The biggest changes to the financial system since the Wallis Inquiry

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Corporate Governance Forum 2014

3 June 2014

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Introduction

Good afternoon and thank you very much for inviting me to speak today. I'm delighted to be here at the Corporate Governance Forum.

Today I will outline the perspective of the Australian Securities and Investments Commission (ASIC) on the biggest changes we have seen in the financial system since the Wallis Inquiry, and what we can learn from them.

Overall, Australia's financial system has performed very well over the last few decades. Our financial system has helped facilitate sustained growth of the economy.

However, there are:

- lessons – positive and negative – that can be drawn from the experience in the financial system over the last two decades, and
- opportunities to build on the successes we have seen.

Today I will focus on three topics:

- first, the significant changes and major developments we have seen in the financial system since the Wallis Inquiry
- second, some lessons we have drawn from our regulatory experience during this time, and
- third, some changes and reforms we have suggested to the current Financial System Inquiry.

Topic 1: Significant changes and major developments in financial markets since the Wallis Inquiry

From ASIC's perspective, three of the biggest changes in the financial system have been:

- structural change in financial markets
- increasing technology and innovation, and
- globalisation.

Structural change in financial markets

Structural change is altering the shape of Australia's financial markets, as well as markets globally.

Since the Wallis Inquiry, markets have become more integrated, competitive, global and complex. This is providing better investment and capital raising opportunities, while competition has the potential to drive down costs and drive up service standards.

There is also a shift to market-based financing driven by:

- the growth in the superannuation and pensions sector, and
- increased banking regulation.

New types of market-based financing are also emerging, including crowdfunding and peer-to-peer lending. These changes have brought new opportunities, but they also create risks for market resilience.

Technology and innovation

Of course, none of these changes would have occurred without technology and innovation.

Technological change has brought considerable benefits to consumers of financial services over the last two decades, and has the potential to provide more choice and allow new entrants. However, technological developments also raise some challenges and risks for financial stability and regulation.

On one level, as a regulator, we need to make sure we are not imposing unnecessary burdens on innovative technologies and non-traditional market entrants. However, at another level, the risk of cybercrime has increased significantly. This poses major challenges for cross-border enforcement.

Globalisation

Finally, globalisation has also been a significant change. As I mentioned, Australia’s financial markets are now much more integrated with international markets than at the time of the Wallis Inquiry.

Encouraging further integration could deliver significant economic benefits to Australia. The area where the most immediate potential benefit lies is in the Asian region.

At the same time, globalisation has challenged regulators to ensure we meet international standards. Failure to keep pace with relevant international regulatory standards could lead to the risk of:

- Australia’s regulatory system not being assessed as adequately equivalent, and
- entry to markets being closed off to our market participants.

Topic 2: ASIC's regulatory experience since the Wallis Inquiry

Turning to my next topic, as well as reviewing the changes we have seen, it is important to understand the lessons – both positive and negative – we can learn from our experience since the Wallis Inquiry.

Some of the most significant lessons come from times where things go wrong – institutions collapse, investors lose money and the system breaks down.

While each case is different, in many instances of financial collapse or failure, consumers:

- did not understand the level of risk they were taking on
- thought they were bearing lower risks than the actual risks of the product or strategy, and
- ended up bearing more risk than they could manage.

A second common factor in these cases has often been conflicts of interest in business models or structures. This meant consumer misunderstandings could be exploited for the benefit of the financial services provider. A particular example of this is the conflicted remuneration structures that were typical in financial advice businesses for a long time. This problem led to the banning of many types of commission payments.

We think that understanding the factors behind consumer losses challenges some of the assumptions and philosophy underlying our financial regulatory system. In particular, the assumption that underpinned much of retail financial services regulation since the Wallis Inquiry – that disclosure is the best tool in almost every instance to fix market failures – has not been borne out in practice.

There are a number of significant limitations to disclosure as a regulatory tool, including:

- People may not have the time, inclination or capacity to read disclosure documents.
- Research in behavioural economics also indicates that consumers are not rational in their decision making. This may mean that people will not read disclosure documents, or misunderstand them if they do.

Understanding all this gives us potential to improve regulatory design with a better understanding of consumer behaviour and decision making.

On the other hand, it is also important to consider the lessons from the many successes in the financial system. A few of these include:

- the significant growth in the range of products and services available to consumers and businesses

- the technological innovations that have allowed consumers to safely undertake financial transactions online or through mobile devices, and
- the strong licensing regimes that have ensured that, in general, our markets are well-run and orderly, and market participants are well regulated.

Topic 3: Regulatory reforms to improve the performance of the financial system

Turning to my last topic, I will briefly outline some of the proposals ASIC has made to the current Financial System Inquiry.

Overall, we have suggested reforms we think will help ASIC and the financial system better meet the needs of Australian households and businesses into the future.

Some of our key proposals include:

- developing a mechanism to monitor and address systemic risk in the financial system
- encouraging further integration of international markets and cross-border flows
- better products and advice to help people manage their retirement savings during the retirement phase
- a more flexible regulatory toolkit for ASIC that would give us greater scope to address market problems without necessarily imposing new disclosure requirements
- a review of penalties under ASIC-administered legislation to ensure they provide the right incentives for better market behaviour, and
- a user-pays funding model for ASIC that better reflects the costs associated with market regulation.

Conclusion

As I said before, there is much we can learn from reviewing the very significant changes that have occurred in the financial system since the Wallis Inquiry.

We welcome the current Financial System Inquiry, as an ideal opportunity for this kind of review, and look forward to continuing to make a contribution to it.