



FINANCIAL SYSTEM INQUIRY - PHASE TWO

CHAPTER THREE

REGULATORY ARCHITECTURE

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OUTLINE

This chapter considers Australia's financial system regulatory architecture.

Previous inquiries into the financial system have led to substantial change in the financial services industry and the Australian economy.

We do not believe that Australia's regulatory architecture requires a significant overhaul.

We do however feel that:

- ❖ Regulatory roles could better defined and targeted;
- ❖ The licensing regime should be expanded to bridge any gaps in the financial system;
- ❖ Vertical integration provides consumers with scope and scale efficiencies alongside new and revised consumer protection mechanisms;
- ❖ Financial sector collection of data responsibilities should be revised; and
- ❖ Data sharing between government and the private sector should be increased.

1. AUSTRALIAN SECURITIES AND INVESTMENT COMMISSION

Role and powers of ASIC

It is critical that ASIC, as Australia's corporate regulator, has an appropriately defined and targeted mandate. At present, its activities sprawl across market supervision, business guidance, consumer education, law enforcement and corporate registry.

FSC strongly supports a streamlined ASIC focused on regulation of

corporations and financial markets integrity. Recent inquiries paint a picture of an over-stretched, at times under performing watchdog.

The interim report states:

“Given the breadth of ASIC’s mandate, it can be argued that ASIC has too many regulatory functions, with staff spread between too many responsibilities.

It is possible that narrowing ASIC’s mandate may allow it to become a more tightly focused regulator and target higher-risk entities, although there are also benefits and efficiencies from bringing together similar functions.”

The concerns on ASIC’s mandate are also highlighted by the Commission of Audit (CoA). We agree with the CoA that it is imperative that the FSI consider the boundaries of ASIC, especially where they overlap with APRA and the ACCC.

“The functions of the Australian Securities and Investments Commission, particularly areas of overlap with the Australian Prudential Regulation Authority and the Australian Competition and Consumer Commission, should be considered in the context of the Financial System Inquiry. In the meantime, the registry functions of the Australian Securities and Investments Commission should be transferred to the Australian Taxation Office, its consumer protection functions transferred to the Australian Competition and Consumer Commission and its financial literacy functions should cease.”¹

We share the CoA view that ASIC should not hold corporate registry functions.

However we disagree with the CoA view on financial literacy, which appropriately sits with ASIC.

RECOMMENDATION

ASIC’s core functions should be:

- The non-prudential regulation of financial entities (conduct, disclosure and enforcement);
- Financial market integrity;
- Financial literacy; and
- International integration and competitiveness.

¹ Page 216-217, Phase One Report, National Commission of Audit, February 2014.

The FSI offers an opportunity to refocus ASIC on its core function as a securities and markets regulator.

Funding

Regarding ASIC's future funding, FSC supports an industry funding model within a narrower, more targeted mandate (as described above). This would be in keeping with the funding approach to ASIC equivalents taken in the UK and Canada.

We believe that cost recovery is the appropriate manner to levy the industry to pay for supervision costs. This model applies for prudential regulation (APRA) and to financial market participants for the purposes of market integrity.

RECOMMENDATION

ASIC should be funded on a cost recovery basis by the industry with a refined focus on regulation of financial services companies and financial market integrity.

FSC's support for an industry funding model and additional powers for ASIC is based on the regulator's mandate being appropriately targeted. We believe a targeted mandate for ASIC would be likely to lead to overall performance improvement.

The FSC also welcomes the Interim Report's proposal of periodic, legislated independent reviews of regulators. Such reviews would enhance both accountability and performance, thereby encouraging maximum efficiency and better consumer outcomes.

RECOMMENDATION

An accountability and transparency mechanism known as a Risk Appetite Statement should be published by ASIC. It would set out surveillance and enforcement priorities and serve as a performance indicator as well as a tool to monitor resourcing and expenditure.

Oversight

The FSC believes that the current regulatory governance model is inadequate. Senate Estimates and Parliamentary oversight hearings provide a mechanism for political oversight of regulators but are unable to properly review the operation and performance of regulators.

A wider and deeper accountability process is required under an industry-funded model.

2. LICENSING

The FSC supports the Interim Report's proposal of applying the AFSL regime to providers of critical administration and technology services where they are large scale/systemically important. Such measures would, respectively, assist market stability, and promote a level-playing field in the provision of financial services.

We have a similar view about any gatekeeper in the industry such as research houses. In our view, if a financial adviser must be licensed and have in place the appropriate professional indemnity insurance and operate inside an AFSL with the appropriate regulatory capital so as to give advice to customers, a research house, whose role is to give advice/information to both advisers and customers, should have similar licensing requirements.

In Australia, credit ratings agencies were brought under the AFSL regime following the crisis. However, this does not apply to research houses.

The fact that a number of research houses may not have the appropriate “protections” means that advisers and customers have no recourse in the case of poor advice. This is unacceptable.

Also, research houses generally don't have a relationship product list construction and platforms 'outsource' their investment lists to these research houses. In both cases there is often a requirement for a fund to receive a minimum rating from a particular research house before it will even be considered for addition to a platform. This effectively makes them the first filter for advice.

In addition, that research houses, generally, don't have a relationship with the adviser's client or knowledge of their client's personal financial situation, needs or objectives and therefore they cannot know or recommend the most appropriate cover for an individual.

Research houses can be an important tool for advisers but they cannot assess/rate the intangibles such as the relationship with the underwriter, claims handling or service levels -

which are all important and relevant considerations when an adviser recommends one insurer/platform over another.

RECOMMENDATION

Expand the AFSL regime to administrative businesses and research houses.

3. VERTICAL INTEGRATION

The majority of the focus on wealth management vertical integration in the interim report is from a superannuation competition perspective. There appears to be an inference that it is reducing competitive pressures in the market.

Vertical integration is a complicated topic in an industry which is heavily intermediated.

This is also complicated by the fact that nearly all superannuation funds are vertically integrated in some way.

Consumers who access a financial product or service from a vertically integrated organisation will benefit from the scope and scale efficiencies.

There are numerous forms of vertical integration which can be found in the superannuation industry as demonstrated in the table on the next page.

Outline

We believe that vertical integration in the superannuation sector is impacted by:

- ❖ Competition between major superannuation segments;
- ❖ Diversity in the distribution of superannuation;
- ❖ MySuper distribution dynamics and general rules framework; and
- ❖ Existing consumer protection mechanisms.

Market structure

The superannuation industry contains the following sectors:

Table 3.1: Sectors in the superannuation industry

	RETAIL	INDUSTRY	CORPORATE	PUBLIC SECTOR	SMSF
Number of providers ²	127	52	108	38	500,000
FUM (\$BN) ³	420	320	61	250	500
MySuper products numbers ⁴	51	48	21	9	n/a

A further sector which exists is Self Managed Superannuation Funds (SMSFs) which are supervised by the ATO.

The market structure is such that retail, SMSF and industry segments have a similar proportion of FUM. While each segment is not completely homogenous, funds within each segment typically operate under a similar structure.

Public sector and corporate segments (combined FUM similar to

² APRA annual superannuation bulletin 2014.

³ Ibid.

⁴ Plan for Life - MySuper report August 2014.

industry funds) do not typically face competitive pressures as occupational schemes, employers typically subsidise these schemes or they are protected against competition through enterprise agreements or Modern Awards.

As the largest retail funds are owned by banking or insurance groups, which are subject to the “four pillars” or former “six pillars” policy, further consolidation in this segment is highly unlikely.

Table 3.2 - SUPERANNUATION

Trustee services	Acting as trustee of the fund and performing necessary legal and compliance functions.
Investment management	Invest the assets of the fund.
Financial advice	Provide advice to members of the fund, includes call centres etc.
Life insurance	Provide life insurance benefits to members of the fund.
Asset consulting	Advise the trustee on appropriate asset allocation of the fund and investment manager selection.
Insurance consulting	Advise the trustee on appropriate benefit design and insurer selection.
Fund administration	Provide administrative support to the fund, including IT services, contributions processing, member records, providing information to members, processing claims and paying benefits etc.
Custody	Provide custodial, investment administration and related services to the fund.

Superannuation distribution

Superannuation distribution differs considerably in each sector. The impact of vertical integration is limited in each case.

As described above, corporate and public sector funds are largely immune from competition as they are a function of occupational superannuation. Distribution of such funds occurs through the industrial system.

Industry funds are also considerable beneficiaries of distribution via the occupational industrial system. However, this is changing

industry funds now source members directly from the public. Industry funds are increasingly vertically integrated through the ownership of the following operations:

- ❖ funds management;
- ❖ administration;
- ❖ financial advice; and
- ❖ asset consulting;

Industry fund vertical integration is similarly tempered by the series of self contained obligations / consumer protections as outlined below.

Retail funds represent a mix of occupational and genuine “retail” members. A financial adviser often advises genuine retail members. Wherever personal advice is provided, the robust FOFA requirements apply.⁵

SMSF members are all “retail” members and mainly advised to establish such a vehicle.

MySuper (default market)

All APRA regulated segments offer MySuper products. Most Australians (approximately 80% of the APRA regulated market) are in a MySuper product.

In the MySuper default market segment, the distribution of products occurs due to an employer choice where permitted, by Modern Award or enterprise agreement.

In all cases, a MySuper product must be selected. MySuper products may not pay commissions and have a range of additional trustee duties, disclosures and conduct requirements.

Large businesses often put their superannuation fund out to tender (where Modern Award restrictions do not apply). Tenders are typically operated by independent parties, who are able typically able to extract scale discounts for employee members.

As a result of varying distribution methods and the MySuper regime, vertical integration in superannuation is limited.

Existing safeguards

There is a range of existing safeguards applying in superannuation to protect consumers, such as:

⁵ See additional FOFA comments in chapter 2.

1) Prohibition on inducements: where an employer is entitled to select a superannuation fund, the trustee is subject to S68A of the Superannuation Industry Supervision (SIS) Act, which prohibits the payment of inducements by the fund or related party (such as bank or union) to an employer;

2) All AFSL holders have a conflicts management obligation.

The FOFA laws provide for a:

1. Best interest duty for financial advisers;
2. Requirement to always place the client's interest first;
3. Prohibition on commissions for personal or general advice (ex risk insurance);
4. Broad-based prohibition on conflicted remuneration payments for personal advice;
5. Permitting scaled advice with legal certainty;
6. New disclosure obligation for advisers; and
7. Suite of new powers for ASIC;

3) The FOFA prohibits certain conflicts such as the payment of commissions generally. The MySuper laws also specifically prohibit the payment of commissions or conflicted payments in relation to MySuper products.

4) The MySuper provisions impose a range of additional duties that MySuper trustees must adhere to. Once such requirement is contained in Section 29VN of the SIS Act: additional obligations of a trustee in relation to a MySuper product:

5) Each trustee of a regulated superannuation fund which includes a MySuper product must:

- (a) promote the financial interests of the beneficiaries of the fund who hold the MySuper product, in particular returns to those beneficiaries (after the deduction of fees, costs and taxes);

6) APRA prudential standards, in particular, Superannuation Prudential Standard "Conflicts of Interest" establish additional explicit requirements for superannuation funds on conflicts.

The standard requires that trustees:

- ❖ develop, implement and review a conflicts management policy that is approved by the Board;
- ❖ identify all relevant duties and relevant interests; and
- ❖ develop registers of relevant duties and relevant interests;⁶

⁶ SPS 521 - conflicts of interest.

We believe this combination of consumer protections addresses concerns about conflicts or priorities

RECOMMENDATION

There are numerous forms of vertical integration which can be found in the superannuation industry. Vertical integration dynamics are impacted by competition, market structure and consumer protection frameworks.

Consumers who access a financial product or service from a vertically integrated organisation will benefit from the scope and scale efficiencies.

4. DATA

APRA has responsibility for the collection, analysis and publication of data, some of which is constructed by APRA. It is readily quoted by media and used in advertising by segments of the industry to influence consumers' decision making, especially in superannuation.

APRA, as an effective prudential regulator, entities rather than publishing consumer data sets.

Collection and analysis of data is a critical component of prudential supervision which would not be impacted by moving the consumer data publication arrangements to another entity.

We believe that The Australian Bureau of Statistics (ABS) is a preferred alternative to APRA for producing and publishing industry statistics. The FSC supports the idea that there is official statistical data produced and made publicly available.

RECOMMENDATION

The ABS should commence publishing industry data for public consumption in place of APRA.

APRA should continue its role analysing data of regulated institutions.

The ABS has experience in collecting, organising, publishing and commenting on data. We are comfortable that the ABS, with industry feedback, could develop a set of meaningful data that can be used to inform the market, and in particular, the regulators and financial commentators.

APRA would be an important stakeholder in determining what data they need to properly carry out their prudential regulatory functions.

RECOMMENDATION

The FSC recommends that APRA retain the role of collection and analysis of data to meet its prudential regulatory responsibilities. Production and publication of data in the financial sector should be conducted by the ABS.

Under this framework:

- ❖ APRA would collect, analyse and pass on the appropriate data to the ABS;
- ❖ The ATO would collect and pass on SMSF data to APRA for analysis and to the ABS for data reporting; and
- ❖ The ABS would undertake data reporting on the entire superannuation and financial services industry.

For the purposes of producing statistics, superannuation industry wide data should be published by the ABS based on the raw collections of the ATO and APRA.

However, we submit that APRA carry responsibility for analysing this SMSF data for the purposes of identifying emerging issues which may need to be escalated to ensure SMSF monies are not at risk. Systemic or prudential issues should be considered by APRA given the risk this large and evolving pool of savings could have on retirement savings if this sector were to suffer a systemic failure.

RECOMMENDATION

SMSF data should be collected and analysed by APRA for the purposes of prudential analysis. The ABS should produce statistical reports on the entire superannuation sector.

Data sharing

The FSC welcomes the Interim Report's observation that 'technology is a powerful force for change in the financial system, potentially improving efficiency and competition, and benefitting consumers'. Effectively harnessing technological change is a core challenge for the financial services industry.

Technology offers much scope for innovation and improved consumer products and services. Accordingly, the FSC supports the Interim Report's proposal to establish a central mechanism or body to monitor

and advise government on technology and innovation, and development of a whole-of-government technology strategy.

An effectively implemented strategy for financial services would yield substantial benefits for consumers, Government and industry. This should form a core element on the government's digital economy strategy.

RECOMMENDATION

A financial services stream in the digital economy strategy should be established. This initiative must determine ways in which to share government data with the financial services industry.

A central tenet of that strategy should be an acknowledgement that the Government must make better use of the vast amounts of data it collects. As noted by the CoA, the Government has to take advantage of 'opportunities that come with the greater availability of data and enhanced data analytic capabilities', so as to enhance policy outcomes and services. The Commission noted that 'data sharing also needs to be improved to facilitate innovation across agencies and from outside the government.

Further, the Productivity Commission has previously highlighted that 'Australia makes relatively little use of its public data resources even though the initial costs of making data available would be low relative to the future flow of benefits...a failure to exploit this evidence would be a missed opportunity given Australia's demographic and structural budget challenges'.

The FSC considers this summation to be both accurate and sobering especially in the context of reducing underinsurance (we canvass this extensively in chapter 2).

Big data

Better management of government data presents great opportunities for the private sector and consumers, including allowing more tailored products and services. Indeed, the FSI Interim Report acknowledged that financial services firms are well placed to benefit from 'big data'. We believe that insurers are particularly well positioned to capitalise on better access to data.

Data sharing between Government and the private sector, and data

analytics, will be crucial to the next wave of innovation in the sector. For example, better collation and management of health data would allow life insurers to offer more personalised, risk-weighted products. Indeed, through the development of health and wellness programs that incentivise healthy behaviour, track this behaviour and provide immediate rewards and the resultant data which is captured for each member, can influence the amount paid in life insurance premiums.

These programs can increase the tangibility of life insurance as consumers can engage with it on a day-to-day basis rather than at the point of claim. From a health perspective, similar programs conducted overseas have had strong impact in helping to reduce hospital and GP visits and improving the health of members over the long term.

In turn, greater up-take of insurance products would help relieve underinsurance and the strain on Australia's welfare system - a system which will come under increasing budgetary stress owing to our rapidly ageing population.

Accordingly, FSC strongly encourages such data sharing, while ensuring privacy and security concerns are carefully managed. We are confident these concerns can be appropriately dealt with so as to allow the Government and private sector to access a valuable, untapped resource. We are firmly of the view that such data sharing would be mutually beneficial, rather than representing a zero sum game where consumers will lose out.

RECOMMENDATION

Additional government data sets should be released to improve consumer outcomes, industry analysis and public policy development.

