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Abstract

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Keywords

Analysis, Financial, Services, Regulations, Australia

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An Analysis of the Financial Services Regulations of Australia

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The purpose of this paper is to critically analyse various aspects of Australian Financial Services Regulation in terms of Llewellyn's Theory of Financial Services Regulation and offer suggestions for the improvement of FSR based on the analysis. A discussion based approach is used to conduct this analysis. It is observed that the FSR Act, 2001 of Australia does not cover credit products thereby leaving an important segment of the market outside the purview of the Act. The policies developed by Australian Securities and Investment Commission (ASIC) on FSR Act relies on Industry self regulation as mechanism of creating trust and confidence in Financial Service Industry. This approach has limitations in achieving its objective. The Australian regulators face considerable challenges in generating confidence and trust although ASIC has put in place disclosure regime and client protection provisions that help in providing relief to the consumers. This paper provides a contribution to the literature on Financial Services Regulation as it examines the development of regulation in terms of a theoretical framework to determine its adequacy and fairness.

Key Words: Financial Regulation

1. Introduction

Financial Services Reform Act (FSR Act) was enacted to be a law in Australia on 27 September 2001. The act became operational on 11 March 2002 after a two year transitional period. The Act was developed as the sixth stage of Corporate Law Economic Reforms Program (CLERP) of the Australian Federal Government. The purpose of the Financial Services Reforms (FSR) Act is to establish a uniform licensing, conduct and disclosure regime for financial service providers in Australia. It is argued that these Financial Services Regulations should help in providing a regulatory regime in Australia which is cost effective, help in reducing the net regulatory burden and make the regulation simple for the industry and the consumer alike (Department of Treasury, 2001). The regulation should "promote confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of goods and services, fairness, honesty and professionalism by the providers of financial service: fair orderly and transparent market for financial products" (Axiss Australia, 2002, p.1)

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In the light of these claims, it is necessary to analyse the likely impact of regulation on various stakeholders and understand the important aspects of the regulation in terms of its stated objectives and in terms of the literature available on financial service regulation. In Section 2 of this paper, important theoretical aspects of literature on financial service regulations are discussed Based on the literature review, various criteria for analysis of the Australian Financial Service Regulations are developed on which the Australian Financial Services Regulations are analysed in Section 3. Conclusions are from the discussion in Section 4 of this paper.

2. Literature Review

The Theory of Financial Services Regulation was developed by Llewellyn in 2005 for British Financial Service Authority. This theory describes the nature of financial transactions and the requirements of regulations for financial services. According to Llewellyn's Theory (2005) retail financial transactions differ from other products and services on a number of characteristics. Llewellyn (2005) differentiates financial contracts from other contracts because "Financial transactions involve incomplete contracts. These contracts are relational rather than transactional. These are long-term. The value of a financial contract is determined by the behaviour of the supplier after the contract has been purchased. This creates the potential for opportunistic behaviour on the part of the supplier after the financial product or service is purchased" Llewellyn(2005) further argues that " the amount of information available at the time of the purchase of a financial product is inadequate to guard against the potential hazard of opportunistic behaviour on the part of the supplier. If the contract goes wrong, exit costs are high for the consumer. The consumers have only limited experience or ability to learn from experience as the products are not purchased frequently. (Llewellyn, 2005, p.333-346). According to Llewellyn (2005), any regulation of financial product or service should take into consideration these unique characteristics of financial product or service and safeguard the consumer against the opportunistic behaviour of the supplier. According to Davies (1998), the regulation of financial services should help "to promote confidence in the markets, help promote public understanding of the risks and benefits of the financial products and prevent the financial businesses being used for the purpose of financial crime". In addition to the specific purposes of the regulation cited above, Davies (1998) also outline general purposes of regulation which are - efficiency, no distortion of the competitive markets, the facilitation of innovation and the requirements to assess the cost and benefits of the regulation. Smith and Walters (2003, p. 336-338) provide the objectives of the regulatory system for financial services. These according to Smith and Walters (2000) are "the maintenance of safe and a sound financial system – one that is resistant to collapse and avoids the contamination of the payment system and the credit allocation system, safeguarding the assets of uninformed retail consumers, who have deposited their savings in good faith under the presumption of absolute safety backed by the institutions and the state and the assurance of fair dealing in financial transactions, avoid moral hazard and adverse selections, assure market transparency, prevent abusive

practice" Any financial service regulation should be able to meet the criteria set by the theory as given above. For the purpose of this paper, the following elements based on the Llewellyn's theory (2005) and objectives of the regulations discussed by Davies (1998) and Smith and Walters (2003) are considered as necessary for a regulatory system in place for financial services. These are:

1. Unique nature of financial product. Financial products involve incomplete contracts because the terms and conditions on which the contract is agreed may change before the maturity of the contract resulting in changes in the outcome of the contract (for the consumer and the FSP) from what was initially agreed. The fulfilment of contract depends on the future behaviour of the supplier and there is a great potential for opportunistic behaviour on the part of the supplier. A regulation should address the issue of the future behaviour of the supplier.
2. Consumer Protection. The future value of a financial product is not immediately clear at the point of purchase. The consumer often cannot know if a bad product is purchased. The value is often critically determined by the personal circumstances of the purchaser. The future welfare of the consumer depends on the performance of the contract. A bad financial product cannot be surrendered except at a substantial cost. A regulation should provide for the safeguards for the protection of the value for the consumers.
3. Disclosures and Transparency. Due to the complexity of the financial contacts, consumers face lack of transparency, information problems, moral hazard in purchasing a financial product. Consumers have only limited experience or ability to learn from experience as the products are not purchased frequently. Therefore consumers have information asymmetry towards the supplier and a regulation should address the issue of information asymmetry between the Financial Service Provider (FSP) and the consumer
4. Trust and Confidence. The regulation should also promote confidence of public in the markets in addition to protecting consumers, promote public understanding of the risk and benefits of the financial products and help in preventing financial crimes.
5. Secondary objectives. An effective regulation should be able to address the issue of costs and benefits of the regulation and be efficient in its delivery

3. Methodology

The theoretical framework developed by Llewellyn (2005) is used to develop a set of criteria on which the impact of Australian Financial services on various stakeholders are analysed. Llewellyn's theory provides the basis for the critical discourse analysis of Australian financial services regulation. The evidence available from literature is used to analyse various aspects of Financial Services Regulation of Australia. This approach helps in understanding the regulatory impact in a systematic way. The aspects of the

Australian Financial Services Regulation mentioned above are examined in this paper.

4. Analysis of Australian Financial Services Regulations

4a. Unique Nature of Financial Product

The unique nature of financial product needs to be considered in the development of financial services regulation. Australian FSR Act differentiates the financial products from other products by providing a broad and functional definition of these products. According to FSR Act, 2001 a financial product is a product which involve

Making a financial investment (s.763B)
Managing a financial risk (s.763C)
Making a non-cash payment (s.763E)

The FSR Act specifically includes (s.764A) products such as shares, debentures, derivatives general and life Insurance, superannuation interests, deposit taking facilities, non-cash payments (travellers cheques, debit and credit cards, cheques) are specifically included in the Act. The most important exclusion in the definition of financial products is the provision of loans or credit facilities, which are not included as financial products. The other exclusions are (s.765A) - the physical delivery of cash and foreign exchange contracts that are settled immediately with physical cash; certain insurance products – health insurance, reinsurance, insurance provided by Federal or State Governments, interest in some unregistered managed investment schemes, contracts for future services (Futures and Forwards)

The exclusion of credit products from the definition of financial products has considerable implications for the operation of the FSR Act. The credit or loan market in Australia is very big and every Australian has some credit contract either for a car or a house. The bank lending to persons in Australia is estimated to be $692.3 Billion during in Feb. 2007 and Oct. 2006 and Commercial lending is estimated to be $439.2 Billion during the same period.(RBA, 2007). The exclusion of credit from the lists of eligible financial product leaves an important segment of the amarket from the provision of the regulatory system and regulatory requirements such as appropriate disclosure regimes, protection of credit clients. The Financial Regulations of UK include Credit as a financial Service.(FSA, 2003) .The Financial Service Authority of UK provide for appropriate norms of disclosure for credit products which are treated at par with other investment and saving products. On the contrary the Australian regulations are focused on deposit products and investments. Even for the products included in the FSR Act there are a number of ambiguities in defining these products. For example, FSR Act introduced a definition of security which includes shares and debentures in bodies corporate but does not include government bonds, interest in registered managed investment schemes or options (other than options over unissued securities). Under FSR Act, derivatives include options over securities and derivatives, options over tangible property and any other options prescribed by the regulation.

Derivatives also include FX(other than spots). equity derivatives and commodity derivatives. However, where a derivative is another type of financial product, it is not considered a derivative. Options over unissued securities are treated as securities only. These ambiguities in definitions are likely to create considerable confusion for the investors and dealers. (Axiss Australia, 2002, p.7) There is no evidence to suggest that the regulation recognises that financial contracts as incomplete contracts The FSR Act thus avoids dealing with one of the most important aspects of the theory.

4b. Client Protection

According to the theory, consumer protection is a critical objective of any regulation in place. It is difficult for the consumer to make a rational choice because of the complexity of the financial contracts, informational problems, lack of transparency, cost and returns on financial products being uncertain at the time of entering into contract. The Australian Regulation seeks to deals with the problems in two ways. First method is by differentiating between wholesale and retail clients. This differentiation places additional requirements on the part of suppliers while dealing with retail clients. The other method is by disclosure requirements placed on the Financial Services Providers and by licensing requirements. Disclosure and licensing requirements are discussed in the later sections of this paper. In this section the obligation placed on the suppliers while dealing with retail clients and the implications of various provisions on the retail clients are discussed.

The regulations provide for different obligations to wholesale and retail clients. Retail clients are to be provided with extra information such as Financial Service Guide(FSG) and Product Disclosure Statements(PDS) and Statement of Advice (SOA). There are special provisions in the legislation that help in determining whether a client is wholesale or retail. There are two types of test recommended in the legislation. The first is the product value test of the client which stipulates that where the price of the financial product (or the value of the financial product to which a financial service relate) is greater than prescribed amount (usually $500,000), the client will be presumed to be a wholesale client. The second test is the individual wealth test where an individual is regarded as a whole sale client if a qualified accountant certifies that the person has net assets of at least $2.5 million or gross income of at least $250,000 in the previous two financial years. (Axiss Australia, 2002, p.14)

The FSR Act, 2001 requires that any financial advice given to clients must be appropriate to client's objectives, financial needs and situations. The financial planner has to give due regard to clients' situation. There are many problems with the approach adopted in the FSR Act. First, most of the financial planners are likely to derive their income from wholesale clients more than they could get from retail clients, the retail clients are unlikely to get the same level of service from financial planners as their wholesale clients With additional requirements placed on the FSPs by way of providing the Financial Service Guide and the Product Disclosure statements, the FSPs will find dealing with the retail clients to be less profitable than wholesale clients. Wholesale clients

are usually sophisticated investors who can shop around for better rates and avoid fees and charges. Retail investors are likely to purchase financial products from providers without shopping much. As such retail clients are likely to get substandard service from FSPs and their advisors. Consequently the services available to retail clients will suffer.

Under the FSR Act, Financial Advisors are required to give proper advice based on their risk assessment of clients. The Act however does not lay down any minimum standards for risk attitude assessment of the clients by Financial Advisors. According to McCrae (2006) this lack of industry standards in risk assessment could significantly influence the validity and accuracy of the risk attitude assessment of the clients by Financial Advisors and could have significant effect on the quality of advice given. McCrae(2006) has suggested observance of minimum standards for assessing the risk attitude of the clients to avoid the effect of "anchoring" and framings in the provision of the financial advice. Moral hazard, particularly for the retail clients is an important issue because retail clients do not have adequate resources or expertise to assess the quality of products or advice given to them by Financial Advisors nor do the retail have adequate information available to them for assessing the solvency or future behaviour of the supplier of the financial services and products. This places the retail clients at a considerable disadvantage with respect to FSPs and Financial Advisors.

4c. Disclosure Requirements

The FSR Act provides for disclosure about products and about the conduct of the business by the service providers to address the issue of information asymmetry between the consumer and the service provider. The product disclosure is administered by ASIC through FSR Act while the market disclosures by the firms are administered through the Corporation law. FSR Act provides for the same information for similar products so that it becomes easier to compare similar products from different suppliers. A Financial Service Guide (FSG) is to be provided to retail clients (s941a). FSG need not be provided where no financial advice is given to clients or where there is a general advice is given. A Statement of Financial Advice is to be given to clients where personal financial advice is given (s944a). A Product Disclosure Statement (PDS) is to be given where a product is recommended or offered. A PDS should include any information which may materially affect client's decision to buy the product. The PDS is required to include information about the benefits of the product, tax liabilities, risks, features, cooling off arrangements. Financial Services Guide (FSG) and Product Disclosure Statements (PDS) are important source of information for the consumer that helps them in the investment decision making process. Consumers get considerable information from these documents that help in comparing products and decide about the suitability of the products to their financial situation. There are, however, many limitations in the provision of information contained in these documents. Consumer Federation of Australia (CFA, 2005) have observed duplication of information between Financial Services Guide and Product Disclosure Statements and caution against over reliance on disclosures in these documents as a consumer protection tools. Hamilton and

Gillies (2003) have observed that the disclosure regimes were ineffective because of - timing of disclosures, the language used in the documents and its format, the documents did not always provide information that the consumers regarded as key

Financial Service Authority (2000) suggests that consumers tended to read risk information in disclosure documents (such as PDS and FSG) as a disclaimer rather than as a warning. The research showed that these disclosure documents appear to have little impact on consumer behaviour. The information supplied was not the information the consumer wanted The regulator's faith in these documents as source of well designed information could be misplaced. Since financial products are complex and uncertain, the consumers may want to look for brand name and trustworthy firms on which they could place their faith rather than depending on the well written and well presented documents such as PDS and FSG.

Experience with the Consumer Credit Code in Australia has shown that when it comes to interpreting new legislation such as FSR Act, financial institutions are likely to be very cautious if they are having difficulty interpreting new legislative requirements. (Allens Arthur Robinson, 2006) This means that that consumers have been provided with lots of detail they neither want nor are likely to read. The information in the documents could be drafted in a defensive way with the purpose of protecting the firms should something may wrong rather than helping the consumer in arriving at an appropriate investment decision. Thus, PDS and FSG have severe limitations in providing the relevant information to the consumers and help them in reaching an investment decision.

4c. (i) Market Disclosures

When product disclosures are not effective in providing information to the consumer about the firm behaviour in future, consumers may rely on the firms' reputation and brand name. The market disclosures by the firms help them in doing that. The market disclosures affect the firms by influencing the firm's reputation. Consequently market disclosures help in inducing a discipline in firm's behaviour. Combined with proper regulatory action, market disclosures can affect the firm's share price, debt rating, managerial remuneration. Even when regulatory action is delayed market discipline can have quick effect on the firm's conduct. Walters (2004) have argued that "regulatory constraints and litigations are relatively blunt instruments in dealing with the issues such as conflict of interest in financial firms". They support the role of market discipline as a consistent and durable basis for providing a deterrent effect on firm's franchise value as compared to external regulatory constraints in dealing with issues like biased client advice, involuntary cross selling, churning, excessive margin lending, misdealing disclosures and reporting. Australian Securities and Investments Commission (ASIC) administers the market conduct of the firm through Corporation Law whereas Australian Prudential Regulatory Authority (APRA) regulates the systemic risk arising due to firm's conduct. By reinforcing market disclosures as a tool of market discipline and regulation for financial firms, Australian Regulators recognise

the limitations of regulatory action on the conduct of business by financial firms. (Walters, 2004).

4d. Confidence and Trust

The issue of consumer confidence in the provision of financial services is important issue because consumer expectation in regard to financial services is high and the degree of consumer dissatisfaction with the performance of financial service providers is also very high. According to Falconer (2005) there is a considerable degree of dissatisfaction with the performance of financial service sector with regard to meeting their fiduciary responsibility. The selection of providers in such a case becomes critical for the consumers. Before doing business with Financial Service Provider (FSP), a consumers would like to have an assurance that that the provider is honest and reliable. Falconer (2005) suggests that the extent to which the providers meet their fiduciary responsibility is important to the consumers. The regulation should need to address the lack of consumer confidence in the financial service industry. The FSR Act addresses the issue of trust and confidence in the financial service industry in two ways. First, ASIC has put in place a licensing regime for Financial Service Providers and specified the qualifications which FSPs have to meet in selecting their agents and renewing their licenses. The second mechanism is of self regulation by industry through Industry Sponsored Code of Conduct. (ASIC Policy Statements No. 146 and 183)

FSR Act states that a business that provides a "financial service" must be licensed. This includes businesses that provide financial product advice and that deals in financial product. This first category includes insurers or intermediaries who make recommendations or statements of opinion that are intended to influence a prospective customer's decision in relation to a particular financial product. It also includes recommendations or statements that could reasonably be regarded as having such an influence. The second category includes agents who arrange for a person to acquire a financial product. Financial Services Licenses are issued by ASIC. ASIC imposes conditions on issuance and renewal of licenses which need to be observed by the licensee. ASIC Policy statement No 164 provides guidance on the licensee's system of business conduct, risk management and dispute resolution system. Any breaches of license conditions are to be notified to ASIC immediately by the licensee.

The licensing regime administered by ASIC has the purpose of providing a regulatory mandate to FSPs. A FSP with an ASIC license is deemed to have more legitimacy than others as ASIC takes the responsibility of enforcing the license conditions and market behaviour of the firm. But the issue of trust and confidence in a FSP is more than obtaining license from ASIC. A license does not guarantee that the FSP will meet its fiduciary obligation to a client as and when these arise. The licensing regime also does not provide for consumer education and information by the licensee although it might be in the interest of the firm to do so. ASIC insists on a dispute resolution process for FSPs licensed. One has to understand that in the event of a dispute between the FSPs and a consumer, FSPs have information asymmetry with respect to

consumers. FSPs also have more resources at their disposal as compared to consumers, which help the FSPs in pursuing their position vigorously. The dispute resolution processes are usually very costly for the consumer. In the event of a dispute, the consumer may have to incur the cost of dispute resolution in addition to the already incurred loss on the contract. Consumers are at a considerable disadvantage with respect to FSPs if a dispute arises between the two.

Further there are numerous exemptions provided in the operation of the licensing regime which dilute the oversight of ASIC. For example, the insurance agents who provide insurance services only to their related bodies corporate are excluded from the provisions of the licensing requirements as handling and settlement of insurance claims is not considered as financial service under the FSR Act. These exemptions contribute to the perception of lack of trust and confidence that consumers have in the Financial Service Providers. (ASIC Policy Statement No. 146)

4e. Industry Code of Conduct

The second method by which, ASIC hopes to create the trust and confidence in financial service providers, is through encouraging the Industry Code of Conduct. ASIC regards that industry codes of conduct play an important part in the regulation of financial products and services in Australia. These codes can deliver benefits to the consumers and subscribers. ASIC believes that codes improve consumer confidence in an industry including financial service industry, raise the service standards and complement the legislation. In short ASIC encourages self regulation by Industry through the development of Industry Codes of Conduct (ASIC Policy Statement No. 183). Wallace et al (2000) have identified many factors that can influence the effectiveness of self regulatory schemes such as Industry Code of Conduct. These factors include the market conditions and the design for self regulatory codes of conduct. Among the market conditions, Wallace (2000) identified the price of product, the extent to which consumers can switch between products and services in response to price or quality, the complexity of products, the level and nature of consumer complaints, the cohesiveness of the industry and the level of participation as the factors which can influence the effectiveness of the Industry Codes of Conduct. Wallace (2000) sets out the conditions which are necessary for self regulatory Industry Codes of Conduct to be effective. These are – transparency and extensive consultation in scheme development, Independence of operation, appropriate representation of consumer interests, easy access to the consumer to dispute resolution process, provision of sanction against firms in case of non-compliance and provision of regulatory review. ASIC has included these conditions as part of its regulatory regime. It remains to be seen how these are implemented in practice. One issue that deserve special attention and which ASIC need to look into carefully is the cost of dispute resolution process to the consumer. It is neither easy nor cheap for the consumer to resolve dispute with the industry provider. The cost to the individual consumer is high and the process is complex. Over-reliance on self regulatory mechanisms is detrimental to the interest of the consumers.

4f. Cost and Benefits of Regulation

An effective regulation should be efficient. One of the main arguments advanced in the development of FSR Act was that the current regulation would be less costly than the previous. The development of FSR has reduced some costs and introduced many other new costs for the regulator. The increase comes from the cost of establishing and implementing a new set of regulation imposes tax on financial intermediaries because the intermediaries subsidise the regulator. Financial intermediaries in turn pass on their costs to consumers by way of increased spread on services they provide. The licensing regime put in place have the potential of increasing the compliance costs for the intermediaries. In addition the licensing reduces competition. This could lead to inefficiencies in the market which increases costs to consumers. The benefits include improved efforts at providing training and greater effort to educate consumers about the product they are purchasing and reporting of information about the products. A better liaison between the two regulators – APRA and ASIC - will help in reducing any duplication in regulation and the resulting costs.

5. Conclusions

The main contribution of this paper is to use a theoretical framework developed by Llewellyn (2005) for the analysis of Australian Financial Services Regulations. This paper provides an application of Llewellyn's theory to the Australian context. The use of a theoretical framework in the analysis of Australian Regulation helps in better understanding of the regulatory impact on various stakeholders. The analysis was done based on five criteria developed by using the theory of Llewellyn(2005) – Nature of the product, consumer protection, disclosure and transparency, trust and confidence and the costs and benefits of developing the new regulation. From the analysis in section 4 of this paper it can be concluded that Australian Financial Services regulations have been developed, to ensure that a balanced approach to market conditions, are combined with community expectations about the implementation of the regulation. The regulations address the issues of competition, safety and consumer protection through its various disclosure regimes put in place for the intermediaries. The criteria set in the theoretical framework of Llewellyn are met by the Australian Financial Regulations and Llewellyn's theory adequately explains the five dimensions of Australian Regulation as discussed. However, there are a number of shortcomings in the regulation and suggestions are offered below which can be useful in better operation of the regulations.

1. Some of the definitions given in the FSR Act, 2001 are confusing (such as derivatives) to the investors. It is the purpose of the regulation to provide clear definitions of terms used in order to avoid the possibility of any ambiguity in interpretation. (Allan, 2002)

2. Credit is not included as a financial product in FSR which results in an ambiguity. Credit market is very big in Australia and non-inclusion of credit leads to lack of disclosures and transparency in the delivery of credit products. A very big segment of the market is not covered by the FSR.

3. Product disclosure documents such as PDS and FSG have limitations in provision of adequate disclosures as the information contained in these documents could be defensive. Market disclosures create more trust and confidence in the consumer in regard to specific firms. Regulators need to recognise that the consumers are better informed by brand names and business reputation and put less reliance on the disclosure documents which making decisions about the investments. Over-reliance on PDS and FSG can be counter-productive.

4. The licensing regime put in place through FSR has the potential of creating trust and confidence in the delivery of financial services as minimum standards are being enforced in licensing by ASIC. The Industry Codes of Conduct are however not likely to help the consumer much as Industry Organisations are known to be defensive in dealing with the consumer although there are specific provisions in the regulations for regular review and penalties for non-compliance which help in generating trust and confidence in the delivery of regulation.

5. The cost of regulation is likely to increase as the two regulators- ASIC and APRA – will enforce product and market based disclosures. The user pay method of regulation means that Industry Organisations are in a better position to influence the regulatory outcomes as compared to consumers. A proper coordination between APRA and ASIC is necessary to ensure that cost of regulation does not increase. It is suggested that appropriate regulatory independence should not be compromised in order to reduce the costs of regulation and net regulatory burden on the industry. The real impact of regulation will become clear after the introduction of Basel. II norms in January 2008. Ultimately the test of every regulation is in the prevention, measuring and predicting financial crisis (Currie, 2006). So far Australian regulations have been able to withstand that test from 2001 onwards.

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