRA, have been criticised and been asked to take a more hands-on role in ensuring that the financial system is reliable and transparent.

Indeed, it is natural that a regulator in these circumstances would adopt a very risk-averse approach to its mission even if that approach were more costly. The incentives the regulator faces are not symmetric – the criticism and impact on reputation of being implicated in a failure of a financial company would be much more severe than any rewards for keeping costs down and encouraging flexibility and innovation in the delivery of financial products.

In order to change the culture of the regulators, the background environment needs to be supportive. In particular, this requires a combination of:

- Encouragement of public debate on the benefits of "smarter" regulation;
- Clear directives from Government as to what it expects of their regulators;
- The translation of the desire to enact less prescriptive regulatory arrangements as indicated by senior regulators into a changed culture throughout their organisations; and
- Supportive approaches from compliance officers in regulated entities.

Each of these is considered in turn.

First, it is important that the current desire on behalf of government and business to develop 'smarter regulation' be translated into action. This objective can be viewed in the context of calls for continued microeconomic reform. Reform of the regulatory system – especially those aspects that are onerous and constraining – is a perfect candidate to assume centre stage in future microeconomic reform agendas. The potential benefits would seem to be of a scale to rival many of the major reforms enacted over the past two decades.[44]

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44 As far as we are aware, there is no thorough study on the scale of the likely net benefits associated with developing well-crafted regulations. Nevertheless, the fact that compliance costs, which represent one part of the net benefits, can quickly amount to hundreds of millions of dollars (as is the case in financial sector regulation) or even billions of dollars (as in the case of tax) implies that the magnitudes involved are substantial. The indirect costs and benefits that results from the incentives created by regulations are likely to be larger than the direct compliance costs.

In order to foster a 'reform of regulation' agenda, business groups can keep the issue centre stage in their public advocacy.

Recommendation 3: The business community should continue to support a broad debate on the need for further microeconomic reform, with the development of well-designed regulations being an essential element of that agenda.

Secondly, it has been acknowledged by those heavily involved that one of the main reasons why the FSRA as originally introduced had so many problems was the failure to translate intentions into appropriate legislation, together with the fact that this legislation was implemented in a rigid manner.[45] This experience is related to a broader problem that arises when the expectations of legislators are not clearly communicated to the regulators, namely the perennial complaints that regulators tend, over time, to progressively take on the role of determining policy and not just implementing it.

The difficulty in communicating clear expectations is highlighted by the fact that regulators are often given mixed messages. In particular, in recent times, APRA and ASIC have been criticised for not being 'ahead of the game' when problems arose in regulated entities. They have been under pressure to not only strictly enforce penalties against breaches, but also be quite interventionist in their general procedures. Our understanding is that while the Government has urged regulators to make significant improvements, it has not argued for a more interventionist approach to regulation. In fact, the contrary is the case, as illustrated by the Prime Minister's quote at the beginning of this report.

This tension calls for the Government to ensure that its expectations of its regulators, and particular regulations, are clear. It does this at the time that legislation is introduced in the context of 2nd reading speeches to the legislature. However, as evident from recent experience, the conversion of these intentions into regulatory practice is not always smooth and, additionally, practice can drift from the original intent over time.

Recommendation 4: For major pieces of financial sector regulation, the Government should release a statement of policy intent, initially in the form of its 2nd reading speech and thereafter conducting a post implementation review within two years to measure whether the objectives were being achieved in the most cost effective manner.

Finally, it needs to be recognised that much of the delivery of regulations is carried out between middle-level officers in both the regulator and regulated entity. Without clear instruction and/or authority, there can be a tendency for regulations to be implemented according to the letter of the regulation – and the *presumed* letter of the regulation – even in quite diverse circumstances. Again, this appears to have been an issue with the introduction of the FSRA.

45 See Murphy (2005).

5.3.2. Accountability and Monitoring of Regulators

Financial sector regulators are primarily accountable to the Treasurer and Parliament. Significant problems can be identified and addressed through these channels. Additional formal layers of accountability are *not* needed.

However, as argued above, it is not realistic to expect the Treasurer and Parliament, nor their advisers, to closely monitor the performance of regulators. Also, often, pressing political agendas of the time will encroach on such oversight. Thus, supportive monitoring structures are desirable.

A proposal worthy of further consideration is the establishment of a Bureau of Financial Sector Regulation (BFSR). The Bureau's role would be:

- To monitor the application of policy by regulators;
- To develop a deeper understanding of the costs and benefits of financial sector regulations;
- To promote continual improvement in how regulation is designed and implemented;
- To monitor areas of duplication and inconsistency across the regulators (see Recommendation 10).
- To identify issues related to regulating complex entities including the development of appropriate skill sets in regulators;
- To encourage regulators to address particular areas of concern that may arise; and
- To recommend to the Treasurer areas where modification to legislation and/or policy is desirable.

In order to perform these functions, the Bureau would need to progressively build a strong understanding of the sector and an analytical base (see the following sub-section).

It is important to emphasise the limits of the Bureau's role. It would not in any sense be a 'super-regulator'. Also, it would not perform the role of an ombudsman on matters of particular dispute between regulators and specific regulated entities. Rather, it would only be involved in systemic issues relating to the implementation of regulatory policy. Of course, these systemic issues may be of a quite detailed nature and it would be important for the Bureau to be able to consult and explore the costs and benefits associated with particular regulations and practices.

In a sense, this proposition contains elements similar to proposals or arrangements made for other sectors of the economy. Perhaps the closest parallel is with the function played by the Inspector-General of Tax. Both would be tasked explicitly with reviewing only systemic issues that may lead to recommendations involving policy design and regulatory practice.

Also, similar ideas appear to be contained in Uhrig's recommendation in his review of the corporate governance of statutory authorities and office holders that an overseer of regulators be established.[46] The Government at the time rejected this recommendation, arguing that there were alternative oversight mechanisms in place. It has been rightly concerned with the possible proliferation of statutory bodies and layers of regulation.

However, the concerns over accountability of regulators that have surfaced in recent years call into question the effectiveness of existing accountability arrangements in the financial sector without additional support of some form. In a broader context, the BCA has recommended that this be addressed through, *inter alia*, a special Cabinet committee and the establishment of an advisory council focusing explicitly on business regulation. Such arrangements could be useful but would require continued focus and time devoted to the issues by senior Ministers, including the Prime Minister.

It seems preferable to seek solutions where the task of scrutinising the administration of regulation can be devolved to a body with this as its primary responsibility. The information and analysis compiled would then be reported to Cabinet and Parliament as needs be. The devolution of the oversight of regulators to the Bureau directly addresses the difficulties that arise with the 'politics of detail' in what is a very complex area.

In principle, such a bureau could be established for all areas of regulation. However, it is likely that this would become unwieldy and ineffective. Rather, it is recommended that only financial sector regulators be included, and only in specific areas of their responsibility.[47]

Recommendation 5: A Bureau of Financial Sector Regulation should be established to oversee financial sector regulation.

In summary, the Bureau would have three main functions:

- The identification and filtering of issues;
- The development of a deeper understanding of the costs and benefits of financial sector regulations;
- As a public voice for best-practice regulation in the financial sector.

46 See Minchin (2004).

47 In particular, the Bureau of Financial Sector Regulation would not be involved in matters of enforcement.

5.3.3. Improving the Information Base

Institutionalising better regulatory regimes requires both effective oversight and much stronger methodologies for assessing the appropriateness of the system. Being able to provide ballpark estimates of the costs involved in implementation have been influential in decisions to modify the FSRA and the AML/CTF proposals. The development of a more comprehensive and consistent approach to determining regulatory costs would contribute in two important respects:

- The fundamental reform of business regulation as a central element if the next wave of microeconomic reform as outlined in Section 5.3.1;[48] and
- The regular monitoring of how regulations are being implemented during periods when the issue is not centre stage.

To develop a stronger understanding of regulatory impact, support is needed in both business and government. Regulation can affect different businesses quite differently, and responses will also vary. This makes it especially difficult to construct common methodologies that will calculate, say, compliance costs across a range of industries.

It is proposed that the Bureau of Financial Sector Regulation be charged with building a better understanding of the sector and providing an analysis of regulatory costs. An alternative option could be to use a revamped Office of Regulatory Review (ORR) in the Productivity Commission. It is judged, however, that it would be extremely difficult for the ORR to fulfil the mandate envisaged and a new dedicated body is preferable.

In particular, the ORR currently has the role of monitoring the burden of regulation, including as a repository of Regulation Impact Statements (RISs). Indeed, the ORR has, on paper, been tasked with quite an extensive role in regulatory oversight. In practice, however, it has had relatively little influence. This seems to be because:

- It has not been resourced at a level where it could hope to meet its mandate. Thus, it has not rigorously interrogated many of the RISs submitted by agencies nor devoted many resources to fostering improvements to the RISs;
- The RISs themselves are often not treated seriously by those producing them but rather are treated as a necessary evil and involve 'filling in the boxes';
- In fact, for the RIS process to work to best effect, a high-quality debate needs to be encouraged between the interested parties on the objectives, techniques and difficulties inherent in the regulations under review; and
- Perhaps most fundamentally, the ORR is not seen to be a core part of government and has little influence on policy decisions.

48 In particular, the ability to quantify the net benefits of policy changes has often been crucial in achieving widespread support for the changes.

Thus, as matters stand, the regulatory review processes in Australia look fine on paper[49] but not in practice. For example, as the BCA (2005) pointed out, only 20 per cent of RISs attempted to quantify compliance costs.

Some of these limitations could be overcome if the ORR were to be mandated with lifting the standards of oversight of financial sector regulation and be resourced accordingly. This indeed may be an element of the recommendations to emerge from the current Task Force into Business Regulation. However, even if this were to be the case, it is argued here that a body dedicated primarily to financial sector regulation is needed. Having the ORR housed in the Productivity Commission means that it will always have difficulty in attracting people with the honed skills of a regulator and that a new, separate body should be created to monitor and analyse the costs and benefits of financial sector regulations.

In summary, while the Bureau and the ORR would coordinate efforts and learn from each other's experience, there is a strong case for a dedicated body to cover financial sector regulation.

The appropriate scope of the Bureau's work is difficult to ascertain in advance. The development of suitable analytical capabilities to thoroughly evaluate the costs and benefits of regulations in this area will be complicated. It is an agenda where advances can only realistically be expected to occur over a number of years. Yet, the potential benefits to the economy of well-crafted regulation for the financial sector are sizeable and worthy of this investment.[50]

In order to make sure that such an exercise is realistic in its aims, especially in the initial stages, it will be important for there to be substantive consultation with industry and regulators particularly on the development of common methodologies.

Recommendation 6: The Bureau of Financial Sector Regulation should be tasked with the development of common methodologies to calculate the costs of complying with financial sector regulation on a regular basis. The Bureau should work closely with FICA (or the different industry associations) to help to ensure that this effort is as cost-effective as possible.

The development of a deeper understanding of the impact of regulations is complicated by the fact that there are serious conceptual issues to be resolved at both a theoretical and practical level. The Bureau should also act to encourage the furthering of the understanding of these conceptual and analytical matters.

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49 For example, Banks (2005) argues that they represent world's best practice. Also, the Productivity Commission's latest annual report on regulation notes that the RIS process is be touted as best practice by international bodies including the OECD. The report does, however, note that there is scope for improvement. See Productivity Commission (2005).

50 A parallel can be drawn with the debate over tariff reform. It was only after considerable effort was devoted to understanding the nature and magnitude of the costs of border protection that sufficient support for the reforms could be established. But the benefits of the reforms are now widely accepted.

Recommendation 7: The Bureau of Financial Sector Regulation should be given a mandate to lift the standards of the cost-benefit analysis of financial sector regulation, and be resourced adequately for this task. The Bureau should encourage a deeper understanding of best practice regulation.

5.4. ENCOURAGEMENT OF LIGHT-HANDED REGULATION – SPECIFIC AREAS OF ATTENTION

Section 5.1 stressed the desirability of financial sector regulation being conducted in a more light-handed manner than is currently the case. It noted a series of proposals under consideration where the likely outcome will be less interventionist than earlier draft proposals.

In addition, there are two aspects of financial sector regulation that warrant specific comment, namely the use of alternative compliance models and the regulation of the payments system.

5.4.1. Encouragement of Alternative Compliance Models

Financial institutions are diverse. Appropriate regulation for one entity may be quite inappropriate for another. This reality is recognised by those designing policy and regulators. For example, it is the reason why APRA developed its SOARS system (see Section 4) and optional risk management models under Basel II.

One of the messages to emerge from FICA's survey of members (see Appendix 1) is that some of the larger members felt that some of the new regulations providing no benefits to them in terms of strengthening their compliance culture because of measures already enacted internally. Of course, such claims need to be tested but where internally developed procedures can be shown to meet the objectives of particular regulations, there would seem to be a good case for alternative compliance mechanisms.

To implement such arrangements, the first step is for the basic objectives of the regulations to be set out in a clear and measurable form. While this is largely a task for the regulator, input from the regulated entities would be desirable. Once such a basic understanding is achieved, it then becomes possible for quite flexible approaches to emerge.

Note that there may be benefits from developing such an approach for not only the regulated entity but also the regulator. Over time, the information developed by individual companies devising their best means of meeting regulatory objectives should assist in the best design and implementation of regulations.

Recommendation 8: The Government should recognise the potential usefulness of regulated entities being able to develop their own compliance models to achieve regulator-specified outcomes. APRA and ASIC, in particular, should be encouraged to define what is expected of regulated entities and to develop a framework for alternative compliance models for specified areas of regulation.

5.4.2. The Regulation of the Payments System

As outlined in Section 4.4, one area where more interventionist regulation has been pursued than Wallis had envisaged is in the payments system. Unlike other major areas of financial sector regulation that are currently under review by Government, the development of regulation for the payments system has been left to the Reserve Bank. It is appropriate that payments system regulation, along with say FSRA or APRA's changes to prudential rules, be subject to closer scrutiny as part of the current investigations into business and, notably, financial sector regulation.

Given its importance to the stability of the financial system, and its central place in the economy, it is appropriate that the central bank be intimately involved in ensuring the safety and transparency of the payments system. This may entail direct participation in the system as with, say, cash or aspects of clearing and settlement arrangements.

However, in addressing the competition and efficiency objectives set down in the Payments System (Regulation) Act, the RBA should be able to adopt a less intrusive course. It most areas of the economy, competition and efficiency are typically advanced through promoting open access and, if need be, measures directed at market structure or conduct. As argued in Section 4.4, the RBA has instead adopted a highly interventionist approach to, notably, the setting of interchange fees despite the basis for doing so remaining quite contentious.

This is an area where the pendulum towards intrusive regulation has moved too far and steps to correct this shift should be encouraged.

Recommendation 9: The Reserve Bank should be encouraged to reconsider its current approach to the regulation of interchange and explore less constraining means to encourage appropriate competition.

5.5. COORDINATION ACROSS REGULATORS (AND REDUCTION OF DUPLICATION AND INCONSISTENCIES)

Some overlap between different regulators is inevitable. Regulators are established to address different policy objectives and sometimes by different jurisdictions. Clear demarcation of areas of responsibility can be extremely difficult to achieve.

Nonetheless, the loss to economic efficiency from duplication and inconsistencies across regulations and regulators in terms of compliance costs and impact on innovation or product offerings can be large. As is already the case at least to an extent, steps to limit these costs include:

- Ensuring that the mandates of the different regulators are clear; and
- Developing procedures to improve coordination and cooperation between regulators (for example, through the use of lead regulators for different tasks, MOUs or mirror regulations).

The overlap that has developed between APRA and ASIC in the area of market conduct has been of particular concern. While the areas of overlap do not appear to be extensive – they include reporting under the fit and proper requirements and outsourcing in risk management – the duplication has been an added complication as regulated entities try to cope with the introduction of several major sets of new regulations.

Part of the issue seems to have arisen from APRA assuming a more intrusive style of regulation than had been intended in Wallis (albeit, in a quite different environment). Wallis envisaged separation of the roles of the two regulators – APRA to be a prudential regulator and ASIC to be a conduct and disclosure regulator. But the model created the potential for overlap and, in such circumstances, it can be complex to resolve. In particular, the coverage of regulated entities and of issues to be addressed will not neatly match. Both regulators are conscious of the issue and are exploring means of minimising the impact (through devices such as carve-outs).

While the current issues of duplication may be manageable through action underway, there does appear to be a need to re-examine the interactions between the two regulators in order to ensure any long-term complications are curtailed. Accordingly, it is proposed that this issue be subject to considered review – see Section 5.10.

Another area of regulatory overlap is the setting of standards for corporate governance. Financial institutions face the corporate governance obligations set out in:

- The *Corporations Act* which incorporate the CLERP 9 reforms;
- The ASX Principles of Good Corporate Governance;
- APRA's proposed Standards;
- The corporate governance guidelines that the BIS has been developing for banks; and
- Other international obligations including those given by the Sarbanes-Oxley legislation.

The corporate failures witnessed over the past decade highlight the need for improved levels of corporate governance. However, multiple sets of obligations aimed at the same objective cannot be justified, even though the requirements are for the most part very similar.

The ASX approach is sensible and is consistent with the objective of encouraging a more outcomes-based approach to regulation. Its principles are not binding but if companies depart from what is set down as best practice, they must disclose such departures to the market in their annual reports. This approach is attractive in that:

- It allows companies some discretion in choosing the governance arrangements best suited to their circumstances; while

- It makes use of market disciplines to constrain poor practice. In this regard, it is consistent with the emerging research noted in Section 2 that highlights the benefits of encouraging private agents to exert discipline on corporations.[51]

On the other hand, APRA has consistently argued that it should set its own explicit corporate governance standards for financial institutions and that these should be mandatory. APRA's view has recently been expressed most comprehensively by its chairman.[52] The thrust of APRA's argument is that financial institutions demand tighter obligations than other businesses given their central role in the economy; that prudential regulators have for some years placed corporate governance standards on banks and, in APRA's view, this should be extended to other financial institutions; and only a small proportion of those institutions subject to APRA's oversight are listed and thus subject to the ASX arrangements.

Notwithstanding these comments, it is the case that there is regulatory overlap in standards for corporate governance. APRA's case is contestable. For example, even though there is a case for strict standards in other aspects of prudential regulations, the empirical basis for the need for mandatory corporate governance regulations has not been made – indeed, as noted above, the evidence tends to support greater reliance on the private sector oversight. Also, APRA's case appears to have largely evolved through regulating banks. The nature of the risks, especially related to systemic issues, differs for other financial institutions and thus it may be that the approach to prudential regulation should also differ.

Recommendation 10: The Bureau of Financial Regulation should have a mandate to monitor areas of duplication and inconsistency across regulators.

5.6. INTERNATIONAL DIMENSIONS

The Australian financial system is intimately related to the international system. Much of the increased regulatory burden has international origins. This has a number of implications:

- It is in Australia's interests to have an international set of rules that works;
- Where possible, domestic regulations should be designed to complement international requirements;

51 See Barth *et al* (2003).

52 See Laker (2005).

- This does not mean that international frameworks need to be adopted in a rigid fashion. For example, Basel II explicitly recognises the desirability of allowing a degree of flexibility in the implementation of the framework to allow for local circumstances. This approach should be encouraged in all areas where international obligations apply (whether they be through multilateral bodies or bilateral); and

- As has been the case over the past two decades with other areas of microeconomic reform, Australia should be encouraged to develop best practice regulation that can inform international practice and agreements.

Australian regulations and regulators for the most part compare relatively well to their overseas counterparts.[53] Given this record, Australia is well placed to encourage well-crafted regulation through international bodies.

Two areas where international pressure has resulted in less than ideal regulation for the Australian financial sector and where, given the right circumstances, efforts could be made for some redress, namely AML/CTF and Sarbanes-Oxley. There is a tendency to place both in the too hard basket, yet:

- All FATF members appear to be struggling with how best to respond to the FATF recommendations on anti-money laundering. A recent FATF report indicates that Australia does not comply with as many of the FATF recommendations as some other member countries.[54] However, the nature of this assessment highlights a theme of this report, namely the desirability of assessing performance against underlying policy objectives and whether these objectives are being met in a cost-effective manner. Adherence to a set of rules or recommendations can distract from this task. As argued in Section 4, the costs associated with AML/CTF are likely to be much larger than had been anticipated and a fresh assessment of how the underlying objectives can be best addressed appears to be warranted. It is likely that this will not just be an issue for Australia but also for other FATF members as they head down this path.

53 For example, the OECD and IMF generally have provided favourable assessments of Australia's regulatory framework relative to other countries. For example, as noted by the Productivity Commission (2005), the OECD views Australia's use of RIS positively. In addition, the tone of the IMF's comments on Australia's record on financial sector regulation has typically been complimentary. The IMF is currently reviewing Australia's financial sector regulations through its FSAP program.

54 See the Minister for Justice and Custom's press release dated 17 October 2005. FATF's assessment indicates that Australia fully complies with 12 of its 49 recommendations, largely complies with 14, partially complies with 13 and fails to comply with 10. The new AML/CFT legislative changes being developed will improve this record.

- Refining the Sarbanes-Oxley legislation, or its global reach, would appear to be an especially large task for a single country like Australia. However, there is widespread concern with the legislation in the United States and elsewhere (e.g. witness Prime Minister Blair's comments in Section 3) and an Australian voice may assist in generating broad support for action. At a minimum, it could help to minimise the risk of similar measures in the future.

In areas of regulation fostered by international bodies, Australia has often been in the lead advocating the development of outcomes-based models of regulation. This activity is supported. At the same time, however, problems have arisen where due regard has not be made at an early stage to the costs and complications involved in converting the policy principles into regulatory practice (as was the case for AML/CTF). The implementation of regulations will be an evolutionary process and thus some flexibility and scope for learning should be recognised throughout the consideration by the relevant international body. Another problem that has occurred in the case of the introduction of new accounting standards has been that the international competitiveness of early adopters has been affected for a period.

Recommendation 11: The Government should continue taking a lead in the developing of outcomes-based models of regulation in international forums. It should also encourage the recognition that regulatory frameworks may need to evolve, as specific regulations are made operational. In adoption of international standards, Australian legislators and regulators should take due regard to the impact of early adoption on international competitiveness of domestic players.

5.7. SELF-REGULATION

A central theme throughout this report is that well crafted regulation will only be successful with shared responsibility. If regulators are going to be able to apply a light-handed approach to their mandate, they need to be supported by both policy-makers and the regulated entities. Furthermore, a philosophy that promotes light-handed regulation and alternative compliance models by its nature will involve at least a degree of self-regulation.

However, self-regulation is not a panacea and brings its own problems. A lack of clarity in the basic objectives of the regulations – whether these objectives are set by policy-makers or the corporation or industry itself – can lead to costly and ineffective compliance exercises. Moreover, where the objectives are being set in response to ill-defined community expectations, there can be a danger of regulatory 'creep' that may, in fact, be more intense than where regulations are imposed externally.

Self-regulation can take a number of forms with responsibility for establishing the regulatory framework falling to individual companies, specific industry sectors (which have developed industry Codes of Practice), professional associations (such as accounting bodies) or exchanges (as in the case of the ASX).

For self-regulation to play a useful role, a number of conditions must be met:

- There needs to be sufficient clarity in the overarching objectives that the regulations are intended to meet for an economical and effective framework to be developed;
- For self-regulation to gain the necessary acceptance of policy-makers and external stakeholders – especially customers – there needs to be genuine accountability, transparency and convenience procedures for the aggrieved parties. In this regard, the role of an independent ombudsman can be very important;[55] and
- There needs to be a *quid pro quo* in that there should be a presumption that there will not be additional layers of regulation.

In light of this final point, a more extensive role for self-regulation can only realistically be developed in the context of fundamental change to how other financial sector regulation is applied. Accordingly, it is suggested that specific recommendations related to self-regulation be developed in the context of the review of financial sector regulation advocated in Section 5.10. (In addition, financial sector regulators should be encouraged to actively explore areas where they could pare back their direct regulation in favour of alternative models as per Recommendation 8.)

5.8. ENGAGING STAKEHOLDERS

The discussion on self-regulation stressed the desirability of engaging all major stakeholders in the development of the specific regulations. This increases the likelihood that the regulations will meet their underlying objectives and gain acceptance by interested parties. This idea, however, applies equally to all regulation.

Examples of the development of new regulations that, reportedly, did succeed in garnering broad acceptance by various stakeholders were the UCCC and the Banking Code of Practice. This is not to say that either set of regulations is without its problems; just that an open dialogue assisted their development. In contrast, as discussed in Section 4, the consultation process for the FSRA and AML/CTF proposals was, initially at least, poor.

5.9. 'REFORM FATIGUE'

Section 4 argued that the design and implementation of a number of key regulations over the recent years has been less than perfect. The difficulties facing the regulated entities have been intensified by the *cumulative* impact of the wave of new regulations that have been introduced. Considerable resources have been consumed in responding to new regulations – and proposals for new regulations, many of which never materialise. The wave of changes has made it difficult for boards and senior management not to become distracted from their core business.

55 These conditions would seem to be met by the industry codes for the banking and insurance sectors.

It is possible to conceive of policies that aim to restrain the rate at which new regulations are introduced, although any such policy would be arbitrary to some extent and may not be sensitive to the relevant importance of different regulations. Accordingly, devices to artificially slow down the introduction of new regulations are not recommended.[56] Instead, it is recommended that the issue of the cumulative burden of new regulations be explicitly recognised by the designers of new policy with any action left to their discretion (subject to enhanced accountability arrangements outlined above).

5.10. TIME FOR AN INDEPENDENT REVIEW OF THE OUTCOME OF WALLIS

The Wallis Inquiry argued that its model of regulation should be seen as applying for the following five to ten years. Given how extensive the changes being recommended were, Wallis intended there be a review of its recommendations and their implementation in this five to ten year period.

The Financial Sector Advisory Committee (FSAC) conducted a review of Wallis in 2003[57] and continues to be a focal point of advice to the Government. However, the nature of FSAC meant that it was well placed to be a sounding board on emerging issues in financial sector regulation, and to assist in specific areas where attention is required, but it is not in a position to provide a substantive reassessment of the underlying premises on which the system is based. Dedicated resources are needed for such an exercise.

There does ***not*** appear to be a need to have an extensive review of the main principles set down by Wallis nor the basic architecture it recommended. Rather, a fundamental examination of the design and implementation of financial sector regulation is warranted. Such a review would evaluate the extent to which financial sector regulation as enacted and implemented today has departed from the overarching principles set down in Wallis, and whether such departures are desirable.

The terms of reference for such a review could include:

- Assessing whether the basic assumptions and philosophy underpinning Wallis' analysis should be modified in light of the corporate failures seen in recent years in the financial sector;
- Reviewing areas where a more outcomes-based style of regulation could be applied;
- Reviewing the extent of convergence in financial services and the extent to which a common approach should be applied to the regulation of financial services;

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56 Similarly, this report does not advocate the use of other artificial methods of constraining the burden of regulation burden such as explicit targets for reduction in the quantity of legislation or the requirement to match any new regulation with the removal of another. The correspondence between such measures and the actual economic (or commercial) costs and benefits is too unreliable to use such devices as anything more than a loose guide for policy-makers.

57 See FSAC (2003).

- Exploring criteria for developing more differentiated approaches to 'general market regulation' (including regulation involving licensing and the disclosure of information);

- Investigating the scope for 'alternative compliance' models where the regulated entity can demonstrate the effectiveness of its processes in meeting outcomes that are set by the regulator or legislator;

- Examining the scope for limiting regulatory overlap. This will include overlap both between jurisdictions and between national regulators, especially APRA and ASIC and possibly the ACCC; and

- In reviewing financial sector regulation, consideration should be given to the appropriate role to be performed by boards and senior management, and the level at which they should communicate with regulators.

Recommendation 12: An independent review of the Wallis Inquiry should be conducted with an emphasis on the appropriateness of its underlying philosophy and the implementation of its recommendations using terms of reference along the lines of those in the text.

6. CONCLUSIONS

The principles of competitive neutrality, accountability, cost efficiency, transparency and flexibility were central to the new regulatory regime advocated by Wallis. These principles were incorporated into the relevant legislation or at least in second reading speeches. That practice has drifted so far from these conceptual moorings is a reflection of the difficulties converting these principles into operational regulations, and may signal that those charged with these tasks have not imbibed the spirit of the law in determining regulatory practice. At the same time, it also reflects the difficult external environment that financial sector regulators have confronted over recent years.

The design and implementation of a well-crafted regulatory regime is challenging and this agenda should form a central element of a fresh wave of microeconomic reform. In this regard, the attention that the increasing burden of business regulation has received over the past year has been encouraging. However, many of the proposed means of tackling the issues cover a broad spectrum of industries and regulations. As argued above, many of the most intractable difficulties in the regulation of the financial sector arise at the micro level and will require specific solutions if they are to be addressed effectively.

For example, among the ideas that have been proposed have been:

- The Business Council has proposed that Federal Cabinet assume a regular gatekeeper role to ensure that the compliance burden of new regulations is better assessed up front. The BCA also proposed a new high-level consultative forum between government and business.[58] While both proposals appear to have some merit, they would involve considerable and continued commitment by the highest levels of government and the opportunity costs involved would have to be taken into account. Moreover, and especially for the regulation of the financial sector, the proposals do not address the challenges that arise because of the "politics of detail". Consequently, the specific recommendations that are presented do not rely on the BCA's approach;

- The recently announced Task Force on Reducing the Regulatory Burden on Business should facilitate improvements in some aspects of business regulation, especially regulatory review. The Task Force's deliberations need to be encouraged. Yet, the breadth of its assignment plus the limited success that regulatory review systems have had in Australia and overseas cautions against expecting too much for financial sector regulation to emerge from the Task Force. Again, a more targeted solution appears to be warranted;

58 The proposed body would be called the Business Regulation Advisory Council.

- The Commonwealth Government has indicated that it expects contributions to improved regulatory practice from all stakeholders, that is government, regulators, industry groups or associations and business itself. As part of this, it has urged business to explore what more could be achieved from self-regulation.[59] However, a joint approach to better regulation requires a degree of coordination and mutual understanding that has not been present in recent years. For example, there has been no allowance made in the development of FSRA for the related commitments assumed by industry in their Codes of Practice.

Accordingly, this report recommends that specific action is required if a well-crafted regulatory framework is to be developed and progressively improved upon for the financial sector. Given the weight of the regulatory burden the sector currently carries, and the importance of the sector to the economy and daily life, sector specific action does appear warranted.

Section 5 set out a range of recommendations designed to achieve better regulatory practice. Running through those recommendations are two core themes:

- The desirability of developing and maintaining an environment whereby the governments' and the community's expectations of their regulators are clearly understood; and

- The establishment of new accountability arrangements for the financial sector regulators that allow systemic problems associated with both the design and implementation of regulations to be identified and appropriate solutions found.

59 See, for example, Hon Chris Pearce, "The politics and regulatory perspective", address to the KPMG Global Financial Services Conference, 27 September 2005.

APPENDIX A: BUDGETS OF FINANCIAL SECTOR REGULATORS

The table below documents how administrative costs of financial regulation have risen in the last seven years with a projection for 2006 where data are available.

Table 1: Administrative costs of financial regulation (1998–99 to 2006–07)

	APRA ($m)	ASIC ($m)	PSB ($m)	Total ($m)	% total financial assets of financial inst.
1998-99	48.6	24.9		73.5	0.0049
1999-00	51.5	23.6	0.10	75.2	0.0044
2000-01	53.1	23.2	0.14	76.4	0.0041
2001-02	59.2	44.2	0.14	103.5	0.0050
2002-03	67.1	45.3	0.15	112.6	0.0054
2003-04	72.0	58.3			
2004-05	74.2	56.8			
2005-06	77.2	57.4			
2006-07	79.4	57.2			

Source: Financial Sector Advisory Council, August 2003, 'Review of the outcomes of the Financial System Inquiry 1997'.

APPENDIX B: QUESTIONNAIRE OF FICA MEMBERS

Questionnaires were circulated to FICA members with 11 members from banking and insurance providing detailed responses.

The intention of the survey was to obtain a sense of the nature of the challenges facing members from the growth in business regulation in recent years. It was recognised that the raw data needed to compile comprehensive and consistent estimates of the cost or scope of business regulation was not available. Accordingly, the survey sought to draw upon existing information related to members' experiences of the regulatory burden they face, both of a quantitative and qualitative nature.

Q1. Compliance Costs. What would you estimate to be your company's compliance costs including internal department costs and external consultants (legal, audit, etc), in terms of both dollar expenditures and the percentage of operating income (if available)? How has this changed over the past 5 and 10 years?

Overall compliance costs have increased sharply over the past 5 and 10 years. As a proportion of income, compliance costs appear to be somewhat higher for insurance companies than banks, and to be inversely correlated with size.

Ongoing Compliance Costs

Ongoing compliance costs for the largest banks appear to represent approximately 0.5 per cent of operating income (or of the order of $50 million a year). These costs have increased significantly over the past decade:

> *Since 1994/95,* [compliance] *expenditure levels have almost doubled every five years, accompanied by growth in staff resources engaged in compliance-related activities.*

This estimate of a roughly doubling in compliance costs over the past five years, in fact, appears to be consistent across all respondents who were able to estimate the magnitude of the increases. For example, a medium-sized insurance company report an increase in compliance costs from 0.8 per cent of operating income 10 years ago, to 0.9 per cent five years ago to 2.1 per cent currently.

Annual compliance costs for the larger insurance companies were of the order of $20 to 30 million. One insurer noted that:

> *Some regulatory changes such as those related to good governance practices were ones we would implement regardless of the regulatory requirements.*

Compliance costs for medium-size insurers (up to 500 employees) tended to lie in the $5 to 10 million range.

Costs for Smaller Firms

One smaller insurer noted that in the past it did not need a dedicated compliance officer with functions "subsumed within the normal duties of its business line personnel". It now has a added direct employment costs of the order of $250K, external compliance recourses in excess of $200K, additional time spent by business-line personnel on compliance and more external audit costs. Another smaller insurer emphasised:

> *The impact is more one of time devoted to compliance issues that would previously have been spent on strategic and operational business activities.*

Q1b. In particular, do you have any specific estimates associated with implementation and ongoing costs of FSRA and/or APRA prudential regulatory changes? If so, please identify these separately.

The one-off implementation costs associated with FSRA, Basel II, the new prudential regime for insurers, SOX and IFRS were all cited as contributing significantly to costs. Insurers noted their implementation costs varied with their product selection.

Banks' Implementation Costs

An earlier survey of ABA members found that:

> *The direct cost of implementing FSR across 23 member banks of the ABA was $200M.*

One regional bank indicated that the majority of implementation costs related to the Basel reforms:

> *FSR – Estimate $5M. Basel – Estimated $25M.*

Insurers' Implementation Costs

Among the larger general insurers implementation costs were estimated at close to $20 million over the last 2 years, and were primarily associated with FSRA compliance:

> *… the costs identified … largely relate to the implementation and continuing costs of FSR.*

For insurers with less than 5000 employees, FSRA implementation costs ranged from $1.4 to $4.6 million. All insurers tended to note specific costs involved with the implementation of the FSRA reforms that are proportionate to the number of products issued:

> *…direct costs of the project team, IT staff, internal and external legal advice, purchase of software and the cost of producing quantities of disclosure documents in relation to some 40 different retail general insurance products for issue to customers and intermediaries.*

Implementations costs for insurers associated with APRA change were mostly reported in terms of management time (see below), however one large insurer noted:

> *On APRA stage 2 reforms, the implementation cost is estimated at $1 million to $2 million depending on the extent of any framework required for outsourcing.*

Q2. Senior Management Time. Beyond explicit compliance costs, can you estimate the time that senior management and boards devote to compliance? How has this changed over the past 5 and 10 years?

One financial institution estimated:

> *As a guide, one business unit approximated that the time spent on compliance by boards was 25% and senior management 20% respectively; 5 years ago it was 7.5%/7.5% and 10 years ago 5%/5% - a 500% increase over the decade.*

This 25 per cent estimate was representative of all respondents able to estimate the time spent by boards, although one was expecting this to increase:

> *Executive Risk Committee and board Risk Committee spends approx 25% of time on compliance / regulatory matters. This is expected to increase to 40% with Basel 2.*

The range of time devoted to compliance matters by senior management tended to vary between 5 per cent and 20 per cent. This figure had increased between 5 and 10-fold over the past decade. Among all insurers similar proportions of senior management and board times were reported:

> *We estimate this to be 10% for senior management time. This has significantly increased over the last 5 years.*

> *… it would not be unreasonable to suggest that an additional 25% of time has been required by the board to consider regulatory compliance issues.*

One insurer signalled APRA requirements had occupied senior management the most:

> *The amount of time that senior management and the board need to devote to compliance has increased over the past 5 years. This has been primarily driven by the new APRA regime which has placed additional requirements on the board…The APRA regulations go beyond the level considered by the board to be necessary and, in most cases, add no value to the policyholders or shareholders.*

Q3. Impact on Business Decisions. Have there been any instances where compliance with regulations has impacted how your business is run? For example, have you been forced to withdraw from particular products or services or restrict supply, have you decided not to proceed with an innovation or new idea, or have you had to increase fees substantially on particular products or services? Please elaborate including what customer groups might have been impacted.

FRSA has resulted a significant majority of respondents reporting that products had been discontinued or modified due to higher costs while a number noted that the launch of new lines had been deferred. Insurers reported the withdrawal of advice more than banks did. Smaller insurers reported the impact in terms of internal resources being diverted from away from normal operations.

Discontinued Products

Maintaining supporting legacy products where volume is not high is not necessarily viable (mainly due to high technology costs) under FSR regulation, therefore some products have been discontinued; Telephone/call centre staff are required to make long disclosures to customers for basic products, this increases call time and ultimately product costs;

- *Additional printing costs were incurred for the issue of new and varied PDSs – this incurred additional drafting costs involving product areas within the business, compliance and legal input – and also the PDS lodgement fees; and*
- *Some employment agencies no longer supply staff for customer facing roles in financial institutions due to the training obligations under PS146…*

One bank noted:

Our Treasury area has withdrawn some products from retail sale because of FSR.

Another bank reported that FRSA had an impact on the following areas:

- *General advice model;*
- *No longer offer long term Term Deposits;*
- *Restriction of some product features;*
- *Indirect impact on fee levels due to overall compliance costs; and*
- *Cost of IT systems changes to comply has impacted on some products.*

Some banks reported other changes to product design:

> *As a result of the Impact of the Financial Services Reform legislation,* [the bank] *made a decision to withdraw an account opening service in a foreign jurisdiction offered to Australian residents travelling overseas…Another example of the impact of the FSR regime has been that overseas-based subsidiary Banks have ceased to service their foreign nationals resident in Australia due to perceived extra territorial consequences of FSR.*

A number of general insurers reported product modifications involving the withdrawal of certain cover:

> *The requirement to register every PDS has meant that it is no longer possible to collate a policy for a small business from a series of available cover options.*
>
> *[We have] withdrawn personal accident cover from our commercial products …*
>
> *…some mixed products have had the retail element stripped from them as this invokes compliance costs.*
>
> *… we need to exit from the smaller end of the group risk market.*

The 'No Advice Model'

It was common among respondents with general insurance operations to report the withdrawal of advice in relation to products:

> *…in our direct business…we have adopted a 'no advice' model.*
>
> *We adopted a no personal advice model, which means that some customers are probably worse off under the new FSR regime.*
>
> *Instead of being able to easily and fully discuss the policy terms and conditions, the majority of our ARs are only authorised for general advice or no advice (just issue the policy). This is to avoid the requirements and liability associated with providing 'personal advice'.*

One insurer noted that advice had also been restricted from its internet site:

> *… an internet comparison of prices and benefits to assist customers is simply too difficult to navigate the guidelines on advice.*

One of the larger insurers (more than 5,000 employees) noted the particular effect for their rural and regional customers:

> *…the increase in compliance requirements has resulted in diminution in the services to rural and regional customers with the withdrawal from the provision of 'advice' to customers on general insurance products…many authorised representatives are restricted to 'arranging' insurance rather than offering any value added services through advice. This is of particular concern in rural and regional areas where agents previously played an important part in considering the range of insurance products and advising clients.*

Business Volumes affected for Small Insurers

One smaller insurer noted the impact as effecting overall operations:

> *…business line personnel (being personnel who do not have primary responsibility for compliance and compliance related tasks and activities) are spending more of their time and attention in effecting compliance and compliance related tasks and activities.*

Q4. Regulation. In your opinion, is there any specific regulation or legislation in the last five years caused a particularly high compliance burden? If so, please identify and provide information on why this has been the case. If applicable, what has been the impact of changes in regulations elsewhere in the world on your business?

A significant majority of general insurers responded that FSRA had created the greatest compliance costs:

> *Obviously FSRA has caused the greatest burden in the last five years, requiring a major effort…*
>
> [We] *would suggest that the implementation of the FSRA would be the specific legislation in the past five years to cause a particularly high compliance burden. The new APRA regime obviously also increased compliance requirements substantially.*
>
> *The disclosure provisions contained in the Corporations Act have come at a large compliance cost.*
>
> *FSR has been the most significant impact…*

A significant majority of members with banking operations responded similarly:

> *FSR has had the biggest impact on the Bank and the financial sector in general over the past 5 years. This has exacerbated the already significant increase in prudential regulation since 1997.*
>
> *The highest compliance burdens have been caused by the following regulation: Financial Services Reform – increased compliance burden is evidenced by the increased cost and resource allocation…*
>
> *Clearly FSR where all our AFSL holders require Licensee Compliance c/tees…*

Q5. Culture. Has new regulation had any effect on the culture within your organisation? If so, please be as specific as possible about the changes and the regulation involved, as well as the consequences for your organisation.

Responses could be categorised as ranging from a quite negative impact to qualified support. The latter were generally in relation to potential benefits from heightened awareness among employees.

Negative impact

Some negative responses were driven by the impact on innovation in business processes:

> *…simple change is no longer simple because we will have to involve legal teams and go through an arduous sign off process. Consequently, we don't change anything unless we have to and unless it's part of something bigger. This sort of culture stifles the concept of continuous improvement.*

> *… the stifling of some innovation due to concern over breaches…*

Members with banking operations tended to summarise the negative impacts in terms of consumer attitudes:

> *The customer's perception of a helpful culture supporting enquiries has changed to an over regulated industry where advice enquiries are routinely directed to Financial Planners.*

> *…some businesses are still concerned that the traditional approach to compliance can be driven by regulatory requirements rather than the customer needs.*

Insurers that responded negatively, tended to emphasise the perceived lack of benefits along side the costs:

> *The FSG and PDS don't give the customer anything valuable… Product understanding has not been increased.*

> *None of the regulation introduced in the past 5 years has caused the Group to review these behaviours – they are not in conflict. Therefore, we believe that there has been no significant impact on the culture of the group. The regulation has caused frustration, increased costs and negatively impact*[ed] *policyholders.*

Another respondent emphasised the negative effects on the ability to attract senior management:

> *Directors' fiduciary duties/responsibilities are more onerous… This has affected institutions' ability to attract suitable directors.*

Qualified support

A number of respondents noted the potential beneficial effects from the change in culture:

> [We] *consider that that many of the requirements and obligations of AFSL licensing were largely incorporated in to* [our] *internal procedures, processes and corporate culture prior to the introduction of the Act…From an industry perspective, however, it is positive that the FSRA encourages good governance, compliance and integrity.*

Overall, people are now more accepting of compliance as business as usual. Has in some respects created a slightly 'nervous' environment however this ensures people become more accountable for their own roles.

…[We] *have observed that there is a greater acceptance of, and less reluctance to adhere to, process revisions that are triggered by compliance and regulatory changes… this is due to a strong understanding by personnel that such changes … are essential business drivers.*

Q6. If you have any other more detailed comments – possibly in the form of previous submissions – or particular anecdotes not provided above that you feel are particularly illustrative of the burden you face, please feel free to elaborate.

Comments provided by some respondents indicated a desire for greater efforts from regulators to minimise the compliance burden:

Regulators demands for statistical data have resulted in average 10% of time of line, IT, actuarial and other specialist staff diverted to manage, rework or complete requests.

Much of the regulation introduced in the past 5 years has been in response to particular situations, such as the liquidation of HIH… Clearly the government has had a knee jerk reaction to events in the industry. The compliance burden does not prevent dishonest operators. What is does do is impose significant burden on companies that already have adequate corporate governance principles in place.

On occasion, regulation is imposed with inadequate consultation and a lack of commercial pragmatism. There are also some concerns about the experience and commercial pragmatism of some staff within the Australian regulators, especially when compared to their peers overseas.

APPENDIX C : INTERNATIONAL APPROACHES TO REGULATORY REVIEW

Many OECD economies have confronted the expansion of regulatory burden within their economies in recent years. The issues being addressed have been similar to those present in Australia with change being instigated as a result of both domestic and international agendas. Two countries in particular that have explored quite radical change in how regulation is treated have been the Netherlands and the United Kingdom. In coming years, Australia may benefit from the lessons to be gleaned from these experiments.

C.1 NETHERLANDS

The Dutch government has focused its regulatory review efforts on reducing the administrative burden, which it defines as "the costs imposed on businesses when complying with information obligations stemming from government regulation" – essentially this is a reference to compliance costs under our terminology. These initiatives began in 1994 when the government set an administrative burden reduction target of 10 per cent between 1994 and 1998. Its approach targets the bureaucracy put in place to implement regulations and does not question the policy objectives of the regulations themselves. A second stage began in 2003 when the government corrected certain defects, such as a lack of ministerial commitment and accountability and set an additional 25 per cent reduction in administrative burden between 2003 and 2006.

The burden reduction initiatives involve a precise methodology made up of three components:

- Measuring the administrative burden – every department used the so-called 'Standard Cost Model' to measure the administrative burden imposed on business through its regulatory activities. This measurement includes all the administrative obligations imposed by central government departments and regulatory agencies under both national and European legislation.

- Commitment to a target – Dutch ministers agreed on the priority for their term in office of reducing the administrative burden across the whole of government regulation. The reduction targets set have been net targets, which means that the reduction must be achieved after taking into account any new burdens from regulations brought in by the government or the EU during the period of the target.

- Organisational structure – to encourage the attainment of the target, the government set up an organisational structure to oversee the process. The Dutch Minister of Finance takes responsibility for achieving the administrative burden reduction target and delivers a progress report to Parliament every six months. The Ministry of Finance coordinates the programme with a dedicated cross departmental team called the Interdepartmental Project Directorate for Administrative Burdens (IPAL).

- The government has also established an independent public body called Actal (the Dutch Advisory Board on Regulatory Burden) to which government departments are obliged to send details of all new legislative proposals, including a calculation of its administrative burden. Actal then reviews the calculation before the proposed legislation is sent to the Dutch Council of Ministers and to the Dutch Parliament. Actal also evaluates the burden reduction programmes that all departments are obliged to present annually to Parliament and makes its evaluation public. The Dutch Cabinet considers Actal's comments when deciding whether to endorse a new piece of legislation. If the Cabinet approves the new legislation, Actal's comments are made available to the Dutch Parliament when it debates the bill. Each department has also set up a small unit of civil servants dedicated to supporting the reduction of administrative burden in that department.

C.2 UNITED KINGDOM

The UK recently set up a Better Regulation Taskforce to review possible processes to improve regulation. The Taskforce recently released its report making the following recommendations:

- Adopt the Netherlands Standard Cost Model for measuring administrative burden and use it to provide a systematic measurement of the administrative burden in the UK by May 2006;

- By May 2006 (or earlier if the results of the measurement are available), set a target for reducing the administrative burden;

- By July 2005, put in place an organisational structure and the necessary resources to facilitate measurement and target achievement, including a central co-ordination unit, a body providing independent scrutiny, and stakeholder participation;

- By the end of 2005, the Regulatory Impact Unit in the Cabinet Office should, in consultation with departments, develop a robust mechanism for the submission of proposals for simplification by business and other stakeholders. The mechanism will require stakeholders to submit evidence in support of their proposals, with options for reform. It should require departments to respond within 90 working days, setting out and justifying the course of action they propose with a time limit for delivery;

- By September 2006, all departments, in consultation with stakeholders, should develop a rolling programme of simplification to identify regulations that can be simplified, repealed, reformed and/or consolidated;

- The Regulatory Impact Assessment process for major regulatory proposals should require consideration of compensatory simplification measures. Where it is not possible to include any simplification measures, there should be a reasoned explanation of why not. Clearance by the Panel for Regulatory Accountability of any major regulatory proposal should include consideration of offsetting simplification proposals;

- The government should progress its promised review of the operation of the Regulatory Reform Act. The review should consider how the scope of the Regulatory Reform Act can be widened to allow a greater number of reforms to be delivered by Regulatory Reform Order (RRO). In particular, it should explore whether the scope of RROs should be extended to deliver non-controversial proposals for simplification. In addition the review should consider whether the whole process for developing an RRO and subsequent scrutiny could be more proportionate;

- The government should start developing a methodology for assessing the total cumulative costs of regulatory proposals. The government should also reassess whether full regulatory budgets, taking into account the cumulative impact of regulation, should be introduced (a fuller discussion of regulatory budgets is provided further below).

In July 2005 the UK began consultation on the Better Regulation Bill which will contain statutory requirements for regulators to use a rigorous risk-based approach and powers to reform penalties according to risk-based principles.

The BRTF has also set out what it considers to be five principles of good regulation, namely:

- Proportionality – regulators should only intervene when necessary. Remedies should be appropriate to the risk posed. Costs should be identified and minimised.

- Accountability – regulators must be able to justify decisions and be subject to public scrutiny.

- Consistency – government rules and standards must be joined up and implemented fairly.

- Transparency – regulators should be open and keep regulations simple and user-friendly.

- Targeting – regulation should be focused on the problem and minimise side effects.

Regulatory budgets

As noted above, the BRTF revived the question of whether regulatory budgets should be introduced in its recent recommendations. Essentially, regulatory budgets are similar to financial budgets in that they involve setting a pre-determined level for the total regulatory costs that any department can impose. Departments then have to manage their regulatory activities within this limit, balancing expenditure (new regulation) and income (deregulation) to avoid a deficit.

The BRTF listed the following options for use of a regulatory budget:

- Impose an annual decrease in the total cost of regulation, thus compelling departments to do more deregulation than new regulation;
- Freeze the total cost of regulation such that each department would need to offset any new cost of regulation by reducing regulation elsewhere by an equivalent amount;
- Allow a pre-set year on year increase in the cost of regulation.

It noted that although the use of regulatory budgets has been proposed since the 1970s, the proposal has so far not been adopted anywhere in the world, largely due to the lack of an agreed methodology and the practical difficulties of measuring the total effects of regulation. A further risk noted by the BRTF report is that taking on full regulatory budgets could spawn a large bureaucracy within government to develop and verify the methodology, manage the regulatory accounts and report, monitor and audit the results.

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