

SURVEY REPORT

Financial services regulation in focus

Australia and the Global Financial Crisis (GFC): lessons learned and opportunities for reform in the financial services sector

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Finsia – Financial Services Institute of Australasia

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Research method

Between 10 and 22 July, 2009, Finsia conducted a survey of 396 of Finsia's Australian members. The survey asked a series of opinion based questions about the key lessons learned and opportunities for reform in the financial services sector in light of the Global Financial Crisis (GFC).

Further information and comments

Rachael Norcott A Fin – Manager – Policy and Public Relations

T > +61 2 9275 7923 **E** > r.norcott@finsia.com

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Introduction

One year on from the Lehman Brothers collapse and the beginning of the ensuing global financial crisis (GFC), seemed like an opportune time to reflect on the key lessons learned and opportunities for regulatory reform in Australia's financial services sector. This Finsia member survey report offers unique and timely insights informing such reflection.

Weathering the storm

Despite admitting that there is a need for a greater focus on governance and enforcement, those Finsia members surveyed largely believe (82 per cent) that the underlying strength of our financial regulatory environment protected us from the worst of the GFC. More specifically, 69 per cent of industry professionals believe this protection can be attributed to Australia's adequate and effective financial regulatory environment, while 68 per cent believe we were placed in a comparatively strong position because our banks' balance sheets were well capitalised in the lead up to the crisis.

Underlying causes, lessons learned and greatest challenges

When reflecting on the lessons learned from the GFC, a significant proportion (77 per cent) of finance industry professionals agree that securitisation needs tighter regulation (27 per cent strongly agree and 50 per cent agree). There is also recognition from a considerable proportion of participants that in the past, Australia's reliance on capital markets understated liquidity risk. These participants (74 per cent), believe that we must regulate to provide for minimum liquidity going forward (19 per cent strongly agree and 55 per cent agree).

When considering the underlying causes of the crisis, 97 per cent of participants blame high leverage investment strategies/ vulnerable balance sheets. In addition, 95 per cent blame the emergence of new mechanisms for shifting risk from party to party in financial transactions (credit risk was widespread and the size and location of exposures unknown) as an underlying cause. Furthermore, 93 per cent blame the underpricing of risk.

With regard to the aspects of the financial services industry requiring greater regulation, 62 per cent of participants claim that ratings agencies require better regulation. In addition, 62 per cent highlighted short selling as an area requiring tighter regulation and 62 per cent claim OTC derivatives should be subjected to greater regulation.

In considering the areas currently providing the greatest challenges with respect to the current economic environment, 67 per cent of participants nominated accessing funding and capital adequacy, Furthermore, 54 per cent nominated the uncertain economic outlook, and 53 per cent nominated risk management and compliance.

Making the most of this crisis

An overwhelming proportion of finance industry professionals are focused on Australia's significant advantage as a result of the crisis and how this can be used to the best advantage. Ninety three per cent of participants are of the view that Australia's success in weathering the global downturn presents a timely and valuable opportunity to promote Australia as a financial centre in Asia (43 per cent strongly agree and 50 per cent agree).

In addition, 89 per cent of participants believe that we should use this opportunity to develop a common Trans-Tasman regulatory framework to facilitate enhanced trade in services between Australia and New Zealand and the wider Asia-Pacific region (38 per cent strongly agree 51 per cent agree).

Interestingly, 74 per cent of participants agreed (21 per cent strongly agree 53 per cent agree) that while our 'twin peaks' regulation model (Australian Prudential Regulation Authority and Australian Securities & Investments Commission) does not need to be altered, there should be greater focus on governance and enforcement.

Conclusion

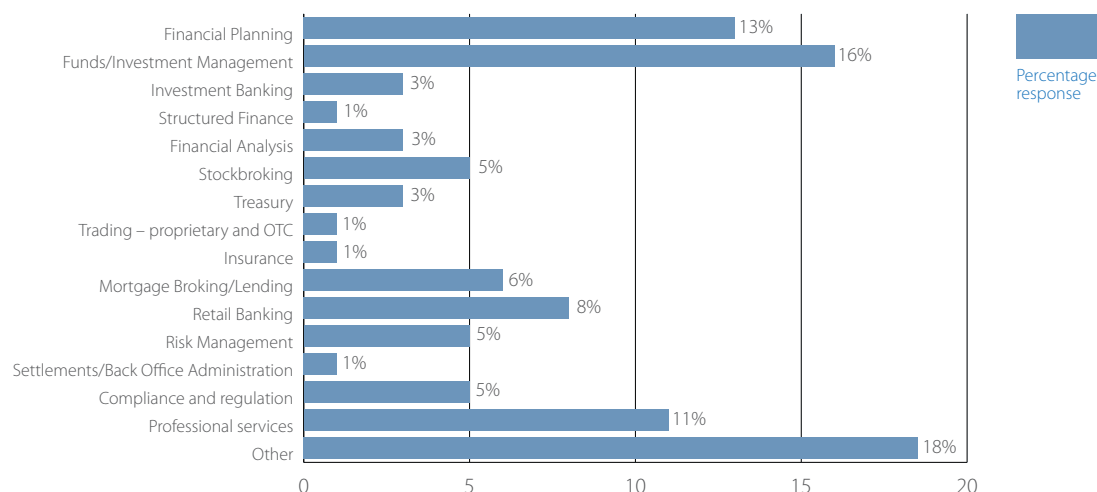
While it may be tempting to celebrate our success to date, it would be reckless to say Australia's financial regulatory framework is perfect and does not warrant review in light of our experience of the GFC. On the contrary, now is the most appropriate time to examine the weaknesses exposed as a result of the crisis and those aspects requiring modification.

Such an examination, together with Australia's significant advantage and credibility in the wake of the crisis, would enhance our ability to lead and influence international financial regulatory discussions and to promote Australia's strength as a financial centre within the Asian region.

Financial services regulation in focus

Q1: Please specify below which sub-sector of financial services is most related to your current role.

A1: Of those Finsia members surveyed, 16 per cent of respondents work in the Funds/Investment Management sub-sector, 13 per cent in Financial Planning, 11 per cent in Professional Services and 8 per cent are working in Retail Banking.



Q2: To what extent do you agree with the following statements regarding Australia’s financial regulatory environment?

A2: The Finsia members surveyed largely agreed with the statements below regarding Australia’s financial regulatory environment. In particular, 93 per cent are of the opinion that Australia’s success in weathering the global downturn presents a timely and valuable opportunity to promote Australia as a financial centre in Asia (43 per cent strongly agree and 50 per cent agree). 89 per cent feel we should use this opportunity to develop a common Trans-Tasman regulatory framework to facilitate enhanced trade in services between Australia and New Zealand and the wider Asia-Pacific region (38 per cent strongly agree and 51 per cent agree) and 82 per cent believe the underlying strength of Australia’s financial regulatory environment protected us from the worst of the global financial crisis (21 per cent strongly agree and 61 per cent agree).

Answer Options	Strongly agree	Agree	Disagree	Strongly disagree
Australia’s financial regulatory landscape will change significantly as a result of the crisis	9%	53%	37%	1%
The underlying strength of our financial regulatory environment protected us from the worst of the GFC	21%	61%	16%	2%
Australia’s financial regulatory setting is likely to be significantly influenced by the changes in international regulation (including the US Treasury and UK Financial Services Authority reforms)	13%	59%	27%	1%
Australia should take the lead in driving changes in the global financial regulatory system going forward	22%	50%	24%	4%
Australia’s success in weathering the GFC presents a timely and valuable opportunity to promote Australia as a financial centre in Asia	43%	50%	7%	0%
We should develop a common Trans-Tasman regulatory framework to facilitate enhanced trade between Australia and New Zealand and the wider Asia-Pacific region	38%	51%	9%	2%

Australia's strength in weathering the global downturn and underlying causes of the crisis

Q3: The latest Organisation for Economic Cooperation and Development (OECD) World Economic Outlook forecast confirms that Australia is the strongest performing economy in the OECD, with lower debt and lower deficits than any major advanced economy. Thinking about the impact of the GFC, which of the following factors do you believe positioned Australia in a comparatively strong position in weathering the global downturn?

A3: Of the Finsia members surveyed, 69 per cent feel that this can be attributed to Australia's adequate and effective financial regulatory environment, while 68 per cent believe we were placed in a comparatively strong position because our banks' balance sheets were well capitalised in the lead up to the crisis. Forty one per cent of members feel the effectiveness of the Federal Government's responsiveness to the GFC contributed to Australia's comparatively strong position.*

Answer Options	Response per cent
Our terms of trade before the GFC were at record highs	37%
Our banks' balance sheets were well capitalised in the lead up to the GFC	68%
The strength of the Australian housing market	27%
Australia has an adequate and effective financial regulatory environment	69%
The four-pillars policy eliminated the possibility of takeovers between our major banks, thereby reducing their incentive to become highly leveraged	34%
Purely good luck	21%
The effectiveness of the Federal Government's responsiveness to the GFC with the introduction of measures such as: the bank deposit guarantee scheme; the guarantee of wholesale funds; the purchase of additional Residential Mortgage Backed Securities (RMBS); and monetary and fiscal stimulus measures	41%

*A number of surveyed members attributed this comparatively strong position to multiple factors.

Q4: Thinking about what triggered the GFC broadly, to what extent do you agree that the factors below were the underlying causes of the crisis?

A4: Of the Finsia members surveyed, a large majority (97 per cent) attribute the underlying cause of the crisis to high leverage investment strategies/ vulnerable balance sheets (66 per cent strongly agree and 31 per cent), 95 per cent blame the emergence of new mechanisms for shifting risk from party to party in financial transactions (credit risk was widespread and the size and location of exposures unknown) as an underlying cause (66 per cent strongly agree and 29 per cent agree). Furthermore, 93 per cent blame the underpricing of risk (53 per cent strongly agree and 40 per cent agree).†

Answer Options	Strongly agree	Agree	Disagree	Strongly disagree
The blurring of roles played by different financial institutions (interlinked financial system)	22%	50%	27%	1%
The emergence of new mechanisms for shifting risk from party to party in financial transactions (credit risk was widespread and the size and location of exposures unknown)	66%	29%	4%	1%
High leverage investment strategies/vulnerable balance sheets	66%	31%	2%	1%
The wave of financial engineering and innovation	49%	36%	13%	2%
Cheap credit/easy money resulting in investors taking on more risk	53%	40%	7%	0%
A lack of transparency and disclosure within the financial services industry	37%	45%	17%	1%
The underpricing of risk	53%	40%	6%	1%
The role of US regulators	43%	44%	12%	1%

†A number of surveyed participants attributed the underlying cause of the crisis to multiple factors.

Lessons learned from the GFC and aspects in need of greater regulation

Q5: In light of the lessons learned from the GFC and in consideration of regulatory reform in Australia's financial sector in the past, to what extent do you agree or disagree with the following suggestions for regulatory reform in Australia?

A5: When reflecting on the lessons learned from the GFC, 77 per cent of respondents agree that securitisation needs tighter regulation (27 per cent strongly agree and 50 per cent agree). There is also recognition from a considerable proportion of participants that in the past, Australia's reliance on capital markets understated liquidity risk. These participants (74 per cent) believe that we must regulate to provide for minimum liquidity going forward.

Answer Options	Strongly agree	Agree	Disagree	Strongly disagree
Securitisation needs stronger regulation	27%	50%	21%	2%
Banks' exposure to securities markets should be heavily regulated and more closely supervised	19%	45%	33%	3%
Investment banking or hedge fund activity should be regulated more closely	32%	45%	20%	3%
In the past our reliance on capital markets understated liquidity risk. We need to regulate for minimum liquidity	19%	55%	24%	2%
We need to re-think systemic risk and the role of the Reserve Bank of Australia as 'lender of last resort'	17%	45%	36%	2%
Our 'twin peaks' regulation model (APRA and ASIC) does not need to be altered, however, there should be greater focus on governance and enforcement	21%	53%	19%	7%

Q6: Please indicate which aspects of the financial services industry listed below require greater regulation (Scale 1-5 with 1 requiring no regulation and 5 requiring much greater regulation).

A6: Sixty two per cent of participants claim that ratings agencies require better regulation (33 per cent claim much greater regulation is required and 29 per cent claim a high level of regulation is required). In addition, 62 per cent highlighted short selling as an area requiring tighter regulation (34 per cent say much greater regulation is required and 28 per cent say a high level of regulation is required) and 62 per cent claim OTC derivatives should also be subjected to greater regulation (30 per cent say much greater regulation required and 32 per cent say a high level of regulation is required).

Answer Options	1	2	3	4	5
Ratings agencies	9%	9%	20%	29%	33%
Margin lending	6%	11%	26%	32%	25%
Stock lending	5%	13%	26%	30%	26%
Short selling	6%	11%	21%	28%	34%
OTC derivatives (CDSs, options etc)	5%	12%	21%	32%	30%
Securitisation	5%	9%	30%	33%	23%
Executive remuneration	13%	22%	25%	17%	23%
Superannuation	14%	29%	37%	11%	9%
Auditing	7%	13%	40%	21%	19%
Governance arrangements	4%	16%	35%	28%	17%

“Over three quarters of participants believe that securitisation requires tighter regulation and over three fifths of participants believe that ratings agencies require better regulation.”

Greatest challenges in the current economic environment

Q7: What areas currently represent the greatest challenges with respect to the current economic environment?
(Scale 1-5 with 1 presenting no challenge and 5 being the greatest challenge).

A7: When respondents were asked what areas currently provide the greatest challenges with respect to the current economic environment, 67 per cent of participants nominated accessing funding and capital adequacy (27 per cent consider this the greatest challenge, while 40 per cent consider it a significant challenge), 54 per cent nominated the uncertain economic outlook (21 per cent consider this the greatest challenge while 33 per cent consider it a significant challenge), and 53 per cent nominated risk management and compliance (20 per cent consider this the greatest challenge while 33 per cent consider it a significant challenge).

Answer Options	1	2	3	4	5
Controlling costs	6%	28%	39%	21%	6%
Retaining customers/ market share	6%	20%	36%	28%	10%
Driving profitability proactively	3%	14%	39%	34%	10%
Accessing funding and capital adequacy	5%	8%	20%	40%	27%
Risk management and compliance	3%	12%	32%	33%	20%
The uncertain economic outlook	3%	13%	30%	33%	21%
The changing regulatory environment	4%	20%	37%	28%	11%
Increased funding costs	4%	13%	30%	36%	17%
Attracting and retaining talent	11%	26%	31%	19%	13%

Key policy challenges and industry opportunities facing Australia's financial services sector

Q8: Thinking now about the GFC and market downturn, what do you believe are the key policy challenges and industry opportunities facing the Australian financial services sector over the next 12 months?

A8: Open-ended response. The following responses are set out in summary format. Such responses are the views of individual participants and the publication does not imply endorsement by Finsia.

Key policy challenges

Restoring confidence

When considering the key challenges facing the Australian financial services sector over the next 12 months, respondents spoke about confidence, saying:

- “One challenge will be to restore confidence with the investing public and institutions that the financial services industry is a genuine service industry, which deserves support”
- “Regaining investor confidence - especially in the area of superannuation given constant change”
- “The lack of public trust”
- “Consumer confidence in funds management to deliver the promise over the medium to longer term”
- “Restoring consumer confidence in Australian and in particular overseas financial markets through uniform and stronger regulations across the board. This will provide opportunities for investors to re-enter the market with a degree of confidence as risk will be easier to assess.”

Avoiding unnecessary regulation

Some respondents also commented on the potential for over regulation, with comments such as:

- “To make changes that are well considered and will protect consumers while not hindering the industry. Knee-jerk reactions are unfortunately likely to occur in such stressed times, with long lasting implications”
- “Quite frankly, the last thing we need is another ‘wave’ of regulations. We say our current regulatory framework helped buffer and protect us from the excesses in other countries. . . until we take clear stock of what we’ve got, we’re wasting our time if more regulations will protect us from a ‘downturn’ or ‘correction’”
- “Key policy challenge is to stop an over-reaction by ASIC and APRA in increased regulation and decimation on the financial planning industry. The regulation is there, and all it needs is better enforcement”
- “Black letter law will add costs and prove ineffective in this sector”
- “To ensure that policy changes are appropriate and do not restrict the ability of the industry to grow”
- “It is a huge challenge to implement consistent, professional, pragmatic light touch regulation.”

Investor education

Many respondents also mentioned that investor education would be a key policy challenge facing the Australian financial services sector over the next 12 months, commenting:

- “There should be a concerted effort to raise public awareness of risk and reward in investments. Financial literacy should be raised through education programs”
- “The balance is ensuring we allow people exposure to the full risk spectrum - that is the opportunity to win and lose”
- “To ensure that investors do not forget about the GFC by ensuring they are educated about markets/financial products and maintain a level of risk aversion”
- “Individuals/members of the public need to be better educated to understand the impact of financial decisions they make, including the potential downsides of investments.”

“With the current strength of the Australian market we can see growth potential in the financial service sector”

Key industry opportunities

Leveraging credibility and strength

When considering the key industry opportunities facing the Australian financial services sector over the next 12 months, Finsia members surveyed commented that Australia’s credibility and strength presents a significant opportunity with comments such as:

- “With the current strength of the Australian market we can see growth potential in the financial service sector”
- “Australian finance industry track records should assist in attracting new capital from overseas markets.”

Punching above our weight

In addition to this, promotion and expansion opportunities were also highlighted:

- “A chance to promote Australia as a financial hub in the Asia/Pacific region”
- “Opportunities exists to promote Australia as a safe and self-sufficient haven – not to become a global player which exposes Australia to more unidentifiable risk”
- “Opportunity for overseas expansion, especially in Asia.”

Increasing transparency

Some respondents also commented that there is a significant opportunity to increase transparency, particularly regarding executive remuneration and financial planning fees with comments such as:

- “A great opportunity for the industry itself to make the necessary changes and move to fee-for-service arrangements and other forms of reward other than commissions. This is a great way for the industry to improve community confidence, as they will be able to see upfront the true cost of their service”
- “Get rid of all undisclosed commissions, trail commissions, volume bonuses”
- “Better linking of executive remuneration with long term financial objectives”
- “Curtail the level of executive remuneration that is based on short term goals (less than 5 years) so that a longer term focus is encouraged”
- “Assess commission payments to financial advisers / planners and whether this aligns with the investors best interests or the sales targets of the adviser / planner”
- “Ensuring that financial advice provided by banks and non-banks are more client-focused and more transparent in the advice of products they recommend. Also banks need to be made more accountable for their behaviour in relation to their lending policies, and how they provide advice to their customers”
- “Greater regulation of distribution of financial products by financial planners, to avoid a repeat of the massive losses suffered by non-sophisticated investors.”

Finsia – Financial Services Institute of Australasia

Australia

Head Office NSW and ACT

Level 16, One Margaret Street,
Sydney NSW 2000
PO Box H99, Australia Square,
NSW 1215 Australia
T > 1300 FINSIA (1300 346 742)
+61 2 9275 7900
F > +61 2 9275 7999
membership@finsia.com

QLD

Level 3, 10 Felix Street,
Brisbane QLD 4000
T > 1300 FINSIA (1300 346 742)
+61 7 3002 0700
F > +61 7 3002 0799
membership@finsia.com

SA and NT

Level 7, Qantas House,
144 North Terrace,
Adelaide SA 5000
T > 1300 FINSIA (1300 346 742)
+61 2 9275 7900
F > +61 2 9275 7999
membership@finsia.com

VIC and TAS

Level 43, 80 Collins Street,
Melbourne VIC 3000
T > 1300 FINSIA (1300 346 742)
+61 3 9666 1000
F > +61 3 9666 1099
membership@finsia.com

WA

Level 5, BGC Centre,
28 The Esplanade,
Perth WA 6000
T > 1300 FINSIA (1300 346 742)
+61 8 9223 8900
F > +61 8 9223 8999
membership@finsia.com

New Zealand

Auckland

Level 12, AMP Building,
29 Custom Street West,
Auckland NZ
PO Box 106826
Auckland NZ 1143
T > +64 9 909 7534
F > +64 9 909 7531
members.nz@finsia.com

Wellington

Level 6, Wakefield House,
90 The Terrace,
Wellington NZ 6143
PO Box 10-793
Wellington NZ 6143
T > +64 4 473 5069
F > +64 4 499 1990
members.nz@finsia.com

International

PO Box H99, Australia Square,
NSW 1215 Australia
T > +61 2 9275 7900
F > +61 2 9275 7999
membership@finsia.com



FINANCIAL SERVICES INSTITUTE OF AUSTRALASIA

