

CHAPTER 13: TAXATION POLICY: GENERAL APPROACH

13.1 Taxes impinge on the financial system in many and varied ways. They have both an impact on financing generally, as well as specific impacts on some individual forms of transactions.

13.2 As an Inquiry requested to recommend improvements to the structure and operations of the financial system, the Committee found it could not ignore the persistent claims that many of the present tax arrangements were adversely affecting the efficiency of the financial system.

13.3 It was clear that the ideal approach would be to examine the taxation system as a whole but that of course was not practicable — nor was it intended — for this Committee. A selective approach has been taken therefore, with concentration on those taxation arrangements:

- which impact unevenly on different areas of the financial system; and/or
- where some of the elements of bias are either unintentional or unnecessary in order to achieve the desired objective.

13.4 Consistent with that approach, the Committee has avoided making detailed recommendations with regard to overall taxation policy; it has instead confined itself to indicating desired directions of reform. Some specific measures however, which are believed to be both justified and feasible, have been recommended.

13.5 The Committee nevertheless considers that the conclusions it has drawn in the area of taxation are no less important and relevant than its other recommendations in enhancing the structure and efficiency of the financial system.

13.6 During the course of its Inquiry, the Committee has received suggestions that income tax should be supplemented or even replaced by an expenditure tax. The question of whether **income** or **expenditure** is the more suitable tax base is the subject of continuing debate.¹

13.7 In framing its conclusions, however, the Committee has made the fundamental assumption that **income** will continue to be the principal basis for tax assessment for some time to come. In its view this is a realistic judgment given the ample scope for improving the present income-based system and the range of problems that would have to be resolved before any radical departure from the present income basis of taxation could be effected. The Committee does not believe that any of its proposals would prejudice a more basic change to an alternative tax system such as one based on expenditure, if desired, at some future date.

¹ The recent publication of two major reports — the US Department of the Treasury's *Blueprints for Basic Tax Reform* (1977), and the UK Meade Committee's *The Structure and Reform of Direct Taxation* (1978) — is evidence of heightened interest in this subject overseas.

13.8 Although secondary objectives can be involved, the primary role of the taxation system is to raise revenue and, in the process, effect a transfer of resources and incomes. It would be generally agreed that this transfer should take place in a manner which:

- unless specifically designed to do so, bears on decision making as little as possible, so that individuals and businesses are not given an unintended incentive to prefer one course of action to another simply because tax considerations make it attractive to do so;
- distributes the tax burden fairly, so that the tax load of individuals is related to their capacity to pay — with those in similar circumstances bearing the same tax load; and
- is readily understood by taxpayers, and straightforward and inexpensive to administer.

Put another way (and subject to the qualifications in paragraphs 13.12 and 13.13) the taxation system should meet the tests of **neutrality, equity and simplicity**.

13.9 There are of course important linkages between these three tests of a good taxation system. Thus:

- if a taxation system were non-neutral, there could well be a departure from equity as some taxpayers would have greater opportunities to reduce their tax burden than other taxpayers;
- a taxation system that is complex and fails to meet the simplicity test will be more open to avoidance and evasion; that in turn implies some loss of both equity and neutrality.

13.10 The Committee endorses the broad concepts of neutrality, equity and simplicity for a taxation system. Its main concern is with neutrality of funds flows but it has also paid close regard to the implications of any tax proposals for equity and simplicity.

13.11 The Committee recognises that governments may at times deliberately wish to inject a tax bias in favour of particular groups or sectors, for social policy reasons or otherwise. Where the bias is clearly intentional but nevertheless has implications for the efficiency of the financial system, the Committee has considered whether the objective being pursued could be achieved by means that are more cost-effective or have a more neutral impact on the financial system.

13.12 In Chapter 36, the Committee draws attention to the benefits from pursuing sectoral and other social objectives through fiscal channels rather than through direct intervention in the financial system. Fiscal initiatives are likely to be less damaging to the efficient workings of financial markets, more open to public scrutiny and more consistent with equity and competitive considerations. As a general rule these fiscal measures should address their objectives directly. Thus where the object of government intervention is to transfer income or resources to a certain sector of the economy, assistance should be delivered directly to the intended beneficiaries; that will ensure that as few unintended distortions as possible are created in the market place.

13.13 The chapters which immediately follow are generally not concerned with the use of taxation policy for sectoral or distributional objectives. They focus principally on ways of removing apparent unintended or unnecessary 'bias' in the pattern of funds flows arising from the tax system; in other words they are

concerned specifically with tax reform directed at achieving greater 'neutrality' — in the broad sense of the word.

13.14 It is important to make this clear from the outset, since many of those advocating tax reform appear to have particular social or economic objectives in mind — such as to encourage greater corporate saving and investment, to enhance the supply of risk capital, to accord small business favourable treatment, or to promote long-term contractual savings. The Committee's views on some of these issues are discussed elsewhere in the Report; see for example Chapter 38 on Small Business.

13.15 Chapter 14, on Company Taxation, is in three parts. The separate taxation of corporate income which presently applies is first discussed; this is followed by parts dealing with the tax treatment of private companies and of companies belonging to a group. The discussion in the latter two parts is conducted against the background of the present separate or 'classical' system of company taxation; it follows that the Committee's recommendations in the first part would also have a bearing on issues in the subsequent parts.

13.16 Chapter 15 analyses the taxation of certain financial intermediaries — life insurance companies, superannuation funds, building societies and credit unions.

13.17 Chapter 16 contains some views and recommendations on the tax treatment of specific financial transactions, including stamp duty, interest withholding tax, the taxation of short-term 'capital' gains and the taxation of foreign exchange gains and losses and related transactions.

13.18 Chapter 17 discusses some generally acknowledged implications of inflation for the taxation of business income and personal investment income.

CHAPTER 14: COMPANY TAXATION

I. THE OVERALL SYSTEM

A. INTRODUCTION

14.1 The provisions of the Income Tax Assessment Act applying to companies and their shareholders have been described in Chapter 13 of the Interim Report; particular attention was drawn there to the fact that Australia employs the so-called 'classical' or 'separate' system of company taxation.

14.2 Under the 'classical' system, the corporation and its shareholders are treated as separate entities for tax purposes. Corporations are taxed at a flat rate (currently 46%) on their income, whether distributed or not.¹ Those after-tax profits which are subsequently distributed, normally in the form of dividends, are then taxed in the hands of the individual shareholders at the relevant marginal rates on personal income, without any allowance for the tax levied at the company stage; on the other hand, profits that **remain** undistributed bear only the company tax rate.

14.3 The following are other important tax provisions bearing on the treatment of company income and the profits from the sale of corporate securities:

- Dividends received by Australian resident companies generally attract a tax rebate which effectively prevents a further levy of tax on the profits represented by those dividends. When those dividends are eventually received by individual shareholders they normally become subject to tax at the personal marginal rates.
- Dividends paid by Australian resident companies to non-residents are, in general, subject to Australian taxation in the form of a withholding tax at 30%, or at 15% if the non-resident receiving the dividend resides in a country with which Australia has a double taxation agreement.
- Private companies are liable, under Division 7 of the Act, to additional tax on retained profits unless they distribute at least a specified proportion² (currently 30%) of their after-tax trading income. A tax of 50% is levied on the amounts by which after-tax income retained exceeds the statutory retention allowance.
- Companies with common ownership are taxed separately; there is no provision for company groups to be taxed as single entities.
- A share trader whose 'normal activity' includes the buying and selling of

¹ The special provisions affecting private companies are discussed in Part II.

² See also paragraph 14.50 for a more detailed description of the distribution requirements under Division 7 of the Income Tax Assessment Act.

shares for profit is assessed in the same way as other business income — profits being taxed and losses allowed.

- If shares (and other forms of 'property') are disposed of outside 'normal' business activity, any profits made therefrom within twelve months of purchase are treated as assessable income of the taxpayer, but with no relief in respect of any such losses. For disposal beyond twelve months, the profit motive and the business tests are applied by the Commissioner of Taxation to determine assessability.

14.4 Many submissions received by the Committee were critical of these tax arrangements, principally on the following grounds:

- that the separate taxation of the corporation and its shareholders has major distorting effects on the pattern of funds flows;
- that Division 7 of the Act has been unduly harsh on private companies;
- that lack of provision for group taxation penalises company groups; and
- that the tax treatment of 'capital' gains or losses on share transactions has been unsatisfactory — particularly in respect of transactions effected within one year.

14.5 The first three of these criticisms are examined in this chapter. The fourth will be touched on in the course of dealing with the first criticism but is more particularly dealt with in Chapter 16.

B. ASSESSMENT OF PRESENT SYSTEM

14.6 The fact that companies and their shareholders are separate legal entities is sometimes held to justify treating them as separate taxation entities as well. The Committee is not disposed to accept this view. It is not convinced that those who own or operate enterprises conducted under limited liability should pay extra tax for that privilege. Ultimately all taxes fall on individuals³ and, in the words of the Asprey Committee,⁴ it is 'necessary to go behind the veil of separate legal personality which the company enjoys and translate the tax formally imposed on company income into a set of individual tax "burdens"'.

14.7 Some critics of the present 'classical' system describe the requirement that shareholders pay personal income tax on company profits that have already borne company tax as amounting to 'double taxation' of dividends.

14.8 The use of the term 'double taxation' is somewhat unfortunate, creating as it does the impression that 'over-taxation' has occurred merely because two lots of tax happen to have been collected from a single income source. In the final analysis what is important is the total amount of tax a particular income directly and indirectly bears.

14.9 The earnings of a company accrue to its shareholders through several channels. Current income may be distributed as dividends. Alternatively, it may be retained by the company. The retention increases the 'net tangible' worth of the company. This element, together with the expectation that such retention will generate additional income, will, over time, be capitalised (with some adjustment for a further tax factor) into the market value of the company's shares. Should

3 This assumes that it is the shareholder who ultimately bears most of the tax — not the consumer.

4 Taxation Review Committee, *Full Report*, AGPS, Canberra, 1975, paragraph 16.6.

shareholders in due course dispose of their shares at a higher market value because of these elements, a capital gain will be made — which under present arrangements would frequently go untaxed.

14.10 It may therefore be oversimplifying matters to talk about the 'double taxation' of dividends; the relevant question is how the individual shareholder's overall tax burden compares with the tax he would have paid had the equivalent income been received through non-corporate channels and the whole amount been taxed at personal rates.

14.11 The authorities have argued that the present 'classical' system of company taxation seeks to achieve approximate equality by imposing a relatively heavier tax burden on distributed company income to offset the lower tax burden on undistributed income. However, it is evident to the Committee that the system is both inequitable and non-neutral in its impact on companies and their shareholders.

(a) Inequity

14.12 Under present tax laws, the amount of tax effectively paid by shareholders at the company and personal levels combined depends on the rate of company tax, the proportion of company profits distributed, shareholders' marginal rates of personal income tax, and the extent to which capital gains on the sale of shares attract tax.

14.13 Table 14.1 sets out, for a range of taxable incomes, the 'excess tax' payable by shareholders, under the present classical system of corporate taxation.⁵ The calculations are based on 1980-81 personal and company tax rates and assume various rates of profit retention. They also assume that no tax is paid on capital gains; where such a tax is applicable, the 'excess tax' would be greater.

14.14 It can be seen from the table that:

- shareholders paying personal tax at marginal rates of 46% or less will, in nearly all cases and for almost the full range of a company's distribution policies,⁶ bear an effective combined company-personal income tax rate higher than their marginal personal income tax rate;⁷ and
- the degree of over-taxation diminishes as the shareholder's income rises; indeed for shareholders subject to the highest marginal tax rate, in companies with very high retention policies, the combined company-personal income tax rate can be below the personal tax rate.

14.15 Present company tax arrangements are thus both horizontally and vertically inequitable,⁸ in that:

5 There is also the separate 'incremental effect' on a taxpayer's marginal tax rate as he moves up the progressive tax scale. That aspect is not dealt with here.

6 The exception is the combined tax payable by a taxpayer on a 46% marginal personal rate with a zero dividend payout by the company — he breaks even.

7 The calculations assume that dividends from shares are the taxpayer's sole source of income. However, the effects discussed here are still apparent even when other sources of income are involved; the grossing of his share of corporate income with his other incomes would, if his marginal tax rate is 46% or less, result in an 'excess' tax liability.

8 The Asprey Committee defines these concepts as follows:

Horizontal equity is taken to require that two persons with the same income pay the same taxes (at least in the first place and 'other things being equal'), while vertical equity would require that, of two individuals with different incomes, the one with the larger should pay more by some correct amount.

Taxation Review Committee, *Full Report*, AGPS, Canberra, 1975 (paragraph 3.9).

TABLE 14.1: EXCESS TAX PAYABLE BY SHAREHOLDERS UNDER THE PRESENT CLASSICAL SYSTEM OF CORPORATE TAXATION

Shareholders' taxable income \$	Marginal tax rate ^(a) %	Excess tax payable (%) ^(b)				
		Payout rates of after-tax corporate profits				
		0	25	50	75	100
4 041 ^(c)	0	46.00	46.00	46.00	46.00	46.00
5 000	32.00	14.00	18.32	22.64	26.96	31.28
10 000		14.00	18.32	22.64	26.96	31.28
17 239 ^(c)		14.00	18.32	22.64	26.96	31.28
20 000	46.00	0.00	6.21	12.42	18.63	24.84
25 000		0.00	6.21	12.42	18.63	24.84
34 478 ^(c)		0.00	6.21	12.42	18.63	24.84
35 000	60.00	-14.00	-5.90	2.20	10.30	18.40

(a) Personal and corporate tax rates used are the rates announced in the 1980-81 Budget.

(b) Excess Tax payable equals $t_c + (r(1-t_c) t_p) - t_p$ where t_c (= 46%) is the corporate tax rate, t_p is the personal marginal tax rate and r the ratio of dividends paid to after-company-tax income.

(c) Top of marginal tax bracket range.

Adapted from: P. L. Swan, 'Is there a Case for Complete Integration of Corporate and Personal Income Taxes?' in Australian Financial System Inquiry, *Commissioned Studies and Selected Papers*, Part 3, AGPS, Canberra, 1981.

- corporate shareowners and partners in an unincorporated business on identical incomes, and therefore with equal capacity to pay, will in most cases bear different tax burdens;
- corporate shareowners with the same capacity to pay, in the sense of 'deriving' the same amount of income from companies, will pay different tax depending on the distribution policies of the company in which they hold shares; and
- shareowners further down the income scale, and therefore with less capacity to pay, are most penalised, implying a general lessening in the progressivity of the income tax scale.

(b) Non-neutrality

14.16 Adverse comments about the present 'classical' system in submissions to the Committee have naturally focused more on its non-neutrality in terms of impact on the financial system than on its inequity — although of course the two are not unrelated. Specifically it has been claimed that the system:

- encourages companies to retain profits;
- encourages companies to use debt financing rather than equity financing; and
- discourages some individuals from investing in shares.

(i) Retention of Profits

14.17 It is said that because the overall tax burden is lower on undistributed than distributed profits, companies are influenced to retain a higher proportion of their profits; the fact that capital gains arising from subsequent disposal of shares often go untaxed reinforces this influence.

14.18 It has been put to the Committee that this particular bias:

- has been a factor restricting the depth and breadth of the new equity market and, in some cases, of the secondary market;
- disadvantages new and developing businesses, which are denied equal access to funds 'locked into' established companies; and

- may permit companies to put retained earnings to less productive use than funds acquired from the market.

14.19 The Committee recognises that the present system has the potential to restrict equity markets and may disadvantage new and developing businesses. Whether the third point is a ground for criticism depends on the view that is taken of company self-financing through retention of profits compared with financing by resort to the market. Studies in this area do not conclusively show that in an efficiently working capital market internally generated funds are put to less productive use than externally raised funds.⁹ Factors other than taxation may have greater influence on the retention decision: there are added expenses involved in raising funds externally and companies may place some importance on maintaining a degree of 'financial independence' through retained earnings to ensure greater stability and flexibility of operations and planning.

14.20 At the same time, the Committee recognises that tax considerations may encourage some shareholders to regard at least part of the return from profit retention as a tax saving; to the extent that companies perceive this, they may respond accordingly. An element of non-neutrality is thereby introduced in favour of retained earnings. This is clearly undesirable.

(ii) Debt/Equity Structure

14.21 The 'classical' system is said to bias corporate decision making towards debt financing and away from equity financing. This is because, in determining the taxable income of a company, a deduction is allowed for interest on moneys borrowed but not for dividends paid on equity capital.¹⁰

14.22 Existing tax arrangements may therefore give companies an incentive to adopt higher gearing ratios than would otherwise be deemed appropriate, although the previously mentioned bias in favour of retaining earnings might move the weight in the opposite direction.

14.23 To the extent that higher gearing does occur, companies are exposed to greater financial risk. However, a range of factors other than taxation may cumulatively have a more important bearing on the financial structure of corporations; these include the general state of the economy, profit expectations, perceptions of the share market, and the risk preferences of investors. Whether gearing would decrease if debt and equity choices were equal (from a tax viewpoint) is therefore open to debate.

(iii) Investment in Shares

14.24 Because of the differential impact of company tax on high and low income

9 For a sampling of the extensive literature on this subject, see for example: W. J. Baumol, P. Heim, B. G. Malluiel, and R. E. Quandt (1970), 'Earnings Retention, New Capital and the Growth of the Firm', in *Review of Economics and Statistics*; G. Whittington (1972), 'The Profitability of Retained Earnings', in *Review of Economics and Statistics*, pp. 152-60; I. Friend and F. Husic (1973), 'Efficiency of Corporate Investment', in *Review of Economics and Statistics*, pp. 122-7; 'Theoretical and Empirical Aspects of Corporate Taxation', OECD, Paris, 1974; R. R. Officer (1980), 'Company Tax and Company Finance', in *Australian Financial System Inquiry, Commissioned Studies and Selected Papers*, Part 3, AGPS, Canberra, 1981.

10 This may be of particular relevance to small businesses operating through private companies. There are often advantages for them in issuing non-voting preference shares, which are discouraged by the classical system. A solution is often found through 'subordinated loans' but these are not always as appropriate if the need is to truly fortify the equity base.

shareholders, different investors can be expected to hold different views on the relative attractiveness of equity and debt investment.

14.25 The Committee has noted that the present ‘classical’ system discriminates, in respect of equity investments, against lower income investors — relative both to individual investors on higher incomes and to certain financial institutions. As a result, the share yields set by the market as a whole have been relatively unattractive to lower income investors; for this group, share prices and yields tend not to adequately reflect the capitalised burden of the overall income tax. In that sense, low income investors have been discouraged from direct participation in the equity market.

14.26 A number of submissions to the Committee have pointed to the declining presence of the individual in the equity market; it is suggested that taxation factors may have influenced this trend. The Committee considers it desirable that all sectors of the community be given equal encouragement to directly participate as equity holders in companies.

C. THE OPTIONS

14.27 From its examination of the deficiencies of the ‘classical’ system, the Committee has formed the view that closer integration between the tax liability of companies and their shareholders would be advantageous.

(a) Full Integration

14.28 Equity and neutrality would be achieved in fullest measure under a tax system in which there was no company tax as such and each shareholder was taxed, at the relevant personal tax rate, on his share of company income, whether received as dividends or retained by the company. This would amount to full integration of the company and personal tax systems; in essence shareholders would be treated in the same way as partners in a partnership.

14.29 Under full integration some relevant features could be that:

- *Companies* would effectively pay no tax; although they could continue acting as a point of tax collection, the tax collected by each company would be in the nature of a ‘withholding tax’, serving as a prepayment of the shareholders’ personal tax on company income.
- *Shareholders* would include as part of taxable income their share of the pre-tax earnings of the company, i.e. not only the corporate dividends they receive but also their share of the retained earnings ‘allocated’ to them, grossed up in both cases to include the tax withheld at the company level; any excess tax paid by the company on their behalf would be refundable to them.¹¹
- Interest on debt and share of income on equity would in each case be taxed only once — effectively as income in the hands of the lender or shareholder.

14.30 The Committee believes that full integration has much to commend it:

- (i) It would be neutral as between corporate and non-corporate income.

¹¹ To the extent that shareholders were subject to tax on realised gains or disposal of shares they could, in calculating share gains at time of sale, be allowed to add retained earnings per share to their cost of acquisition; therefore only share gains in excess of the retained earnings component (on which tax has already been paid) would be liable for tax on the occasion of share disposal. (The taxation of realised gains from the disposal of shares is discussed in Chapter 16.)

- (ii) It would ensure a more equitable tax system:
 - As the returns from corporate share ownership would bear the same tax as the returns from investing in other ways and from personal effort, greater horizontal equity would be achieved.
 - As all corporate source income would be taxed at progressive rates applicable to the individual shareholders, there would be greater vertical equity between shareholders.
- (iii) With all earnings (retained or distributed by way of dividend) being fully taxed as shareholders' income, it would remove the tax bias favouring profit retention; Division 7 tax would thus become redundant.
- (iv) It would remove the present tax bias in some corporate decision making towards debt rather than equity finance.
- (v) It would eliminate the present tax disincentive to the ownership of equities, as a form of investment, for many potential shareholders in the lower and middle income ranges. (The Committee recognises however that there are other important influences at work; these are discussed in Chapter 33.) The calculations in Table 14.2, which assume certain retention ratios and withholding tax rates, illustrate that these groups would be relatively the larger gainers from such a scheme as the normal progressive tax schedule would apply to all income from all sources.
- (vi) A system of full integration could be applied in such a way as to place corporations, life offices, superannuation funds, other financial intermediaries and individuals on substantially the same tax footing.

TABLE 14.2: COMPARISON OF SHAREHOLDERS' AFTER-TAX DIVIDEND RECEIPTS UNDER THE PRESENT CLASSICAL SYSTEM AND A FULL INTEGRATION SYSTEM^(a)

Share holders' Marginal tax rate (%)	Classical system (\$)				Full integration system (\$)			
	Co. tax	Personal tax on dividends	Total combined tax	After-tax dividend receipts	Withholding tax	Tax credit (debit)	Total tax	After-tax dividend receipts
0	46	0	46.00	27.00	46	46	0	73
32	46	8.64	54.64	18.36	46	14	32	41
46	46	12.42	58.42	14.58	46	0	46	27
60	46	16.20	62.20	10.80	46	(14)	60	13

(a) Assumptions and notes

- Company income = \$100
- 50% of 'after-company-tax' income is retained, namely \$27.
- After-tax dividend receipts = company income less total tax paid less retained earnings.
- **Full tax credit is provided** under the integration system; tax payable on company-sourced income is calculated on the basis of the individual's personal tax rate.

(b) Partial Integration

14.31 The Committee is aware that there are ways of achieving at least some of the benefits of the integration of company and personal tax which stop short of full integration. Some involve an imputation system, some a split-rate and others a combination of the two; all depart in varying degrees from the two basic features of the 'classical' system of:

- taxing companies and their shareholders separately; and
- treating the distributed and undistributed components of company incomes differently.

(i) Imputation Systems

14.32 Under imputation systems some or all of the tax paid by the company on income distributed is treated as prepayment of the shareholder's personal income tax. The individual shareholder's assessable income would include the dividend received, grossed up by the company tax deemed to be prepaid on that dividend; against the personal income tax assessed on that amount would be credited some or all of the company tax deemed to have been prepaid. Any excess of credit over the personal tax would be refunded.

14.33 These systems, which involve the integration with personal income tax of only the distributed portion of company income, differ fundamentally from full integration in that there is no notional 'allocation' of undistributed company income to the shareholders, only dividends actually distributed being assessed to shareholders as personal income. As a consequence:

- neutrality as between debt and equity and as between retained earnings and distributions is not entirely achieved; and
- complete integration of the shareholder's economic benefit from his shareholding in the company with his personal income is not achieved; a degree of inequity therefore remains with the lower income earner being the more disadvantaged.

14.34 Thus from the Committee's point of view, financial decisions are biased away from those that would lead to the most efficient functioning of the financial system.

(ii) Split-rate Systems

14.35 Split-rate systems seek to mitigate the so-called 'double taxation' of dividends under the 'classical' system by taxing companies at a lower rate on distributed as distinct from undistributed income. The shareholder continues to be taxed separately on dividends as under a 'classical' system, no account being taken in his assessment of the tax paid by the company — although some relief is provided at the company level.

14.36 As split-rate schemes generally involve partial integration of company and personal taxation in respect of only the distributed component of company income, there is not complete neutrality between that and retained income.

14.37 Hence, while split-rate systems, like the imputation proposals, go some of the way to rectifying the shortcomings of the 'classical' approach, they fail to achieve the degree of neutrality of full integration.

D. PREFERRED OPTION

14.38 Full integration is the Committee's preferred option, succeeding as it does more completely than any form of partial integration in removing the non-neutral and inequitable features inherent in the 'classical' system.

14.39 To facilitate administration and to protect government revenue, a withholding tax would need to be collected at the company level. The question then arises as to what is the appropriate rate.

- If it were set at the rate applicable to shareholders in the top tax bracket — i.e. at 60% — problems could be posed for lower income shareholders, especially

those heavily dependent on dividend income. While they would eventually be reimbursed for any excess tax withheld, there could be delays; in the meantime their cash flow might be considerably and uncomfortably reduced.

- If it were set at say the standard rate (at present 32%), high income shareholders would have to pay further tax later on income they may not have in fact received, and this also would have certain undesirable features — although it is felt that high income shareholders are usually better placed than low income shareholders to plan their financial affairs in advance.

14.40 An administratively more straightforward way would be for the withholding tax to continue at the present company tax rate of 46%. This would minimise disruption to the existing pattern of cash flows for both companies and shareholders in the sense that:

- Companies would be in a position to pursue the same distribution and retention policies as at present; dependent debt amortisation programs for instance would be unaffected.
- Lower income shareholders would not be disadvantaged compared to present arrangements. Assuming company distribution policy remained unchanged, they could expect to receive the same distributed 'income' as at present; moreover, additional after-tax 'income' would be forthcoming where the tax withheld at the company level exceeded the tax applicable to the individual.

14.41 The Committee therefore *recommends* that:

- (a) The Government should work towards the introduction of a system of full integration of company and personal income tax.**
- (b) An administratively suitable scheme could involve tax being collected (withheld) from companies at the corporate tax rate (at present 46%) and credited against the personal tax liability of shareholders whose taxable income would include their share of the pre-tax income of the company (i.e. their share of both dividends received and retained earnings, grossed up to include the tax withheld by the company).**

14.42 It is appreciated that to date no country has proceeded as far as full integration, and that there might be a number of difficult practical issues that need to be resolved. While the Committee does not underrate the problems to be faced in implementing a somewhat radical and untested departure of this kind, it is reasonably confident they can be surmounted. In Appendix 14.1 some thoughts are recorded on a number of specific issues bearing on the administration of an integrated system and on the treatment of certain categories of shareholders under such a system — particularly non-resident shareholders.

E. INTERIM MEASURES

14.43 The Committee sees merit nevertheless in proceeding to full integration by stages, in that:

- it would facilitate community education and acceptance of the new basis of taxation;
- the business and investment community and the taxation authorities would have more time to revise their administration and accounting practices to accommodate the new system;

- there could be problems for the government revenue if the tax refund aspect of an integrated system were adopted in full from the start.¹²

14.44 The Committee therefore *recommends* that, as an interim step, the *minimum* personal tax applying on a shareholder's 'allocated' share of corporate income could be set at the existing company tax rate (at present 46%). A shareholder whose personal tax rate is less than the company rate would pay no additional tax on his dividend income. In contrast, such a taxpayer is (or may be) taxed on dividend receipts under the present system.

14.45 Such an interim arrangement would be consistent with the long-term aim of full integration without creating the same early difficulties for administration.

14.46 The proposed step would still represent a considerable improvement over the existing 'classical' system of company taxation in that:

- low income shareowners would be, on balance, better off; although their position would be unchanged in respect of the tax paid on undistributed company income, they would no longer have to pay additional tax in respect of their dividend receipts;
- shareowners on maximum marginal tax rates would bear a tax burden appropriate to their tax bracket; and
- share investment decisions would no longer be substantially affected by non-neutral, non-equitable taxation applications.

14.47 Following the introduction of the interim arrangement, the Committee envisages that there would be in due course further moves towards full integration. The next stage could be, for example, a reduction from 46% to 32% in the *minimum* personal tax rate on company incomes allocated to individuals.

II PRIVATE COMPANIES: DIVISION 7 TAX

A. BACKGROUND

14.48 Division 7 of the the Income Tax Assessment Act draws a distinction between public and private companies and requires the latter to make minimum distributions or incur additional tax, at a rate of 50%, on the excess retention.

14.49 There is no definition of a private company as such in the present Tax Act; s.103A defines public companies and classifies all other companies as private. Appendix 14.2 summarises the developments leading to the present definitions and provides brief background to the fundamental issue in this area of taxation, namely the task of striking an equitable tax burden between unincorporated and incorporated enterprises on the one hand and between 'closely held' and 'widely held' corporations on the other.

12 It should be noted, however, that while estimates of the net cost to revenue of converting to full integration must be somewhat speculative, the calculations of Professor Officer and Dr Swan, undertaken on behalf of the Committee suggest that the cost might be equivalent to no more than 1-2% of current total income tax revenue. (See R. R. Officer, 'Company Tax and Company Finance', and P. L. Swan, 'Is there a Case for Complete Integration of Corporate and Personal Income Taxes?', in Australian Financial System Inquiry, *Commissioned Studies and Selected Papers*, Part 3, AGPS, Canberra, 1981.) The Committee's integration proposal is of course less ambitious initially than full integration.

14.50 Private companies wishing to avoid Division 7 tax must distribute to shareholders at least:

- 30% of trading or business income;
- 90% of property ('non-trading') income;¹³ and
- 100% of dividends received from other private companies.

14.51 The Committee has received a number of submissions seeking additional — in some cases total — relief from Division 7 tax on the grounds that it is inequitable and that it 'penalises' businesses operating as private companies.

14.52 The majority of those submissions were received before the retention allowance on trading and business income was increased (in the 1979–80 Budget) from 60% to 70%. In the previous year the allowance had also been raised; before that it had been 50% for some years.

B. PURPOSE OF DIVISION 7 TAX

14.53 Division 7 is designed to ensure that the proprietors of private companies pay income tax comparable to that which they would have to pay were they operating as unincorporated businesses.

14.54 The need for Division 7 arises because the rate of company tax which private companies bear (currently 46%) is well below the maximum marginal rate of tax on individuals. If there were no Division 7 tax, owners of successful, closely held companies would be able to arrange their affairs in such a way as to reduce the tax on a significant part of their income to 46%, instead of paying full marginal personal rates as do owners of unincorporated businesses.

14.55 Moreover, whereas an individual operating an unincorporated business pays tax on all his income at whatever marginal rates are prescribed by the rate scale for individual taxpayers, the proprietor of a private company can draw a part of his income as salary or interest and retain the remainder in the company to be taxed at the company rate. In the absence of Division 7, opportunities to arrange this mix so as to reduce tax liability would be enhanced, placing the private company proprietor in a more favourable tax situation than his opposite number in the unincorporated sector.

14.56 The incentive for proprietors of a private company to undertake such arrangements will of course be influenced by the degree of common interest (particularly family ties) among the proprietors, their marginal personal tax rates and the gap between those and the company tax rate. Of common relevance is the gap between the company tax rate and the maximum marginal rate of personal income tax.

14.57 The authorities stress that while Division 7 does not necessarily ensure that incorporated and unincorporated businesses bear identical tax burdens, it aims to attain a 'degree of rough balance' by ensuring that a reasonable proportion of the taxable income is paid as dividends and thus bears personal income tax.

13. 'Property' income, in this context, encompasses interest on loans, dividends on public company shares, royalties etc., as well as rent and other returns from real property. To avoid possible confusion between these two concepts of 'property' income, the Committee has chosen to describe the income covered by the 90% distribution requirement as 'non-trading' income (see paragraphs 14.80–85 below).

C. CONSIDERATION OF THE ISSUES

(a) Equity in the Treatment of Shareholders

14.58 The present tax treatment of private companies impacts unevenly as between shareholders and unincorporated proprietors. An investor in a private company on the highest marginal personal tax rate of 60% in fact pays less tax than his unincorporated business counterpart. This is so whether the company retains all its earnings and pays the excess retention tax or complies with the Division 7 requirements: in the former case the investor pays an effective marginal tax rate of about 54%, and in the latter case of about 56%. On the other hand, an investor in the 32% marginal tax bracket faces an effective rate of tax of about 54% if the company retains the whole of its profits and of about 51% if the minimum distribution requirements are observed.¹⁴

14.59 Under present tax arrangements therefore, high income shareholders in private companies tend to be better off than their opposite numbers in the unincorporated business sector; Division 7 has the desirable effect of bringing them closer together.

14.60 On the other hand, lower income shareholders tend to be disadvantaged by Division 7, especially where the sole or major source of income of the shareholder is dividends.

14.61 This inequity in the impact of Division 7 between shareholders on lower and higher incomes has been exacerbated in recent years by increases in the retention allowance, which have tended to be of more benefit to higher income earners.

14.62 As noted in Part I of this chapter, the harsher treatment of low income shareholders applies to their equity investment in companies generally, whether private or public. In a full integration system the vertical inequities of the present company tax system would disappear, and with it the need for Division 7.

(b) Private v. Public Companies

14.63 It has been claimed that the Division 7 provisions penalise private companies relative to public companies, which are not subject to these provisions.

14.64 On the other hand, public companies, because their shares tend to be rather more widely held and the distinction between ownership and management more clear-cut, are less influenced by the tax position of particular shareholders in distribution/retention policies. The percentage distribution requirements imposed on the trading and business income of private companies under Division 7 also fall short of the average percentage distributions actually made by public companies

14: In judging how the overall tax on private company income, including the personal tax on shareholders' dividends, compares with the tax on equivalent income earned through an unincorporated business, it must not be overlooked that shareholders in private companies will be subject later to personal tax on retained earnings should those earnings eventually be distributed by way of liquidation or otherwise. However, in the case of private companies — closely held ones in particular — a substantial part of the income of the enterprise is often received by the proprietor shareholders in the form of tax-deductible interest or salary and thus would not be reflected in company taxable income; the vehicle of a private company also lends itself to family income splitting. Hence, to draw conclusions on the tax position of a shareholder in a private company solely on the tax paid on his share of current company income or on his dividends can be misleading.

over recent years. There is thus said to be less need to impose similar profit retention restraints (to Division 7) on public companies.

14.65 Although this argument has some broad appeal, it might give too little weight to the fact that the financial circumstances of private and public companies differ in important respects — not least in their degree of dependence on retained earnings to finance investment growth (see below).

14.66 It has been pointed out to the Committee that while public company distributions may on average be higher, **some** public companies do, in fact, distribute less than the Division 7 requirements.

14.67 This poses the question whether Division 7, if it were to be retained for private companies, should not also apply to public companies.¹⁵

14.68 The Committee has given this matter serious consideration; in the absence of full integration there would appear to be a strong case on equity grounds for such an extension.

14.69 The authorities have advised that an extension of the Division 7 provisions to public companies would involve substantially heavier administrative and monitoring costs. The Asprey Committee drew the same conclusion. Given that the majority of public companies are already voluntarily making greater distributions, the Committee finds it difficult to justify any recommendation which would increase administrative and monitoring costs for, at best, a small return. However, were there to be a marked change in public company distribution policies, the Committee believes that it would be appropriate for the authorities to reassess the matter.

(c) Small Business

14.70 Privately incorporated small businesses have expressed concern that Division 7 constrains their ability to retain funds and hence their capacity to finance growth by internal funding.

14.71 They claim that in practice they are forced to rely more heavily than large businesses on retained earnings to finance their expansion because external finance facilities (particularly for equity) are less widely available to them and because retained earnings as a form of proprietorship capital are more appropriate to the risk nature of their businesses. To the extent that Division 7 has forced them to depend more on external finance, particularly debt, their debt/equity ratio has been adversely affected and the cost of capital made more expensive because of the search and borrowing costs associated with outside finance.

14.72 It has also been argued that a rigid retention allowance may limit the capacity of private companies, especially new and fast-growing ones, to adapt their distribution policies to changing financial market conditions. During critical periods a public company may, if it wishes, reduce its payout policy without incurring an additional tax. Survival or maintenance of competitive position may in fact depend on this kind of financing flexibility. Private companies have at least equal requirements.

¹⁵ The Committee understands that an undistributed profits tax of 10% was imposed upon public companies from 1940 to 1951. However, this extension of the tax to public companies was basically a wartime measure with the objective of increasing government revenue.

14.73 Division 7 does not of course prevent proprietors of private companies from reinvesting funds in the business. It seeks to do no more than ensure that the amount of tax paid by the proprietors of a private company corresponds as closely as possible to that which would be payable on the same income were it derived from an unincorporated business. To the extent that this objective is achieved, Division 7 must be seen as no more an obstacle to obtaining funds for expansion than is the tax payable by proprietors on the income of an unincorporated business.

14.74 In other words, Division 7 has little bearing on the claims of shortcomings in the market facilities available to accommodate the financing needs of small businesses; these claims are discussed in Chapter 38.

14.75 The view has been put that the retention allowance provisions should be given a greater degree of flexibility so as to help lessen the discriminatory effect of an 'excess retention' tax under changing financial circumstances. The counter argument is that a settled and predictable tax provision is more useful in the framing of investment plans than one that is subject to discretionary changes by the authorities.

14.76 The debate surrounding the administration of the retention allowance provisions must be viewed against the background of recent increases to the allowable retention allowance.

14.77 From its discussions with small business, the Committee is satisfied that many find the present 70% retention allowance a 'workable ratio' in relation to their financing needs. With the prospect of further increases in the retention allowance,¹⁶ the Committee sees a risk that (on average) the balance of tax advantage may swing strongly in favour of private companies — at least for higher income shareholders. In the event that full integration were adopted, any such anomalies would disappear; at the same time private company shareholders on lower incomes would gain as a result of integration.¹⁷

(d) Revenue Significance

14.78 It has been suggested that because the amount of revenue collected from Division 7 tax is so small, it could be removed with little revenue cost to the Commonwealth.¹⁸

14.79 However, the revenue collected is not a good measure of the significance of the tax. On the contrary, for any given rate of retention allowance, the smaller the amount of Division 7 tax collected, the more effectively can the provisions of Division 7 be said to be operating.

(e) Non-business Income

14.80 As pointed out in paragraph 14.50, in contrast to the 70% retention allowance for trading and business income, the retention allowance on 'non-trading' income¹⁹ is fixed at a much lower figure of 10%, and on private company dividends at zero.

¹⁶ The Prime Minister foreshadowed a further increase in his 1980 election policy statement.

¹⁷ As explained in paragraph 14.58, an investor in the 32% marginal tax bracket faces at present an effective rate of tax of about 54% if the company retains the whole of its profits.

¹⁸ \$20m in respect of the 1977-78 income year, which can be compared with the primary tax of \$703m assessed to private companies with taxable incomes totalling \$1716m for that income year. (Information provided by the Australian Taxation Office.) Also the increases in retention allowance in recent years (see paragraph 14.52) would have helped to keep Division 7 revenue down from that which it otherwise would have been.

14.81 If dividends received by a private company were to attract a retention allowance, an individual with a portfolio of share investments would be in a position to secure significant tax savings by vesting the portfolio in a private investment company which derives the dividends on those shares. Because of the tax rebate on dividends allowed to a company, the dividends would not be taxed in the hands of the investment company. The effect of a retention allowance for the dividends would be to defer tax on that fraction retained. The interpositioning of one or more private companies between the company holding the portfolio of shares and the ultimate shareholder could be used to achieve further time extension.

14.82 'Non-trading' income does not appear to have the same tax deferral potential as dividends. At the same time it differs from business income in not being accompanied by the same degree of requirement to retain funds in the furtherance of business operations. This is generally given as the reason for 'non-trading' income attracting a far lower retention allowance than trading or business income.

14.83 It has been suggested that with the lifting of the retention allowance on trading and business income to 70%, there should have been a corresponding adjustment to the retention allowance on 'non-trading' income, which still remains at 10%, so as to restore previous relativities.

14.84 The Committee's proposal for full integration would also have a bearing on this issue; in effect 'retention allowances' would no longer be relevant to the determination of tax liability.

14.85 **The Committee makes no recommendations on the present retention allowance for 'non-trading' income and dividends received from other private companies.**

D. CONCLUSIONS AND RECOMMENDATIONS

14.86 In its discussion on the general principles of taxation the Committee has sought to demonstrate that neutrality and equity of the taxation system would be most completely realised under a **full integration** of the personal and company tax system, where the only taxable entity was the individual and where company and other income was attributed directly to the individual.

14.87 To the extent that Division 7 seeks to ensure that closely held companies distribute a specified proportion of after-tax profits (which are taxed in shareholders' hands), it seeks to achieve closer integration of the company and personal tax system and in that sense it can be said to lean in the right direction.

14.88 The Committee is however concerned that under the existing provisions some lower income shareholders, particularly those whose incomes consist solely or substantially of dividends from a private company, may be relatively disadvantaged compared to individuals in an unincorporated enterprise situation. This may have the effect of discouraging share participation in private companies.

14.89 The Committee therefore **recommends** that a private company should be given the option to be treated as a partnership for tax purposes with the shareholders being taxed accordingly.

19 See footnote 13.

14.90 The Asprey Committee made a similar recommendation.

14.91 The Committee fully agrees with the Asprey Committee that to discourage misuse of this option, some restrictions may need to be imposed relating to eligibility to elect that option. It sees (as did Asprey) the undermentioned pre-conditions as appropriate:

- the eligibility to elect the option be confined to companies with small numbers of shareholders (not more than ten), all of whom are individuals beneficially entitled to their shares and resident in Australia; similarly the company should be a resident in Australia;
- to permit ease of allocation of profits to shareholders, only one class of shares be allowed;
- to safeguard the interest of minority shareholders, the unanimous consent of all shareholders be required in the making of and in the revocation of an election;
- to minimise scope for tax avoidance and to keep administrative arrangements simple, the right to revocation of an election be restricted;
- both profits and losses be allocated to shareholders by reference to the daily shareholdings of shares throughout the year.

III TAXATION OF THE COMPANY GROUP

A. BACKGROUND

14.92 The Committee has received a number of submissions proposing that the present system of taxing each company in a group separately should be replaced by one making provision for a single tax assessment of the group as a whole.

B. NATURE OF PROBLEM

14.93 The proposals put to the Committee that company groups be permitted to be assessed as one entity were mainly, but not totally, put on grounds relating to the **treatment of tax losses**. Where there is a flat rate of company income tax, as in Australia, and where no companies in a group incur taxable losses, the consolidation of taxable income for the year would not alter total group tax. The situation is different where there are losses.

14.94 The Income Tax Assessment Act provides that a tax loss incurred in a particular income year may be carried forward against taxable profits for up to seven years. After seven years the tax benefit of any remaining loss is forfeited (except in the case of primary producers, who may carry forward losses indefinitely). The same provisions extend to a company which is a member of a group, even though other members of the same group may be making taxable profits.

14.95 Because there is no provision for a group of companies, with common ownership, to be taxed as a common entity, company groups claim that they are being treated unfairly in comparison with a single company operating along divisional lines.

- 14.96 Group assessment, it is said, would redress that inequity by enabling:
- tax losses by companies in a group to be claimed sooner;
 - tax losses by companies in a group to be claimed which would otherwise never be claimable because of insufficient income in subsequent years to absorb those losses; and
 - a company group's new investment proposals and expected cash flows to be evaluated on the same tax premises as that of a single company.

C. CONSIDERATION OF THE ISSUES

14.97 In support of the *status quo* it has been said that:

- There is no need to convert to a group tax system, as company groups already have the ability to transfer activities between group companies, to enter into joint ventures or to undertake other transactions which have the effect of reorganising the pattern of reported income within the group.
- Group structures already derive substantial benefits from the separate limited liability of individual group members and the financial protection this affords; group companies would be placed very much in a 'best of both worlds' situation were they to have the tax advantage of **consolidated** status as well as the legal advantage of **separate status**.
- Under a system of group taxation, evaluation of the viability of projects could be heavily influenced by tax loss offset considerations.
- New single businesses — traditionally a major source of innovative activity — would be placed at a relative disadvantage if group taxation were introduced, since such businesses would have to bear the risk of losses (often heavy for new ventures) without the ability to offset such losses against the profits of another company in the group.

14.98 There is a **contrary** view, however, which would query each of these claims and argue that:

- Manoeuvres designed to transfer income between companies in a group to circumvent the disadvantage of the present tax system are often costly and cumbersome and, moreover, not universally available.
- A 'neutral' tax system should not influence the choice of corporate structure; the existing taxation legislation tends, in particular cases, to disadvantage those companies which, for one reason or another, need to undertake activities under separate corporate structures.
- Evaluation of the viability of projects is unlikely to be dominated by tax loss offset considerations, although these could be of significance in some cases; where tax loss offsets are not available, the tax system might be said to have a bias against risky projects.
- Companies **without** group links would be neither better nor worse off than they are under the existing tax arrangements while new businesses **with** group links would clearly be assisted by a changeover to group taxation; it is thus conceivable that more innovations would be attempted. On the other hand a larger proportion of innovations might well occur through established corporate groups than is now the case; whether such an emerging pattern would be socially desirable is of course a matter of judgment.

14.99 The Committee has weighed both sets of arguments carefully and formed the view that, **on balance**, allowing company groups with common ownership the option to be assessed as a single unit would be beneficial. In particular it could be expected to give rise to a more **neutral** tax system because the choice of corporate structure for particular operations would be less influenced by the way losses are treated for taxation purposes. Again the system would be less biased against 'risky' projects.

14.100 It is realised that the introduction of group taxation would lead to an initial loss to revenue to the extent that company losses not previously used could now be offset against profits and other losses could be claimed earlier. It may also lead to some new tax avoidance schemes. Nonetheless the Committee believes that the advantages (in terms of greater neutrality) outweigh the potential loss of revenue.

D. GROUP ASSESSMENT OPTIONS

14.101 Appendix 14.3 contains a summary of how some countries treat company groups.

14.102 A clear majority of countries offer some form of group taxation; they do so either by consolidation or by permitting the transfer of tax losses within groups. The Committee has examined both options closely.

(a) Consolidation of Accounts for Taxation

14.103 The first option would enable a group of companies to set off losses against profits in the year the losses are made by taxing the group as one entity.

14.104 A shortcoming of this approach is that consolidated accounts for taxation purposes may be quite distinct from conventional consolidations and in many company groups the former consolidation may represent additional costs. However, this is not pertinent to the issue of whether corporate groups should be given the **option** to consolidate their accounts for taxation should they judge it to be in their interest.

14.105 As well, many conceptual and procedural issues would have to be settled including how any tax saving resulting from consolidation should be allocated between companies in the group — especially if any of these were not wholly owned. However, these difficulties are not insurmountable; for example, the US legislation (which permits consolidated returns) contains extensive rules, of some complexity, detailing the methods for computing a group's taxable income.

14.106 Nevertheless, consolidated tax returns and a consolidated tax assessment would have important advantages including facilitating the reconciliation of the net profit of a group disclosed in its published accounts with its taxable income.

(b) Transfer of Losses within a Company Group

14.107 The second option would permit members of a group of companies to surrender tax losses to another member of the group; however, companies would continue to be assessed individually as separate legal entities.

14.108 This approach is fairly simple to administer, since the existing treatment of companies as separate legal entities for taxation purposes could continue. Moreover, as companies would not be required to prepare additional consolidated

accounts records for taxation purposes, administrative and compliance costs ought to be reasonably modest.

14.109 On the other hand, there are similar conceptual and procedural problems to those under consolidation (e.g. definition of a group, existence of differing balance dates, treatment of overseas interests). Again these should be capable of solution, as countries that offer group taxation have demonstrated.

E. CONCLUSIONS AND RECOMMENDATIONS

14.110 Neither of the above options has a clear advantage over the other. The Committee is of the view that the important principle is that a company and its wholly owned subsidiaries should be given the option to be treated as one entity for the purposes of company tax.

14.111 Accordingly, the Committee *recommends* that:

- (a) **A loss suffered by one company should be permitted to be offset against the taxable income of another company in the same group.²⁰**
- (b) **This option should be made available either by a consolidated tax return or by permitting a transfer of tax losses within a group.**

14.112 Although many countries allow group taxation in situations where companies are not wholly owned subsidiaries, the Committee is of the view that extending the option to groups with less than 100% common ownership could:

- disadvantage minority shareholders should their own company transfer, for an inadequate value, the tax benefits from deductible losses to another company in which they have no equity interest;
- raise complex issues concerning subvention payments;
- be more costly to administer; and
- produce greater loss of revenue.

14.113 The Committee therefore further *recommends* that the options be available only to company groups satisfying the 100% common ownership requirement. However, consideration could be given at a future date to some relaxation of this requirement.

14.114 The administration of group taxation would need to be kept as simple as possible. Consideration might be given, for example, to:

- confining the ability to transfer tax losses to companies resident in Australia during the whole of the income period and to companies employing the same tax year;
- requiring that companies lodge tax returns under one cover;
- requiring that the transfer of tax losses be effected by means of certification between the group companies involved.

14.115 The Committee believes that where an overall group taxation loss has been incurred in any one year, that loss should be carried forward (for a period up to seven years) against the otherwise overall group taxable income of future years.

²⁰ It is envisaged that the seven-year rule (see paragraph 14.94) would remain, but this would obviously be of lesser importance for company groups.

If, however, the initial costs to revenue of that approach were too great or that method led to tax avoidance schemes (which could not be closed) some narrowing of the carry-forward provisions could be considered for the group. For example, the use of tax losses for group purposes could be limited to those incurred in the **same year of income**. Losses of the separate companies not so offset within the group in the same year would of course continue to be eligible for carry forward by the separate companies against their future profits.

14.116 In Appendix 14.1 dealing with some aspects of the integration of company and personal taxation, the Committee envisaged no actual allocation of company tax losses to individuals under an integrated system; the recommendation here on group taxation would thus have equal application under an integrated system of corporate taxation.

14.117 The Committee has also considered the possibility of allowing companies to carry forward losses incurred in one year to offset against profits in another year, but this is not recommended.

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14.126 The Committee has also considered the possibility of allowing companies to carry forward losses incurred in one year to offset against profits in another year, but this is not recommended.

FULL INTEGRATION: A CONSIDERATION OF SOME ISSUES

ADMINISTRATION

Day of Record

1 Because of record-keeping requirements, allocating corporate income to shareholders on a *pro rata* basis, where shares have been traded, based on the number of days that shares have actually been held, would be unworkable.

2 Consequently, it would seem necessary to choose a 'day of record'. A shareholder on the register at that date would be allocated a full year of income for the shares then held and would be liable for personal income tax on that income.

3 In the Committee's view, an appropriate choice of 'day of record' would be the date on which the share register closed for the determination of final dividend (or like event — such as notice of annual general meeting), so that the additional information required by shareholders could be posted out some weeks later along with the final dividend cheque.

4 It is recognised that there could be complications when a sale took place prior to the 'day of record' (the date the register closed), and the broker had not actually transferred the scrip by the time of the register closure. However, this problem would be essentially no different from the present one of brokers having to reassign dividend cheques when the share register at the date of closure is not fully up to date. Procedures currently exist to resolve these mismatches; with the trend towards increased computerisation of the recording of share transactions, these recording lags should diminish.

5 It would not be necessary to ensure that the tax liability assigned according to the 'day of record' was proportionate to the actual fraction of the year for which the shares were held: share prices could be expected to take into account anticipated tax liability, just as at present where shares are priced inclusive (*cum*) and exclusive (*ex*) of dividends. A single 'day of record' would serve precisely the same function as a date on which dividend entitlement is determined under the present workings of the share markets.

6 It is said by some that the creation of a single day of record for these purposes could open up incentives for high income earners to sell to low income earners just prior to the day of record and perhaps reverse the transaction a little later.¹ This avenue is of course available now in respect of dividends. The possibility is substantially reduced, in the opinion of the Committee, by the existence of the other provisions of the Tax Act dealing with share traders and income splitting. If these provisions were found to be inadequate it would not seem all that difficult to remedy matters by further legislation.

Lags and Timing Differences

7 It would clearly be difficult to have the company's 'taxable income' for the current year available in time to be reported in a shareholder's current tax return.

¹ To a large extent these share disposals are motivated by the tax-free nature of the realised gains for some taxpayers. Without this tax exemption element, the valuation of an asset (share or bond) by an investor would largely be independent of his personal tax status. (See P. L. Swan, 'Is there a Case for Complete Integration of Corporate and Personal Income Taxes', *op.cit.*)

8 However, there is no practical necessity to achieve concurrent matching of individual and company income; in fact present company tax assessment is applied on the previous financial year's income; similarly final dividends are usually issued and taxed in the following financial year.

9 Under an integrated system, what was included in the individual's current tax return would effectively be his share of the company's 'taxable income' of the previous year. Quarterly company tax payments (withholds) would continue to be collected as they are now and provisional tax arrangements would continue to apply to shareholders — with rights, where appropriate, to have this varied.

10 It would not matter if the financial (or tax) years of the different companies and the personal taxation year did not coincide. Personal tax liability from shareholdings would arise on only one day — the 'day of record' — and whether a company reported on a financial year or calendar year or some other basis would be immaterial as far as assignment of personal tax liability was concerned. The individual would include his share of company income so determined in his personal income tax return in the following year.

Audit and Tax Appeals

11 The reopening of company and individual tax returns to incorporate subsequent amendments could pose major problems.

12 The most practical solution would be to concentrate all the adjustments to company income and applicable withholding tax payable in the year in which the amendment was made.

13 Any share price value problems could be substantially eliminated if there were adequate reporting on the part of the company of pending tax appeals. The Committee understands that present stock exchange rules require that major events likely to affect share prices be reported.

Loss Companies

14 To discourage trafficking in losses by individuals, no actual allocation of losses to individuals should be allowed.

15 In all other respects, it would be appropriate that losses continued to be absorbed for tax purposes within the company sector.

- In Part III of Chapter 14 it is recommended that a company and its wholly owned subsidiaries be allowed to submit a group return; the losses in one company would be allowed to offset income of another company within the group.
- For a unitary or a non-wholly-owned subsidiary the loss would be carried forward as is the current practice.

Chains of Companies and Interposed Companies

16 The opportunity for tax avoidance through the cycling of income for extended periods in chains of companies and interposed companies would probably be reduced in an integrated scheme.

17 If the withholding tax rate on company-sourced income were set at the highest marginal personal rate, there would be no obvious advantage for high income shareholders to seek a postponement of their tax liability through income retention within the company entity.

18 Even if the withholding tax rate on company income were to remain as suggested by the Committee at the present 46% some tightening of potential tax deferral would be expected. This is because under present tax rules a public company can choose not to pay a dividend at all so as to postpone indefinitely the personal income tax on dividends. However, under an integrated system shareholders would still be liable for personal tax on the entire taxable earnings (of the company) regardless of whether the company chose to

pay a dividend or not. An integrated scheme would thus make avoidance of personal tax liability for income earned via company sources much more difficult than at present.

19 Nevertheless, because the gap between the top personal marginal rate and the company withholding rate would persist, there could still be some incentive to retain earnings within an interposed company. One possible solution would be to subject income passing between certain classes of companies to an **additional** tax which would ultimately be credited, along with the 46% tax already collected, to the shareholders on the allocation of income to individuals.

Income Splitting

20 Under both the present and an integrated system scope for the splitting of income between family and close members exists. The incentive is likely to be greater with integration. Remedies to discourage such activities seem equally available under both systems. In this regard, the Committee notes the significant changes that have taken place in the treatment of the taxation of trusts and of minors.

Administrative Costs

21 In any taxation system, administrative costs will be expended by the authorities while taxpayers will incur compliance costs.

22 As can be expected with the introduction of a new system of taxation there will be initial one-off costs incurred in educating business and other taxpayers on the mechanics of the new scheme.

23 The Committee does not expect any significant changes in the administration, record keeping and accounting practices of companies to be brought about by the introduction of an integrated system. For the 'day of record' the company would need to compute the taxable income and the tax paid by the company per share for the year. This is a fairly simple mechanical exercise. Shareholders would then be sent a 'voucher' to be included in their tax return indicating the number of shares they held, the taxable income allocated to them and the tax credit on those shares.

24 Similarly, the Committee has no reason to believe that the Taxation Office would face major difficulties in their income verification and assessment tasks under an integration system. Similar tasks have to be performed at present for the group certificate system and non-wage returns.

25 The Committee believes that there would be a reduced reliance on paper work with the growing use of computerised technology.

SPECIAL CATEGORIES OF SHAREHOLDERS

Incomes Accruing to Life Offices and Superannuation Funds

26 In Chapter 15 the Committee has recommended changes in the taxation basis of life offices and superannuation funds which would effectively treat them as trustees for their 'beneficiaries' and tax them on their net investment income at a rate approximating the average of the marginal rates of personal tax of 'beneficiaries'. Under full integration these institutions would obtain a refund for tax paid on their share of income from companies equal to the difference between the company rate (currently 46%) and the 'trustee' tax rate just referred to. The granting of this tax refund must be judged in the light of the Committee's full set of recommendations bearing on life offices and superannuation funds. If, as part of **transitional** arrangements, company income accruing to individuals were taxed at a minimum rate of 46%, it should follow then that these institutions **would similarly not receive** a tax refund for tax paid on their share of incomes from companies.

Incomes Accruing to Charities

27 Charities at present enjoy the status of a taxpayer with zero marginal tax rate.

28 In their normal operation, many of these institutions carry company shares in their portfolios. To achieve strict consistency with current government policy, charity organisations should, under a fully integrated tax system, be entitled to a full tax credit for company tax withheld. To deny them a full credit would amount to subjecting them to tax, which might be seen as running counter to the expressed purpose of the tax charter, as well as disturbing the present relative standing between charities and taxable shareholders.

29 However, it is recognised that this would enable charitable institutions to earn a much more favourable return on shares than is now the case, and the Government might wish to maintain the existing structure of tax relief; the 46% tax rate at the company level could be viewed as fully satisfying their tax obligation.

Incomes Accruing Overseas

30 Were the system of full integration to be extended unreservedly to non-resident shareholders, the host country would be placed in the position of forgoing all its tax on non-resident share of company income, whether distributed or not. That, of course, would hardly be acceptable, especially for a capital-importing country like Australia where a significant part of the economic benefit of foreign investment consists of the tax revenue produced.

31 It would be appropriate to endeavour to ensure that non-resident shareholders bore broadly the same Australian company tax burden as they now do. At present in addition to the tax at the company level a withholding tax of 30% is imposed on dividends payable overseas and this is reduced to 15% where a double tax agreement operates.

32 The Committee suggests that the tax credit for Australian company (withhold) tax paid should not be extended to non-resident shareholders; consequently there would be no need for any major change in the present tax status of non-resident shareholders:

- Non-resident investors presently have a clear knowledge of the tax position in respect of their investments in Australia; that *status quo* would not be changed under an integration system. Because their weight of tax has not increased, the Committee believes their incentive to invest in Australia should remain unaltered.
- A large part of the economic benefits from overseas investments in Australia accrue to the community via the present company tax collection; non-extension of tax credit to non-residents would preserve existing levels of economic benefits to the Australian community from foreign investments.

33 Nevertheless, it has been put to the Committee that an integrated scheme which confined tax credits to domestic shareholders would be open to the criticism of involving discrimination against foreign nationals.

34 The Committee is aware of a tax measure introduced in the United States Congress, known as the Rostenkowski Bill,² which, if enacted, would empower the President to impose discriminatory taxes on US subsidiaries of foreign parent companies where the foreign country imposed a higher rate of tax on domestic subsidiaries of US parents than on locally controlled corporations.

35 The Committee, however, does not share the view that non-residents would be discriminated against if tax credits were not available to them under an integrated scheme. It is believed that what is proposed amounts to a consistent application of Australia's current double tax agreements with overseas countries.³ The onus should be on overseas countries to **renegotiate these double tax agreements after Australia had introduced an integrated system**; only at such time would it be logical for Australia to consider extending tax credits to non-residents as a reciprocal arrangement with countries which had also

2 US House of Representatives 8892, 95th Congress, 1st session (August 5, 1977).

3 A similar view is expressed in P. T. Kaplan, 'European Discrimination and American Retaliation', *British Tax Review*, No. 4 (1978), pp. 206-22.

adopted an integrated system and were prepared to consider granting tax credits to Australian resident shareholders of companies operating overseas.

36 Moreover, under the existing international tax framework and particularly where the 'classical' system of taxation applies in the other country, the main beneficiaries of an extension of tax credits to non-resident shareholders would be the foreign Treasuries. This would create the unacceptable situation of economic benefits from foreign investment in Australia, accruing as taxation revenue, being transferred to foreign taxation authorities.

APPENDIX 14.2

PUBLIC/PRIVATE COMPANY DISTINCTION: HISTORICAL BACKGROUND

1 When Commonwealth income tax was first introduced in 1915 provisions were included which allowed the Commissioner of Taxation to deem that distribution had been made where a company failed to make a 'reasonable' distribution (later fixed at two-thirds of the taxable income) and to assess such deemed distribution as income in the hands of the shareholders. In practice the Commissioner applied the provisions only to closely controlled companies.

2 Following the report of the Ferguson Commission (1932), the tax legislation was amended to formally define a private company and confine the deemed distribution provisions to such companies. It was argued that unlike listed public companies, private companies' dividend policies were more likely to be influenced by taxation considerations.

3 The definition of a private company was complex and did not encompass all closely controlled companies. In 1952, following the recommendations of the Spooner Committee, a new definition of private company was adopted and an undistributed profits tax introduced, aimed at forcing private companies to distribute all profits in excess of a specified retention allowance. However, by making sufficient distributions to a series of related companies or through circles of related companies, or by creating de facto non-private companies, companies were able to avoid this tax while retaining effective control of the 'untaxed' profits.

4 In 1964, following the recommendations of the Ligertwood Committee, another attempt was made to identify a private company, this time by defining a public company and classifying all other companies as private. The provisions allowing a tax rebate on dividends passing between private companies were amended at the same time. The practice of storing profits in a pipeline of companies was now made unattractive by a partial denial of the rebate when dividends were received by a private company from another private company. However, the Commissioner was given a discretion to allow a full rebate. That discretion was ordinarily exercised if the Commissioner was satisfied that the dividends would reach the hands of persons, who are not private companies, within twenty-two months of the end of the year of income in which the dividends had been received by the company claiming the full rebate.

5 Apart from some minor amendments in 1973, this represents the tax position today.

TREATMENT OF COMPANY GROUPS IN SELECTED COUNTRIES¹

<i>Countries giving group relief</i>	<i>Type of grouping</i>	<i>Ownership required² %</i>
Austria	Entire profits/losses of joint stock companies transferable to parent under profit-pooling arrangement.	100
Denmark	Consolidated return offsetting profits against losses.	100
France	Separate returns lodged but profits and losses combined and tax levied on the parent in respect of consolidated corporate income; authorisation for such treatment restricted to cases where subsidiary results from a restructuring of group.	95
Ireland	Group relief in respect of prescribed items including losses.	75
Netherlands	Consolidated returns whereby parent and subsidiary considered as one entity for tax purposes.	100
New Zealand	Automatic offset of profits and losses within wholly owned groups. Group taxation is also available where common ownership is 66 ² / ₃ and more, but subvention payments must be made to minority shareholders when intra-group transfers of profits and losses are made.	66 ² / ₃
Sweden	Group relief in the form of permissible shifting of profits between group companies.	90
United Kingdom	Group relief in respect of certain specified expenses and outgoing including losses; no offset for capital gains and losses.	75
United States	Group can elect to file consolidated return showing aggregate of individual members' incomes adjusted for intercompany transactions and other items.	80
West Germany	Profits or losses transferable to parent subject to profit/loss transfer agreement, being approved by minority shareholders.	50
<i>Countries not giving group relief</i>		
Belgium		
Canada		
Italy		
Japan		
Portugal		
South Africa		

1 Sources: *Corporate Taxes in 80 Countries*, Price Waterhouse Publication, 1980; *Taxation of Company Groups*, A Research Paper for the Taxation Institute of Australia Research and Education Trust, 1977.

2 Basis for determining ownership varies between countries.

CHAPTER 15: TAXATION OF INTERMEDIARIES

INTRODUCTION

15.1 In this chapter the Committee seeks to determine the most equitable and neutral basis for taxing certain intermediaries which are subject, at present, to a mix of arrangements. It examines suggestions that:

- life offices be taxed on a trustee basis;
- 'net income' of superannuation funds be taxed (with distributions therefrom including pensions being exempt from tax);
- credit unions be taxed on the same basis as competing intermediaries, particularly building societies.

It does not discuss the social merits of tax arrangements designed to encourage particular forms of saving. This is essentially a question for government. However, views are offered on the most cost-effective techniques of providing encouragement through the tax system.

I TAXATION OF LIFE INSURANCE COMPANIES

A. NATURE OF LIFE INSURANCE BUSINESS

15.2 In the process of providing life insurance facilities, the life offices perform two functions for policyholders:

- as insurance underwriters: pooling risks and redistributing funds from one group of policyholders to another;
- as financial intermediaries: receiving premiums from policyholders and investing them on the policyholders' behalf.

15.3 There is a need to consider how the underwriting profit and the investment income associated with these two functions should be treated for tax purposes.

15.4 In Australia, the bulk of life insurance business is conducted by mutual life offices.¹ The Committee's consideration of the issues is set in this context, although the situation of shareholder companies² is examined in connection with underwriting profits.

1. At 30 June 1981, life insurance in Australia was conducted by eight mutual life offices, thirty-seven proprietary companies and three state government offices. In terms of Australian assets, the mutual offices' share represented about 70% of the non-government offices total.

2. The Life Insurance Act requires that shareholder companies apply not less than 80% of the surplus (profits) of participating policies for the benefit of policyholders.

B. PRESENT TAXATION ARRANGEMENTS

15.5 Present taxation arrangements of life offices and their policyholders are set out in paragraphs 13.23–32 of the Interim Report. Generally life offices are taxed (in respect of their non-superannuation business) at the general company rate (currently 46%) on their investment income, plus realised gains on disposal of investments, after the allowance of deductions in respect of:

- all expenses directly incurred in gaining investment and other assessable income;
- a proportion of expenses of general management notionally attributable to the gaining of assessable income; and
- realised losses on the disposal of investments.

15.6 In addition, where a life office complies with 30/20 provisions³ it is eligible for:⁴

- exemption from tax (subject to certain provisos) on the investment and other income and profit relating to superannuation business;
- a deduction equal to 1% of 'calculated liabilities', i.e. the present actuarial value of expected future liabilities under the company's policies after taking into account expected future premiums, interest income, claims etc; and
- where it is a resident — a full s.46 rebate⁵ on company dividends received.

15.7 Premiums received in respect of life policies are not assessable income; at the same time expenditure incurred in gaining such receipts (e.g. agents' commission) and claims paid on life policies are not deductible.

15.8 For completeness, it is worth noting here that life insurance premiums are included in the income tax schedule of personal expenditure items covered by the general concessional rebate.

C. 'TRUSTEE' BASIS OF TAXATION

15.9 The life offices' submissions argue that because the bulk of life insurance business in Australia is written on a participating basis, life offices are best seen as acting in the capacity of 'trustees' for their policyholders in the management of collective funds.

15.10 On the basis of this principle, it could be further argued that the life office itself should not pay tax and that tax should be imposed on individual policyholders in respect of:

- an allocation to them of the annual net investment income and underwriting profit earned by the life offices; or

³ See Chapter 10 for a detailed discussion of these provisions.

⁴ If a life office does not comply with the 30/20 rule:

- (i) it does not qualify for the exemption on investment income relating to superannuation business;
- (ii) the special deduction under s.115 is reduced on a sliding scale (it would be increased on a sliding scale if the company held more than the prescribed amount of government securities);
- (iii) the s.46 rebate is reduced to the level corresponding to dividends derived in income year 1960–61 for that company.

⁵ See also Chapter 14, paragraph 14.3.

- the 'net gain' they receive through their policies, i.e. the excess of policy proceeds over premiums paid.

15.11 This approach seeks to impute the income of a life office to its individual policyholders and would be consistent with the integration of company and personal taxation.

15.12 There are difficulties, however, in this approach.

15.13 In respect of the annual allocation basis, it is impracticable to determine annually for each and every policyholder (and to have included in their relevant tax returns) an amount which could be regarded as imputed income to the policyholder. This is because of the very large number and range of policies and holders involved.

15.14 In respect of the 'net gain' basis, there are practical difficulties and certain inequities arising from:

- the treatment of the excess of death claims over premiums paid;
- the postponement of tax until policy proceeds are paid, and the difficulty of taxing in a fair manner the receipt in one year of a large sum which has been accumulated over a long period;
- the treatment of cases where the policy benefit (for example, an early surrender) is less than premiums paid; and
- the treatment of that part of the policy proceeds comprising accumulated reversionary bonuses; these could be seen as repayment of capital sums representing excess premiums paid.

15.15 The Committee believes that the practical approach would be to collect the appropriate tax from the life offices themselves. In other words, the life offices should be regarded as a conduit through which income passes to policyholders; tax is taken from the conduit instead of from the policyholder.

15.16 Accordingly, the Committee agrees that the 'trustee' principle is an appropriate basis for taxing mutual life offices. To the extent that there may still not be complete neutrality with some other intermediaries, it believes that comes about because of the lack of an integrated tax system.

D. CONSIDERATION OF THE ISSUES

15.17 The 'trustee' principle suggests that the amount of tax paid should be equivalent to that which policyholders in aggregate would have paid had it been practicable to tax them directly on the total earnings of the life office. Application of the principle requires resolution of a number of issues including:

- (i) The treatment of particular categories of expenses.
- (ii) Whether a single rate of tax should be applied; **and if so, what that rate should be.**
- (iii) The implications of the 'trustee' approach for those tax provisions relating to:
 - the treatment of realised gains and losses on investments;
 - the s.46 rebate on dividends received from companies; and
 - the s.115 deduction allowed for 1% of 'calculated liabilities'.
- (iv) The tax status of underwriting profits.

15.18 It is proposed to examine each of these matters in turn, drawing out some of the issues involved and suggesting the general direction of resolution.

(a) Treatment of Expenses

15.19 There is broad agreement that the 'trustee' concept implies taxing life office investment income net of applicable expenses; payments to policyholders exceed the total premiums paid only by an amount equal to the investment income less the operating expenses incurred. There is, however, disagreement about the scope of the expenses which should be deducted. Specifically:

- the life offices have suggested that under the trustee concept the net income base should be investment income less **total expenses**, including expenses incurred in gaining premiums;
- the authorities, on the other hand, consider that the deduction should encompass **only those expenses incurred in gaining taxable investment income**.

15.20 The life offices base their case on two arguments:

- In soliciting life insurance business, they are in a sense performing the same role as other financial intermediaries in marshalling funds which are later on-lent or otherwise invested. Premiums are essentially capital payments similar in character to deposits paid into banks and building societies; commissions paid to life insurance agents are similar to the salaries of tellers in a bank or a building society. It is thus anomalous not to allow life offices their full running expense as a tax deduction when other financial institutions are given this deduction.
- From the policyholder's point of view, the commissions paid to life office agents correspond to management services fees paid to investment advisers, which are presently accepted as a normal business expense of investors.

15.21 The Committee does not accept these arguments.

15.22 It believes that for taxation purposes the expenses incurred by a life office as a trustee for its policyholders must be categorised into those expenses which are of a 'capital' nature and those which are of a 'revenue' nature. The Committee sees a life insurance transaction as comprising:

- *A contract of insurance* — The contract and the expenses incidental to its initiation and maintenance being (from the policyholder's point of view) of a 'capital' nature. Accordingly profits or losses arising from that contract would be neither taxable nor deductible.
- *An investment contract* — The contract and expenses incidental to its initiation being (again from the policyholder's point of view) also of a 'capital' nature. The continuing expenses of servicing that investment contract however might be reasonably regarded as of a revenue nature — akin to continuing investment management services paid and allowed in respect of alternative investments.

15.23 Consistent with that view the Committee believes that the expenses of a life office should be treated for taxation as follows:

- *Non-deductible* — that part of expenses applicable to the writing of the insurance contract in the first place, its continuing management and that part of expenses which initiated the investment contract.
- *Deductible* — those expenses which are directly attributable to the collection of

the investment income together with those expenses reasonably attributable to the continuing management of the investments.

There will be some expenses which will need to be apportioned between 'capital' and 'revenue' for these purposes.

15.24 In broad terms, what is considered to be appropriate is unlikely to differ very much from the deductions presently allowed in respect of:

- all expenses directly incurred in gaining investment income; and
- specified general management expenses.

15.25 On balance, therefore, the Committee sees little need for a change in the present treatment of expenses.

(b) Rate of Tax

15.26 Acceptance again of the 'trustee' concept implies that the appropriate rate of tax to be applied on taxable income should represent some weighted average of the marginal rates of policyholders.⁶ It might not be feasible, however, to determine a precise figure for this rate, and it could well vary from one life office to another. Additionally, for many policyholders, their rates of tax will vary during the period of the long-term saving contract. The industry view is that the standard (or basic) rate of personal income tax (at present 32%) should apply. It is possible, however, that for some life offices the weighted average of the various rates of policyholders is higher than this rate. The current rate of tax applied to life offices' taxable income is the company tax rate of 46% — which is also the present 'middle range' marginal rate for individuals.

15.27 Until such time as it is practicable (if ever) to tax other than the trustee, some compromise in the rate is clearly necessary. The Committee simply records this and, having made no assessment of the matter, issues no finding as to a fair rate for the intervening period.

15.28 Consideration of rate generally assumes that life assurance arrangements are accompanied by long-term savings-investment contracts. Where these arrangements are initiated for shortish terms, further consideration might need to be given to the appropriate trustee rate for taxation purposes.

(c) Treatment of Realised Gains

15.29 A number of submissions argue that the taxation of gains on the sale of life offices' investments is inequitable, particularly viewed in the light of the 'trustee' concept. They point out that had it been practical to tax policyholders, profits on the resale of their investments would, in most cases, have been treated as non-taxable gains.

15.30 Under the 'trustee' principle, a life office should have the tax status of an individual policyholder conducting a similar investment activity. Under the present tax provisions, where an individual undertakes, as part of his normal income-earning activity, the regular and frequent review of his investment portfolio, with consequent disposals and acquisitions, it is generally held that profits arising therefrom are assessable and losses deductible. He is taxed on gains

6 The Committee recognises of course that using an 'average' rate has distributional implications — it makes life insurance relatively more attractive for high income earners than low income earners.

arising from the carrying on of a business in buying and selling investment type securities and from investments acquired for the purpose of profit making by sale.

15.31 On the other hand, where investments are acquired as a long-term addition to an individual's portfolio as a means of producing dividend income, any profit arising out of the eventual realisation of the investment (not being a normal part of his income-producing activities) is generally treated as being of a capital nature. In this case profits are not assessable; nor are losses deductible.

15.32 Life offices are clearly both traders and long-term investors. The Committee notes that over recent years, many of them have engaged in regular and frequent revisions of their investment portfolios.

15.33 It is the Committee's view that it would be desirable to **strive for greater consistency in the treatment of realised gains and losses as between life offices and individual investors so that the effects of taxation on investment choices are similar for both groups.** In this regard it may be appropriate for the Taxation Commissioner to judge the eligibility for taxation of each life office on a case by case basis, consistent with the principles applicable to individuals.

(d) Section 46 Rebate

15.34 Under present tax arrangements, the life offices, like other resident companies, are entitled to a s.46 rebate on dividend income received.

15.35 The purpose of the s.46 rebate is to prevent the imposition of additional tax when dividends pass from company to company.⁷ **Under the 'trustee' approach, life offices would be treated like individual shareholders and the s.46 rebate would no longer have relevance.**

15.36 In Chapter 14 the Committee has recommended a change in the method of taxing corporate shareholders from the classical to an integrated system. Under the latter, taxpayers would receive credit for taxation withheld by the company on their behalf in respect of their share of the taxable income. The adoption of that change would need to flow through to life offices under the trustee principle — totally negating in these circumstances the effect of the disallowance of the s.46 rebate.

15.37 Removal of the s.46 rebate would represent a further move towards tax 'neutrality' in the treatment of given income flows. The Committee recognises that, in the absence of an integrated tax system, the relative attractiveness of share investment for some life offices could alter.

(e) Section 115 Deduction

15.38 The s.115 deduction currently reduces a life office's taxable income by an amount equal to 1% of its 'calculated liabilities'.

15.39 This section of the Act was apparently introduced to give effect to the view endorsed in the report of the 1934 Royal Commission on Taxation⁸ that:

a life insurance company should be taxed on the basis of its investment income which cannot be correctly determined without providing for the interest assumed to be earned on the investments set aside to provide for the payment of the liabilities of the company to its policyholders.

⁷ See 'Company Income Tax Systems', *Treasury Taxation Paper No.9*, November 1974.

⁸ *Third Report of the Royal Commission on Taxation*, Parliamentary Papers — General (Session 1934-35-36-37) Volume III, Commonwealth Government Printer, Nov. 1934, p. 2019, para. 858.

15.40 The life offices claim that this view gives recognition to the notion that the relationship between a life office and its policyholder is identical to that between, say, a bank and its depositors, and that the interest earnings assumed to be incorporated in the design of life insurance policies correspond closely to 'cost of funds' applicable to the investment earnings of banks. The conclusion drawn is that a s.115 deduction, or a similar proxy for the assumed 'cost of funds', should be deductible against life offices' investment income.

15.41 The Committee recognises the apparent similarity between the 's.115 allowance' and a 'cost of funds deduction'. However, this cannot be viewed in isolation from other aspects of the tax treatment of life offices. Thus in the case of banks, while the 'cost of funds' is an allowable deduction to the bank, the interest payment is assessable income to the depositors; if life offices were to be treated similarly, it would require the recipients of the 'interest' to bear tax on that income — which means the policyholders or, under the 'trustee' principle, the life offices on behalf of their policyholders.

15.42 It is clear from the foregoing that **the s.115 deduction is inconsistent with the 'trustee' concept and accordingly should not be allowed as a deduction against assessable income within that concept.**

(f) Underwriting Profits

15.43 The present taxation arrangements and the 'trustee' approach as described above relate only to the taxing of the net investment income earned by life offices — i.e. the surplus earned by life offices in their capacity as 'financial intermediaries'. Life offices also earn a 'profit' in their capacity as insurance underwriters (see paragraph 15.2).

15.44 Underwriting profits arise when, in the longer term, premiums (less applicable expenses) charged for insurance cover exceed benefits paid out to policyholders. This can happen because of favourable life office experience or because premiums are set on the basis of conservative estimates of mortality and expenses.

15.45 Although, ordinarily, underwriting 'profits' in the life insurance business are conceptually no different from the operating profits of other incorporated businesses, the Committee sees, under the 'trustee' principle, the insurance transaction as a transaction of a 'capital' nature — the profits and losses on which are exempt from taxation. While this is clearly the correct treatment in the case of mutual life offices, it is not correct for that part of any underwriting profit earned by a proprietary life office (for the benefit of its shareholders).

15.46 At present, underwriting profits retained within the mutual life office are not taxed. The Committee would see no change to this under the trustee principle.

15.47 With a proprietary life office, the Committee considers that the underwriting 'profits' earned by these companies and belonging to their shareholders (as distinct from policyholders) should be taxed at full company rates.⁹ The fact that these profits arise from premiums (ordinarily exempt for life

⁹ The surplus within the Statutory Fund of a proprietary life office is shared, in different proportions, by the policyholders and shareholders. This surplus comprises both net investment income which has been taxed and underwriting profits which have not been taxed. Joint stock corporations (proprietary life offices) are presently not taxed on their share of the underwriting profits which passes to them — a share available to their shareholders. The Committee seeks only to impose tax (at corporate tax rates) on that component which represents the untaxed underwriting profits of a proprietary life office.

offices) should not alter that position. These joint stock companies are in the business of underwriting for profit and accordingly should be taxed on any such profit.

E. TAX INCENTIVES FOR LIFE INSURANCE

15.48 At present, life insurance premiums and superannuation contributions are included in the income tax schedule of personal expenditure items covered by the general concessional rebate.

15.49 As the minimum general concessional rebate is available to all taxpayers, an individual can effectively claim a tax concession for expenditure on life insurance and superannuation only if his total expenditure on other concessional items equals or exceeds a stipulated figure — at present \$1590 p.a. For taxpayers who do so qualify, life insurance premiums, aggregated with superannuation contributions,¹⁰ are rebateable, at the standard tax rate, up to \$1200 p.a., but only in respect of policies for ten years or longer.

15.50 In 1979–80, 0.7% of taxable individuals received the full rebate of \$1200 (covering both life insurance and superannuation), with a further 6.1% receiving a partial rebate.¹¹

15.51 In the preceding section, the Committee has sought to develop a basis for taxing life insurance companies which would, as far as possible, be neutral vis-a-vis other financial intermediaries.

15.52 If the Government wished to maintain strict neutrality in funds flows, the present personal concessional rebate for life insurance and superannuation contributions would either need to be extended to other forms of savings — or abolished altogether.

15.53 However, the Government may consider it desirable on social or other grounds to give special encouragement to individuals to enter into and maintain life insurance contracts. The Committee does not express any judgment on this issue but the question of the best method of any encouragement needs to be addressed.

15.54 It is the opinion of the Committee that any encouragement that government wishes to provide for life insurance should be in the present form, that is by way of a tax rebate. As indicated elsewhere in the Report,¹² a tax concession has a number of attractions as a method of providing government assistance.

15.55 Should the Government wish to offer specific further encouragement for life insurance, it could remove life insurance premiums from the schedule of general concessional expenditure rebate items and from its common grouping with superannuation payments and accord it separate rebate status. However, the Committee offers no recommendation on the desirability or otherwise of any such change.

10 Following changes made in the 1980 Budget, superannuation contributions by self-employed persons and employees not covered by employer-sponsored superannuation arrangements are deductible from assessable income up to a maximum of \$1200 p.a. Contributions in excess of this amount, and aggregated with life office premiums, are rebateable in the manner outlined in this paragraph.

11 Information provided by the Treasury.

12 See, for example, Chapter 36.

II TAXATION ARRANGEMENTS FOR SUPERANNUATION

A. BACKGROUND

15.56 The present taxation provisions applying to superannuation may be summarised as follows:

Contributions to funds:

- Employer contributions to a fund for employees are an allowable deduction, subject to certain conditions.¹³
- For self-employed persons and employees not covered by employer-sponsored arrangements, contributions to a qualifying fund¹⁴ made after 19 August 1980 are **deductible** from their assessable income up to a limit of \$1200 p.a. Contributions in excess of \$1200 (up to a further \$1200, inclusive of any life insurance) are **rebateable** at the standard rate.
- Contributions by employees, covered by employer-sponsored arrangements, are **rebateable** at the standard rate, up to a limit of \$1200 p.a. (inclusive of any life insurance).
- A full rebate is obtainable in all instances only if total expenditure on other rebateable items equals or exceeds a specific figure — at present \$1590 p.a.

Income of funds:

- The income of superannuation funds meeting particular conditions (including compliance with the 30/20 rule) is exempt from tax.

Benefits received from funds:

- Pension benefits are assessable income, except to the extent that they are matched by previously unrebated contributions in excess of \$1200 p.a.
- 5% of lump sums received on retirement or termination of employment by employees who are members of employer-sponsored schemes is assessable.¹⁵
- 5% of lump sums received from qualifying funds after 19 August 1980 by self-employed persons and 'unsupported' employees is assessable, to the extent that those lump sums are derived from contributions after that date and from earnings of the fund from the investment of those contributions. That part of such individual's lump-sum retirement benefits derived from contributions made up to 19 August 1980, and from earnings on the investment of these contributions, is tax free.

15.57 The Committee believes that these provisions involve significant departures from tax neutrality in that the relative attractiveness of saving through superannuation is artificially enhanced vis-a-vis other forms of saving, including alternative means of saving for retirement.

15.58 It has been put to the Committee that the 30/20 rule has substantially offset the tax advantages enjoyed by these institutions. Even if that were so, as indicated in Chapter 10, the Committee sees considerable difficulties flowing from

¹³ The conditions relate primarily to the rights of members, regularity of contributions by the employer, the avoidance of excessive benefits and the Fund meeting the 30/20 requirement.

¹⁴ A fund that qualifies under s.23(ja) or s.79 of the Income Tax Assessment Act.

¹⁵ In addition, employers obtain deductions for retiring allowances paid **direct** to retiring employees (so-called 'golden handshakes'). Usually 5% of these lump sums is assessable in the hands of the retiring employees.

quid pro quo arrangements of this kind. It is possible that competitive balance may be fortuitously restored as a result of offsetting factors but this is unlikely and, in any case, allocative and operational losses are still imposed on the financial system. Accordingly the 30/20 rule and the taxation arrangements should be treated as separate issues; the former is examined in Chapter 10 and a recommendation made to abolish the 30/20 rule; this of course would, taken on its own, enhance the 'privileged' position of most superannuation funds now subject to the rule.

15.59 Submissions from the industry have not denied that the present taxation arrangements contain concessional features but they emphasise that these arrangements reflect a deliberate government policy of encouraging long-term systematic saving for retirement.

15.60 While the weights to be given to various social objectives are matters for government judgment, the Committee nevertheless has a legitimate interest in the methods of assistance used to achieve those objectives and their implications for the efficiency of the financial system. Therefore, an examination of possible ways of increasing tax neutrality in the area of superannuation is followed by a consideration of how any desired tax incentives to encourage savings through superannuation might best be pursued.

B. TAX NEUTRALITY

(a) Departures from Neutrality

15.61 Under a neutral tax system, tax considerations would not influence the choice between saving through formal superannuation arrangements and saving for retirement through other financial intermediaries or through direct investment.

15.62 The present provisions are conspicuously non-neutral in several respects:

- The employer's contribution, although tax deductible to the employer, is **not taxed in the hands of the employee or the superannuation fund**,¹⁶ which amounts in effect to superannuation funds being financed with 'tax-free' moneys.
- The tax-exempt status of most funds allows the **deferral of tax on incomes** involved ('untaxed' contributions and investment income earned by the fund) until after retirement.
- Whereas **pension** benefits are assessable income, for tax purposes, benefits taken in the form of **lump sums** are substantially free of tax.¹⁷
- There is non-uniformity of tax treatment between the different categories of funds.

15.63 These substantial departures from tax neutrality impact on market competition and market choice in a variety of ways:

- The tax-exempt status of superannuation funds imparts a competitive advantage to these funds vis-a-vis other collective funds.

16. Strictly, one should also include that portion of the employee's contribution that has been rebateable under s.159R.

17. This perpetuates the tax-free character of the investible amounts for these beneficiaries.

- The different tax treatment of lump-sum and pension benefits biases choice between these types of benefits.
- The incentives have been primarily directed towards employer-sponsored schemes (section 23F funds). Although the opportunities for individual participation have been recently extended (see paragraph 15.56), the present system still perpetuates a situation where the benefits enjoyed by superannuation funds (partly paid for by the general pool of taxpayers) accrue principally to a relatively small proportion of the community¹⁸ — namely, to those who, because of the level of their income or nature of their employment, can take full advantage of superannuation arrangements.¹⁹

15.64 The substantial freedom from taxation enjoyed by superannuation arrangements has inevitably attracted schemes for tax minimisation; on the authorities' own admission it is to curb such schemes that complex safeguarding provisions have had to be introduced.²⁰

15.65 These safeguard provisions, in turn, have had the undesirable effect of impeding the operational efficiency and flexibility of superannuation funds.

(b) Appropriate Basis for Taxing Superannuation

15.66 The departures of present arrangements from tax neutrality would be eliminated if:

- flows of 'income' (including employer and other tax-deductible contributions) through superannuation schemes were 'allocated' to beneficiaries and taxed as they were 'earned'; and
- the amount of tax paid on these income flows were to correspond with that which individuals would have paid had they received this income directly as it was earned.

15.67 Such an approach would be consistent with our proposed integration of company and personal taxation, whereby all company incomes would be imputed to individual shareholders.

15.68 However, there are practical difficulties in proceeding in this way:

- in many superannuation schemes the employer-financed benefit is conditional on the employee remaining with the particular employer until retirement; thus until the employee actually retires there would always be the possibility of his being assessed (either directly or on his behalf) on income which in the end he never received;
- in the case of 'unfunded schemes', most notably the Commonwealth Public Service Scheme, pensions are set at a fixed percentage of final salary level (with provisions for commutation to a lump sum), and it would not be known

¹⁸ According to figures quoted in a supplementary submission from the Life Insurance Federation of Australia, only about 20% of the private sector workforce are presently covered by superannuation. While this proportion can be expected to increase as a result of the measures announced by the Treasurer in August 1980, it is likely that the great bulk of the tax benefits will continue to be enjoyed by a small proportion of the workforce.

¹⁹ Employees covered by employer-sponsored arrangements cannot opt out in favour of the post-August 1980 arrangements.

²⁰ Treasury Paper No.6, 'The Role of Life Insurance Companies and Superannuation Funds in the Capital Market', submission to the Committee of Inquiry into the Australian Financial System, p. 59.

year by year during an employee's working life what his 'true' earning for that year should be for tax purposes.

15.69 This would seem to leave only two alternatives:

- to tax the income flows only when they are ultimately received as benefits in the employee's hands; or
- to treat superannuation funds as quasi trustees of the income accruing to individuals, tax being collected from the funds on behalf of the ultimate beneficiaries.

(i) Taxation of Benefits in Employees' Hands

15.70 If the approach of taxing benefits in employees' hands were to be adopted, it is important for reasons of efficiency and equity that there be substantial equivalence between the treatment of pensions and lump-sum payments.

15.71 This is not the case at present. While pensions are wholly assessable, only 5% of lump sums are subject to tax. The concessional element is not so apparent when investment of the lump sum produces assessable income. Nevertheless, a tax bias remains.

15.72 At present, the great bulk of people in Australia in superannuation schemes (outside the Commonwealth Government sector) are covered for lump-sum benefits only.²¹ This undoubtedly importantly reflects current tax arrangements.

15.73 The Committee recognises, of course, that it would not be equitable for the whole of a lump-sum benefit to be taxed at the applicable personal rate in the year it was received. If the approach of taxing the employees themselves were to be pursued it would be necessary to determine the most appropriate method of spreading or notionally spreading lump-sum benefits over a series of years for tax computation and payment purposes. Appropriate transitional arrangements would be essential.

15.74 It has been suggested that the simplest solution would be to prohibit lump sums or to severely limit their availability. However, the Committee does not favour this course in a market economy where freedom of choice is important, and more particularly in situations where pensions generally are not indexed to inflation.

15.75 Even if the tax bias arising from the treatment of lump-sum benefits were removed by treating lump sums and pensions on a reasonably comparable basis, a considerable departure from neutrality and equity would still remain because of the effective deferral of tax on employers' and other tax-deductible contributions (which are in essence a form of wage payment) and on the investment income of the funds.

15.76 Such residual bias is capable of **partial** resolution by, for example, taxing the employers' and other tax-deductible contributions at the fund level or by specifically excluding all or part of the contributions as an allowable deduction. Less effective and less radical methods might seek to continue or extend the present 'tests of reasonableness' to limit the size of employer contributions or to impose a limit on benefits that can be provided. Some taxation of the investment income of the funds would also be necessary for completeness. Alternatively,

21 Treasury Submission No.6, op.cit., p. 59.

higher tax rates on lump sums and to a lesser extent pensions would be needed to compensate for any deferred tax advantages. Such piecemeal 'patching up' could well add to the complexity of existing arrangements and is not in the opinion of the Committee a preferred course.

(ii) Taxation of Superannuation Funds

15.77 Alternatively, neutrality could be achieved by making 'incomes' generated within superannuation funds annually liable for tax in the hands of the funds at the time they are 'earned'. The 'income' in this case would be:

- employers' contributions;
- that portion of contributions to the fund made by self-employed persons, and employees not covered by employer-sponsored arrangements, which is presently allowed as a tax deduction; and
- the net investment and related income of the fund.

15.78 Total neutrality could not be achieved however unless the rate of tax levied on the fund's various income components equalled in each and every case the rate applicable to each beneficiary. In that event there might not be any tax incentive for the employer to establish a superannuation fund for his employees. Again, for the purposes of achieving total neutrality, rebates granted could be taxed within the fund. This treatment, however, would have the effect of cancelling the rebate incentive. The Committee offers some suggestions later on how the Government might encourage superannuation if it wishes.

15.79 It would follow that with 'incomes' taxed within the fund, **pension benefits and lump-sum payments when ultimately received by the beneficiaries from the fund should properly be exempt from tax.**

15.80 In effect the superannuation fund would be treated as a 'quasi trustee' receiving incomes on behalf of members which are ultimately paid out to them as tax-exempt benefits. Accordingly, the rate of tax on the 'incomes' of the fund should correspond as closely as possible to that which members as a whole would have paid had the income been taxed in their hands. Something approximating the weighted average of the marginal rates of all members of each fund might be an appropriate rate. As with life offices (see paragraph 15.27), practical considerations could well bear importantly on determining the most appropriate rate.

15.81 From the point of view of neutrality and equity, this basis of taxing superannuation funds has obvious attractions. For instance:

- Problems about choice of forms of benefits and their different tax treatment would be avoided. More specifically there would be greater tax neutrality as between lump sums and pension benefits.
- With incomes taxed on an earned basis within the funds, the tax deferral problem would be reduced.
- There would be greater equity than at present as between employees covered by employer-sponsored schemes and those that are not.
- More importantly for the financial system, income from savings through superannuation would bear the same weight of tax, in the aggregate, as income from savings in other forms — life offices for example.
- Many tax minimisation issues under the present system would be automatically resolved or substantially reduced in their effect.
- There would be uniform tax treatment of the various categories of

- superannuation funds; more specifically, the administrative complexities and
- the artificial segmentation of superannuation business that can arise from the
- present categorisation of funds and benefits would be largely avoided.

15.82 For all of these reasons the Committee concludes on efficiency grounds that the taxation of superannuation funds could be made more neutral and equitable by adopting a basis of income taxation whereby the funds are taxed on annual 'income received', net of operating expenses, at a rate representative of the weighted average of the marginal rates of members. 'Income received' would be defined as investment income plus the contributions to the fund by employers or self-employed persons or non-employer-sponsored employees — where these contributions are allowed as a tax deduction. On that basis pension benefits and lump-sum benefits when ultimately received by beneficiaries from the fund should properly be exempt from tax. The Government should consider the implementation of such a scheme with appropriate transition arrangements to cater for existing superannuation and like commitments (see paragraphs 15.90–92).²²

15.83 It would be important that the realised gains on disposal of investments receive the same treatment as that accorded to individuals. (See the previous section for similar comments on life offices.)

15.84 The Committee recognises that the Government, in pursuit of social and other objectives, may wish to use the tax system to provide special incentives to encourage saving through superannuation. Such encouragement could be built onto the neutral system outlined above. This is outlined later (see paragraph 15.99).

(c) Further Issues

(i) 'Unfunded' Schemes

15.85 Under the basis being suggested, 'unfunded' superannuation schemes, such as the Commonwealth Public Service Scheme, should in principle be treated for taxation purposes no differently from private sector funds.

15.86 It is of course possible to tax such funds on the investment income derived from the employees' contributions. It is not possible however to tax the employers' contributions and the investment income therefrom as no such contributions are annually made on account of future entitlements.

15.87 It should follow, for many reasons, that this anomaly should be corrected by having such schemes fully funded on an annual basis; that possibility should be fully evaluated by the authorities. Questions would arise of retrospective 'shortfall' and the continuing matter of maintaining the fund. It is possible this form of correction may not be preferred as it carries with it far-reaching fiscal and other ramifications.

15.88 One may need to look at alternatives. These might include:

- benefits to be taxed directly as they are received by the employee;

²² It is clear to the Committee that the application of tax at such a rate on the 'income' (as defined) will substantially reduce the accumulation benefits otherwise available. In footnote 25, the Committee draws attention to the implications of this for the size of any tax rebate needed to maintain the status quo.

If it proves impracticable to achieve the Government's desired level of concession through the rebate mechanism, it could apply a lesser rate on the 'income' of the Fund.

- personal entitlements to be received on an after-tax basis, with the tax collected from the 'fund', as trustee, as benefits are disbursed. (In the case of the Commonwealth Government unfunded scheme the Government would in effect be virtually 'funding' and 'collecting' contemporaneously.)

Whatever system is chosen, it should aim to achieve equality in the treatment between government and private superannuation funds and between 'funded' and 'unfunded' schemes, and hence equality between the benefits derived from the various schemes.

15.89 The Committee recognises that other benefits in lump-sum form can be paid upon retirement; these are presently taxed as to 5%. For consistency and neutrality this matter may need to be addressed by the authorities. It does not seem, however, to be an 'efficiency' matter with particular implications for the financial system. Nonetheless, it could be important where the concern is an effective taxation arrangement for superannuation.

(ii) Transitional Provisions

15.90 The Committee is mindful of the fact that in addressing itself to the taxation of superannuation, it is dealing with matters involving long-term commitments entered into by taxpayers on the basis of existing provisions of the law.

15.91 It would be unfair to individuals already participating in such schemes to subject them to a new system of taxation without adequate transitional arrangements. It would also be most unwise to force changes on existing institutions so abruptly as to create a disruptive and deleterious impact on the functioning of financial markets.

15.92 The Committee sees the devising of appropriate phasing-in arrangements as quite crucial and a matter for detailed discussion between the fund administrators and the taxation authorities. The Committee believes that all past contributions and accrued benefits up to the phasing-in period should continue to be treated under the 'old' arrangements. Transitional provisions should as far as practical lean on the side of generosity to ease the changeover to the proposed new taxation basis.

C. SOCIAL OBJECTIVES

15.93 Governments have frequently viewed the income tax concessions in the superannuation area in a much wider social and economic context than that suggested by purely efficiency considerations.

15.94 The Committee does not question the importance of such social objectives. Nevertheless, as indicated earlier, it has a legitimate interest in ensuring that the methods of intervention chosen are those which achieve their objectives with the least disturbance and distortion to the competitive workings of the financial system.

15.95 It is necessary first to identify the precise nature of the objectives underlying present policies. While some may not be clear, it must be presumed that the aim is **not** to foster saving **generally**. If this were the case all forms of saving should receive equal encouragement.

15.96 For a given national income, **across-the-board** encouragement of saving is virtually impossible under an income tax regime; the basis of taxation would need to shift from income to consumer spending to achieve the desired effect, which would amount to replacing income tax with an expenditure tax. This would of course represent a fundamental restructuring of the tax system.

15.97 For this and other reasons, governments have preferred to give selective encouragement to particular forms of saving such as through superannuation funds. It might be considered that the special features offered by superannuation funds — financial protection in the event of death or incapacity, security in retirement, and the long-term contractual structure of the savings flows — justify that selective treatment.

15.98 The question is to determine how the taxation basis for superannuation outlined in paragraph 15.82 could be modified to accommodate the social objective of encouraging systematic saving through superannuation funds with minimal adverse consequences for the financial system.

15.99 It is the Committee's view that this could be achieved in the most cost-effective way through the provision of a tax concession for the contributions made by employees and self-employed persons to superannuation funds, rather than through tax concessions to the funds themselves — which is a distinguishing feature of present arrangements. The following advantages are seen in the former approach:

- Superannuation coverage might well increase because the concession would be more readily accessible to individuals and more clearly perceived.
- Individuals would have full freedom of choice in respect of superannuation facilities. In those areas where employer-sponsored schemes were unavailable or inadequate, the employee would have the option to seek or supplement an employer-sponsored facility with alternative superannuation facilities offered by commercial fund managers, such as life offices and banks, and still receive the full benefit of the tax concession. Recent changes in superannuation arrangements, while permitting greater freedom of choice, do not provide the same degree of flexibility (e.g. see fn. 19).
- Offering the concession in a way which allows individuals maximum freedom in superannuation choice would in turn provide greater opportunity for financial institutions to participate in the superannuation business. Any financial institution prepared to set up an approved superannuation scheme would be free to do so; at present, such opportunities are limited to s.79 funds and to institutions invited to manage employer-sponsored schemes. (It is not envisaged that employers would be seriously discouraged from sponsoring superannuation schemes — their contributions would continue to be deductible for tax purposes and a number of other reasons conducive to sponsorship would exist, e.g. industrial relations etc.)
- There would be greater opportunities for vesting and portability: at present, particularly in employer-managed schemes, an employee who resigns before the prescribed retirement date often surrenders his claim on all or part of the employer's share of contributions.
- By focusing the tax concession at the individual level, wider access to the tax benefits would be achieved.²³

²³ In this sense, the basic thrust of the changes announced in the 1980-81 Budget in respect of superannuation arrangements for self-employed persons and unsponsored employees would still be retained in the Committee's proposal.

15.100 The most cost-effective method of dispensing social assistance in the superannuation area depends to a large extent on the nature of the social objective. For a given budget outlay, a taxation concession by way of a tax rebate benefits a wider section of the community (and in particular the lower income groups) than an income tax deduction. On the other hand, a deduction will obviously provide greater incentive to those individuals whose marginal rate is above the standard rate.

15.101 As explained earlier, the existing tax provisions already contain an element of a tax rebate system; but it is a very modest element benefiting only a small percentage of the community.²⁴ Present specific deductions are biased away from those on low income. A first basic step would be to remove superannuation contributions from the present schedule of 'general concessional expenditure' and accord them separate tax rebate status. The extent of the rebate would of course depend on the degree of encouragement the Government wished to provide, having regard to other policy initiatives it might take (such as removal of the 30/20 — see Chapter 10). As with life assurance, the Committee does not itself express any judgment about whether special encouragement should be given to saving for retirement and it makes no recommendation on the issue.²⁵

15.102 To sum up, if the Government wishes to continue to encourage saving through superannuation it could more efficiently do so through a tax concession on individuals' contributions to superannuation schemes.

D. RESOURCE ALLOCATION IMPLICATIONS

15.103 The Committee has considered the implications of a new basis of taxation of superannuation on the pattern of funds flows and in particular on the availability of long-term capital. It has focused on this question, in part, because of the concern expressed in the various submissions that Australia faces a potential shortage of long-term capital in the 1980s. (See Chapter 35.)

15.104 It should be stressed immediately that the Committee has not taken any view on the appropriate level of government involvement in superannuation: it has only explored the form which such involvement should take, starting from a suitable neutral base.

15.105 The suggested change in the form or method of encouraging saving for retirement need not mean any decline in the overall volume of investible funds generated by those institutions. If, for example, the Government decided to allocate the same amount of revenue for the Committee's proposal as it does through the present arrangements, the net overall impact on retirement saving could well be favourable. In particular, the benefit of the concession would be available directly to individuals over a broader spectrum of the community and any financial institutions prepared to set up approved schemes would be encouraged to do so.

²⁴ See section on 'Taxation of Life Insurance Companies'.

²⁵ A concession in this form would need to be considerably greater than that which presently exists if it were the Government's wish not to reduce substantially the benefits presently enjoyed by most beneficiaries under employer-sponsored, lump-sum schemes.

15.106 On the other hand, the Government could choose to pursue a policy of greater neutrality as between various forms of saving and reduce the value of the concession available for retirement saving; if so, there could be a reduced level of saving through superannuation funds but this would not necessarily mean a reduced overall supply of long-term capital. Any assessment would need to take account of:

- The use made by the Government of the additional revenue gained. The Government could, for example, use the extra revenue to provide general or specific incentives to save or simply reduce the tax burden on households and businesses, or it could choose to finance a larger proportion of public investment out of revenue. In any of these cases there would be at least a partial offsetting effect on the supply of long-term capital.
- The use of funds that might be attracted to other institutions. For example, some institutions like banks might lengthen their portfolios while others like investment trusts might widen the range of long-term investments they might undertake.

15.107 Moreover, the Committee's suggestions in regard to superannuation should not be viewed in isolation from the other recommendations in the Report.

15.108 For example, in Chapter 10 the abolition of the 30/20 requirement is recommended; this would give superannuation funds greater flexibility in their portfolio mix. More scope would exist for higher ultimate returns, long-term project involvement and so on — all of which should improve their competitive position relative to many other financial intermediaries. Other recommendations in the Report are also of relevance — e.g. removal of controls on banks might facilitate their participation in long-term lending. More generally, the Committee's recommendations would make it easier for financial institutions to respond flexibly to opportunities in all parts of the capital market.

15.109 The Committee sees no basis for concern about future shortages of long-term capital provided the financial system is not shackled by too many restrictions. It has no evidence of an existing or impending structural imbalance in the capital market and sees no justification for government intervention on the basis of spurious or at best uncertain projections of future supply and demand for capital. But even if an imbalance in the demand for long-term capital were to develop some time in the future, an efficient, competitive and resilient capital market would be able to respond effectively to it. (It might of course mean an increase in the **relative cost** of long-term capital which would in turn inhibit the more marginal long-term investment projects at least for a time, but this would not necessarily be an undesirable outcome.)

15.110 To sum up, the Committee does not accept that the Government should resile from moving towards greater neutrality in the tax treatment of superannuation **simply because of supposed implications for the existing pattern of resource allocation**. It is recognised, however, that the Government may have broader social and economic reasons for favouring superannuation relative to other forms of saving. If so, the suggestion for a more generous tax rebate (or deduction) scheme would be the most cost-effective and equitable method of promoting such objectives.

III TAXATION OF BUILDING SOCIETIES AND CREDIT UNIONS

A. BACKGROUND

15.111 Under the Income Tax Assessment Act building societies (which meet the relevant tests) are treated as 'co-operatives' and credit unions (which again meet the relevant tests) are treated as 'mutual associations'. These instrumentalities are, to a degree, taxed differently from joint stock financial corporations and from each other.²⁶

15.112 In the computation of assessable income, co-operatives:

- may deduct all dividends, rebates, bonuses and other distributions to members as well as interest on borrowings;
- are treated as public companies for the purpose of s.46 rebate on dividends received from companies; and
- **are taxed at the company tax rate on what effectively amounts to retained net income.**

15.113 The difference with mutual associations is that the latter **are not taxed on their retained net income** (operating surplus), Credit unions failing to meet the criteria set out in the Income Tax Assessment Act²⁷ are taxed as co-operative societies.²⁸

15.114 The present tax basis accorded building societies and credit unions largely reflects the historical mutual, co-operative or self-help character of their operations.

15.115 Some submissions to the Committee have called for a review of the way these institutions are taxed. They argue that:

- the present tax treatment has the effect of encouraging the growth of these institutions beyond their traditional roles; and
- the activities of building societies and credit unions in recent years have become increasingly commercial in character, with a weakening in the mutuality concept; in particular they are now engaged in banking-like activities and services in a manner very akin to other intermediaries but without the corresponding burdens.

26 See Interim Report, paragraphs 13.10-22.

27 S.23G of the Income Tax Act specifies the criteria that have to be satisfied by credit unions. See paragraph 13.20 of the Interim Report for a summary. Other 'mutuals' are governed by the common law principle of mutuality which requires that the transactions carried out by these bodies be 'non-profit' in character.

28 Without the need to comply with the other requirements of being a co-operative.

15.116 On the other hand, building societies have argued that they enjoy no tax advantages and indeed are disadvantaged by the tax treatment of statutory reserve allocations — at least by comparison with credit unions.²⁹

15.117 Credit unions have argued that they are still essentially mutual or non-profit in character and should continue to be taxed on a special basis.

B. ASSESSMENT

15.118 The Committee maintains that the taxation system should not disturb the competitive equality of financial intermediaries unless there is some clearly identified economic or social justification.

15.119 In a competitive financial system, financial institutions will be encouraged to market different financial products and packages to meet the diverse preferences of investors and borrowers. Essentially this means the development of financial institutions with characteristically different financial structures.

15.120 The usual investment options offered to investors by a joint stock financial corporation are (i) fixed (non-withdrawable) share capital (equity), with returns in the form of dividends (and capital gains or losses); and (ii) interest-bearing deposits or loans (debt).

15.121 A co-operative building society's main products generally comprise withdrawable share capital (which is similar to debt) and interest-bearing deposits and loans. The 'dividend' received on such 'capital' is akin to an 'interest' payment.³⁰

15.122 Credit union participants receive mainly interest on deposits and loans and some bonuses or rebates.³¹

15.123 For co-operatives and mutual associations (which meet the tax tests) there are no true beneficial owners of the equity in the same sense as that which

29 The savings banks — the principal alternative provider of finance for housing — are also expected to maintain a satisfactory reserve base and are taxed on the surplus income used to support the reserve base. (The Committee noted in paragraphs 13.8-9 of the Interim Report that trustee savings banks and banks which are established as a public authority under a state Act are exempt from taxation. The separate taxation treatment of these banks is obviously anomalous but the issues involved are more relevant to the discussion of government-owned institutions — the subject of discussion in Chapters 26 and 27.)

30 A building society's liabilities may also comprise non-withdrawable shares. In NSW a building society registered under the Permanent Building Societies Act, 1967 must, on formation, have minimum funds/capital of \$2 million of which \$1 million must be share capital and other funds of at least \$1 million of which \$500 000 is not withdrawable for ten years after establishment. In addition, it may not commence business until at least ten members (including all the directors) contribute \$5000 each of share capital; this capital may not be withdrawn within seven years from the date of allotment, except with the written consent of the Advisory Committee. No new societies have registered under the Act since 1973. Most of the remaining societies are registered under the Building and Co-operative Societies Act, 1901, which latter Act has been repealed, except in respect of the few remaining societies; these societies are now subject to the Co-operation Act, 1923, and have a permanent non-withdrawable capital base — special rights may attach to these shares. The Registrars in each state have a discretion to permit the establishment of fixed-capital building societies.

31 Credit unions do not issue non-withdrawable share capital. (Information in footnotes 30 and 31 provided by the Department of Housing and Co-operatives, NSW.)

exist in joint stock corporations. As a consequence there is no provision for a return via capital gains in the case of building societies or credit unions, even though retained earnings are a feature of both.

15.124 The tax situation of building societies and credit unions vis-a-vis other financial intermediaries needs to be examined against the background of these differences in the financial products being offered.

(a) Building Societies

15.125 A comparison of withdrawable building society shares with shares in joint stock corporations reveals certain basic differences.

- (i) The generally perceived view of the investing member in a building society is that he is lending money — not acquiring an equity position, as is the case in a joint stock corporation.
- (ii) The 'dividend' (or interest) on withdrawable shares is regulated by state authorities (at least in NSW and Queensland). No such regulation generally applies to joint stock corporations.
- (iii) Building societies' withdrawable shares are generally repayable at the option of the holder. (The amount received is limited to the capital sum invested plus any accrued 'dividend' or interest). The ordinary capital of a joint stock corporation is not repayable at the initiative of an individual shareholder (court consent to reduction etc. is required).
- (iv) The Income Tax Assessment Act:

- requires that the number of shares which may be held by or on behalf of any one shareholder of a building society (being a co-operative) be limited;
- prohibits the quotation of the society's shares; and
- seeks to ensure that it operates as a true co-operative.

No such taxation requirements exist in respect of joint stock corporations although certain characteristics may dictate whether they are a public or private company for taxation purposes.

15.126 A key issue is the differing tax treatment of dividends as between building societies and joint stock financial corporations. Joint stock corporations are taxed on profits before dividend distributions and these dividend distributions are taxed again in the hands of shareholders. Conversely, building societies pay tax only on retained profits (after 'dividend' distributions) — their distributions, whether in the form of dividends or interest, are taxed in the hands of the recipients.

15.127 The Committee has already indicated that withdrawable shares of permanent building societies are more akin to debt capital. The differential tax treatment is thus relevant only in respect of that part of the building society's capital which is **non-withdrawable** — the distinction being that the dividends of joint stock corporations are non-deductible for tax purposes, while the dividends on non-withdrawable shares of building societies, which are more akin to equity, are deductible. However, non-withdrawable shares constitute only a very small proportion (0.2%), of the aggregate 'capital' and liabilities of all building societies.³²

³² This figure is the average for 1975–1980 and based on the figures provided in *Permanent Building Societies, Assets, Liabilities, Income and Expenditure, Australia*, various issues, Australian Bureau of Statistics.

15.128 A related point made to the Committee is that corporations have to service an equity base, whereas building societies do not. However, the proportionate size of non-withdrawable share capital and reserves base of building societies overall is somewhat similar to that of joint stock financial corporations in like competitive businesses, such as savings banks (see Tables 5.11, 5.26 and 5.27 of Interim Report) — although differences do exist from society to society and bank to bank. It should be noted, nevertheless, that there are fundamental differences in the beneficial ownership of their respective capital bases.

15.129 In summary, a tax anomaly appears only to exist in respect of the dividend deductibility on non-withdrawable shares. Notwithstanding the relative insignificance of non-withdrawable share capital, the Committee does not wish to see that anomaly perpetuated. It recognises, however, that the Government may not wish to make retrospective changes affecting established capital structures.

15.130 The Committee, therefore, concludes that **there is no need (on competitive neutrality grounds) to change any aspect of the taxation of building societies, except to the extent of disallowing the deduction for dividends on existing, but more particularly new, capital of a non-withdrawable nature.**³³

(b) Credit Unions

15.131 The non-neutrality of the tax treatment of credit unions as compared with building societies and other intermediaries is more easily identified; credit unions unlike building societies are not taxed on their retained profits.

15.132 However, the Tax Commissioner presently monitors profits (retentions) of credit unions to ensure they are not, in his view, unreasonable given their 'mutual nature'; to the extent they are deemed unreasonable the profits are subject to tax at the rate of 46%. The competitive advantage gained by credit unions over building societies and other intermediaries thus does not appear to be particularly substantial at this stage. Nevertheless, again the potential exists and the Committee notes that untaxed retained earnings of credit unions have grown from \$1m in 1972 to \$81m in 1980.³⁴

15.133 The Committee is mindful that the Government may wish to offer an incentive to organisations fulfilling certain co-operative and mutual objectives. It is concerned, however, in this regard at the current trend to extend the ambit of the 'common bond' to the point where, in some cases, it is difficult to differentiate credit unions from other intermediaries providing general financial services. The application of the mutuality principle in these cases gives the credit union an unfair 'trading' advantage.

15.134 The Committee sees a need to neutralise the tax privileges enjoyed by these organisations when they are in 'commercial' competition with taxable organisations, including building societies and savings banks. This is particularly important where the common bond is so loosely defined, for example covering so wide a geographic area and cross-section of the community, that the unique identity and purpose of its mutuality is lost.

33 In which case the Income Tax Assessment Act should be amended to permit a corporate shareholder who owns non-withdrawable share capital in a co-operative company a s.46 rebate in its assessment in respect of dividends paid to it by that company. This aspect has further ramifications, of course, under an integrated system of company and personal income tax.

34 Source: RBA *Statistical Bulletin*, Financial Flow Accounts Supplement 1953-54 - 1979-80, June 1981.

15.135 The Committee concludes that:

- On competitive neutrality and efficiency grounds, it would be appropriate to put credit unions on the same tax basis as other financial intermediaries in respect of the treatment of retained earnings.
- Should the Government decide to retain the present tax treatment for social or other reasons, the membership of credit unions should be closely and continuously monitored to ensure that the principle of mutuality is strictly applied.

CHAPTER 16: TAXATION OF SPECIFIC TRANSACTIONS

16.1 The Committee's attention has been drawn to the taxation of certain specific transactions which, it is suggested, impinge on the efficiency and competitive equity of the financial system, in particular:

- stamp duties on financial instruments and transactions;
- interest withholding tax;
- taxation of gains from disposal of 'property'; and
- taxation of foreign exchange gains and losses and related transactions in respect of borrowings.

I STAMP DUTIES ON FINANCIAL INSTRUMENTS AND TRANSACTIONS

A. BACKGROUND

16.2 Stamp duties are levied by governments on the issue and transfer of a range of financial instruments and on some consumer finance transactions; Appendix 10 of the Interim Report gives details. Stamp duties are also levied on the registration/transfer of motor vehicles and on certain other 'non-financial' transactions; these are not of specific concern of the Committee.

16.3 The primary objective of stamp duties is to raise revenue. Prevented constitutionally from levying commodity taxes and as a result of the Uniform Tax cases virtually precluded (by mutual agreement) since 1942 from imposing their own income tax,¹ the States have depended on a miscellaneous array of taxes on property, gambling, ownership and operation of motor vehicles, payrolls, and on financial transactions in the form of stamp duties and, up to recently, death duties, as an important ingredient of their revenue. The various states presently derive some 16% of their revenue² from stamp duties, other than duties on the registration/transfer of motor vehicles.

1 Both the States and the Commonwealth have the power to impose income tax. However, as a result of the Uniform Tax cases, the States ceased to impose their own income tax in return for a reimbursement from the Commonwealth. Although the States were recently allowed greater scope to impose income taxes, they have chosen not to utilise this increased capacity. (See Interim Report, paragraph 10.49.)

2 For the 1979-80 financial year the figures for the various states are; Victoria 14.3%, Tasmania 17.6%, NSW 18.1%, Western Australia 11.9%, South Australia 5.5%, Queensland 31.3%. (Calculated from information provided by the various states.)

16.4 In the Committee's view, the present system of stamp duties on financial transactions fall far short of meeting the neutrality, equity and simplicity requirements of an efficient tax.

16.5 Stamp duties are **non-neutral** in their impact on methods of financing transactions since:

- (i) They apply to the issue³ (and or use) of:
 - bills of exchange, debentures, mortgages, unsecured notes, bank overdrafts, loans carrying interest rates above a prescribed threshold, and certain consumer finance transactions but not other forms of borrowing;
 - life insurance policies but not other forms of savings; and
 - cheques but not other forms of payment (apart from bankcard in Queensland).
- (ii) They are not levied on all financial transactions, being limited essentially to those transactions based on a particular transfer document — although not extending to government securities.
- (iii) Rates of duty are far from uniform, varying both from state to state and between transactions involving different classes of financial instruments.
- (iv) The incidence falls more heavily on corporations with relatively short-term asset portfolios and higher security turnover than on those with longer term debt and equity portfolios.

16.6 Stamp duties are often seen as '**inequitable**' in that they are levied with little or no regard to the capacity to pay of the individuals involved in particular financial transactions. For example, less creditworthy or lower income borrowers required to pay higher interest rates are treated more harshly than other borrowers.

16.7 Inequities are also involved to the extent that the large transactors can more easily minimise duty than the small.

16.8 The existence of different rates and conditions between states introduces the possibility of ambiguity and increases the scope for over-the-border avoidance; thus stamp duties also fail the **simplicity** test.

16.9 As well, efforts to reduce duty absorb managerial and other resources which could be more productively employed in other activities.

16.10 While the detrimental impact of stamp duties on the financial system may seem modest compared with a number of other influences, it is nonetheless significant and has been a focal point of criticism in a number of submissions. Closer examination of stamp duties in relation to particular instruments and transactions is therefore called for.

B. ISSUES OF FINANCIAL INSTRUMENTS

(a) Bills of Exchange

16.11 The incidence of stamp duty on the issuing of bills of exchange:

- (i) Gives issuers an incentive to opt for longer maturities since on maturities

³ For more detailed information of the stamp duties applying to financial instruments and financial transactions, see Appendix 10 of the Interim Report. It should be noted that there have been a number of subsequent amendments to stamp duties schedules in some states.

beyond 120 days there is a continuous fall in the rate of duty expressed as a per cent per annum of face value.

- (ii) Gives borrowers an incentive to resort to non-dutiable methods of finance (e.g. via the intercompany market), particularly in the case of short maturities. This in turn has the effect of:
- encouraging lenders to accept what might otherwise have been a less preferred liquidity/risk/return package;
 - generally distorting the pattern of financing; and
 - reducing the size of the primary and secondary markets for bills.

16.12 The UK experience, where the restructuring of duty on bills of exchange from *ad valorem* to flat rate in 1961 and its later abolition (in 1971) was followed by growth in the use of commercial bills, has been quoted as evidence of the effects of non-neutrality. There was also an increase in the institutional sales of debentures following the removal of stamp duties on debentures around the same time.⁴

(b) Loan Securities

16.13 Among the complaints against stamp duty on the issue of loan securities (mortgages, debentures etc.) are that it:

- discourages shorter maturities since duty is at a flat rate;
- is non-uniform between states; for example there was no duty in the ACT prior to the 1981–82 Budget;
- can lead to the double imposition of duty; where the security is issued in one state but to a resident in another, it is possible for both states to collect duty on the one security; and
- adds to the cost of acquiring a home, and may as a consequence be at cross purposes with other government policies to encourage home ownership.

16.14 At the same time it must be borne in mind that there are a number of other costs (besides stamp duty) involved in issuing some securities, e.g. prospectus costs for debentures issued to the public.

(c) Life Insurance

16.15 Submissions have argued that stamp duty acts as a deterrent to life insurance relative to other forms of saving. They point out that:

- the cost tends to be passed on to policyholders and becomes a cost that savers must meet before they can invest in life insurance;
- most other forms of saving are not liable for duty; and
- it sits oddly with tax arrangements which seek to encourage individuals to take out life insurance.

16.16 In view of the complex set of factors influencing sales of life insurance it is difficult to assess to what extent stamp duty has been an inhibiting factor. Whatever its effects, there is no doubt that it represents a breach of the neutrality and equity of funds flows.

4 See *Financial Statistics*, October 1973 Table B and October 1976 Table D, Central Statistical Office.

(d) Cheques

16.17 Cheques provide a quick, convenient and safe way of settling accounts. To the extent that stamp duty on cheques has inhibited their use in favour of cash and credit cards, it fails the neutrality test.

16.18 To keep the matter in perspective, however, it should be noted that the level of stamp duty is relatively modest, with the possible exception of small transactions.

16.19 The Committee's attention has been drawn to several inequities:

- Co-operatives, including building societies and credit unions, which compete with the banks, can generally draw cheques on their bank accounts without incurring stamp duty, irrespective of the payee.⁵
- Only part of the cost of collecting the duty, said to amount to some 10% of the duty raised, is reimbursed to the banks by governments; the balance must be passed on to customers through one means or another, involving a further element of non-neutrality and inequity.
- Double imposition of duty sometimes occurs. This happens when cheques are sent across state borders, duty being collected by the issuing bank from the sender and by the receiving bank from the recipient when he lodges it.

C. TRANSFER OF FINANCIAL INSTRUMENTS

(a) Duty on Marketable Securities

16.20 The basic criticism of stamp duty on the transfer of marketable securities is that it acts as a deterrent to the development of secondary markets. Financial instruments are thus made relatively less liquid and so require relatively higher yields to compensate. To the extent that the level of duty discourages turnover, revenue (rather perversely) also suffers.

(i) Debentures and Notes

16.21 Submissions have pointed to the thin secondary market in debentures and notes. Such limited statistics as are available tend to confirm this. In 1979 and 1980 the annual value of turnover in debentures and notes, as recorded in stock exchange figures, amounted to only about 1.6% and 1.2% respectively of the total value of company debentures and unsecured notes listed on Australian Stock Exchanges. Moreover, probably up to half the turnover involved exempt institutions and forced sales.⁶

16.22 It is clear that stamp duty has affected the shorter maturities in particular. For example, the practice of institutions selling debentures and notes within a year of maturity to invest in higher yielding long-term securities is much less common

5 The NSW Government has made building society third party cheques liable to stamp duty but cheques payable to the investor from his own account remain exempt from stamp duty.

6 The comparable turnover figures for government and semi-government securities were 8% and 10.6% respectively in 1979 and 3.9% and 11.7% in 1980. Source: AASE Statistical Information, Melbourne Stock Exchange, 1980 *Annual Report*.

in Australia than elsewhere and contrasts with the quite large turnover in shorter dated government paper.

16.23 The bias against shorter dated securities has received state government recognition. The NSW Government has introduced a sliding scale of duty for debentures and notes maturing within two years of the date of transfer in order to stimulate some marketability.

16.24 It is difficult to say how far the secondary market for longer term securities would be boosted by removal of duty. The inhibiting effect of duty may not be large relative to other influences such as trading costs, institutional factors, and the size of the primary market. As previously pointed out, however, in the United Kingdom the removal of stamp duty on debentures did coincide with a significant increase in institutional turnover.

(ii) Equities

16.25 Similar arguments have been raised in relation to equities. However, the impact of removing duty is even more uncertain in this market.

16.26 Lower rates of duty in the Northern Territory have facilitated minimisation by encouraging the transfer of company shares, particularly larger transactions, via a Darwin register.

(b) Mortgages

16.27 A number of submissions have expressed the view that the imposition of stamp duty on the transfer of mortgages or mortgage-backed securities has significantly impeded the development of a secondary mortgage market. While some state governments are understood to have considered reducing the duty on such transfers, no such action has yet been taken (with the exception of a reduction in duty on certain types of mortgage-backed securities in Victoria).

16.28 This issue is discussed in more detail in Chapter 37, where the Committee concludes that stamp duty on transfers of mortgages and mortgage-backed securities is a major impediment to the development of a secondary mortgage market.

D. CONSUMER FINANCE TRANSACTIONS

16.29 Credit business, credit card transactions and hire purchase/instalment credit agreements are mostly liable for duty at the same rates within each state, with two principal exceptions: (i) in the case of credit business, duty is not payable where the rate is below a prescribed threshold; and (ii) in all but one state, duty is not payable in respect of loans by credit unions.

16.30 As with other stamp duties, non-neutralities and inequities are introduced into financial transactions. Among other things:

- (i) The application of duty to credit business or loan instruments where the interest rate exceeds a prescribed threshold (e.g. currently 17% in NSW):
 - puts certain institutions at a competitive advantage;
 - penalises smaller and less secure borrowers who tend to be in the lower income bracket; and
 - does not serve the purpose for which it was supposedly introduced —

namely, to prevent usury — as it is the borrower rather than the lender who effectively bears the tax.

- (ii) The duty on credit card transactions, which is presently applicable on credit utilised beyond the 'credit-free period' is also inequitable since it is the less affluent consumer who is more likely to be unable to repay during the credit-free period; similar arguments apply to the duty on hire purchase/instalment credit agreements.
- (iii) The exemption of credit unions in some states places other intermediaries, particularly finance companies, at a competitive disadvantage.

16.31 In many cases, and particularly in the case of finance companies, stamp duty is paid on both borrowing and lending. From an efficiency viewpoint it is questionable whether stamp duty should be collected at two points on what effectively is a single transaction. This is particularly so when the total cost is, ultimately, largely borne by the borrower.

E. CONCLUSIONS AND RECOMMENDATIONS

16.32 While recognising that the States must be allowed to raise revenue in a flexible and unrestricted manner, the Committee has no doubt that stamp duties in general impact unevenly and often inequitably on the flow of funds. As such they interfere with the efficiency of the financial system. While raising revenue they also seem to conflict with some other objectives of policy, such as reducing the cost of borrowing for housing.

16.33 From its point of view, the Committee sees the most harmful effects of stamp duties on the financial system generally arising from the nature of the transfer duty scale, which inhibits trading in debt securities (including mortgages), particularly those with shorter dated maturities, the regressive effect of the duty on consumer finance transactions (see paragraph 16.30), and the non-uniformity of duty between states and between instruments. Although duties on cheques, on the issue and transfer of debt instruments and on the transfer of equities also pose problems, their harmful effects are perhaps less significant in some instances given the influence of other costs.

16.34 The Committee believes that **total abolition of specific duties in the financial area has much to commend it**. However, because of the revenue needs of the States such a course would only be feasible and acceptable to the States if there were Commonwealth compensation or replacement with another tax. The Committee offers no suggestion on this issue other than to point to the benefits of an efficient and neutral tax system.

16.35 Although the Committee believes that in the long run, abolition of stamp duties or their equivalent may be a viable proposition, it accepts that due to their revenue implications and their long-entrenched nature, some form of levy on financial instruments or transactions could well need to be retained for the time being.

16.36 From the point of view of tax neutrality and hence the efficiency of the financial system, the preferred form of levy is that: **for similar kinds of financial transactions there be an Australia-wide uniform duty so structured as not to impact on the choice of financing arrangements.**

16.37 Stamp duty if applied might have regard for the following principles:

- it should be uniform for each class of transaction across all states;
- all transactions falling within the same category (e.g. all consumer finance transactions) should be subject to common rates of duty;
- rates of duty should not discriminate between loans of different sizes;
- rates of duty should not discriminate between loans bearing different rates of interest; and
- it should apply to all loan transactions but intermediated funds should only bear duty once.⁷

16.38 The Committee believes that the extension of stamp duty to **all** loan transactions might allow the revenue base to be extended, enabling lower rates of applicable duty to specific transactions. Some of the benefits which would flow from this include:

- the alleviation of the inequity to smaller, less secure borrowers, generally in the lower income bracket;
- a greater development of secondary securities markets;
- more competitive neutrality between financial intermediaries;
- greater neutrality and thus less distortion between different methods of borrowing and lending and different types of activity;
- simpler administration by government; and
- lower costs of administration for intermediaries.

16.39 Appropriate arrangements between the States and Commonwealth would, of course, have to be negotiated.

16.40 The Committee *recommends* that:

- (a) The agreement of the States be sought at an early date to abolish the existing system of stamp duties on financial transactions and instruments and replace it with a uniform and Australia-wide duty for similar kinds of financial transactions and instruments.**
- (b) If such an agreement cannot be reached, the States be at least encouraged to achieve greater uniformity of duty as between loans, advances and securities and as between the States along the lines suggested in paragraphs 16.36 and 16.37.**

16.41 To preserve consistency and equity it would also be desirable to extend transfer duty to government and local and semi-government securities, but the Committee appreciates the particular difficulties involved with this.

II INTEREST WITHHOLDING TAX

A. NATURE OF PROBLEM

16.42 Australia, like many other countries, imposes a tax on interest paid

7 In this way it ensures that financial intermediaries are not levied on both their borrowing and lending function and in that sense 'double taxed'.

overseas by withholding a portion of the payment before remittance to the overseas lender.

16.43 Apart from specific exemptions applying to interest on borrowings overseas by the Commonwealth Government (where the prospectus so indicates) and by the AIDC, there are two broad categories of case by case exemptions, involving:

- interest on certain publicly held or otherwise widely distributed bearer debentures issued outside Australia; and
- private loans raised overseas by an Australian-owned⁸ and controlled company ('Australian entity'), where the money is for use either in a predominantly Australian-owned and controlled enterprise or for financing a substantial Australian equity participation in an enterprise.

(These provisions have been described in more detail in Chapter 13 of the Interim Report.)

16.44 The first of these two broad categories of exemption, which is available to all Australian resident companies whether foreign or locally owned, appears non-controversial.⁹

16.45 The Committee, however, has received a number of complaints in respect of the second category, primarily on one of two grounds:

- that the exemption of 'Australian entities' imposes competitive disadvantages both for foreign-owned financiers operating in Australia and for Australian-owned financiers intermediating offshore funds for foreign-owned borrowers resident in Australia; and
- that the requirements of the 'Australian entity' test are complex and involve substantial administrative and compliance costs.

(a) Competitive Disadvantages

(i) Foreign-owned Financiers Operating in Australia

16.46 A foreign-owned financier operating in Australia is, by tax definition, not an 'Australian entity'; hence the interest payable on overseas loans which it intermediates for an Australian borrower is liable to interest withholding tax, even if the ultimate borrower meets the 'Australian entity' test.

⁸ By tax definition.

⁹ In the case of bearer debentures, the institutional arrangements that have been adopted for the payment of interest make it impracticable to operate an interest withholding tax scheme. This is because these arrangements generally provide for interest to be paid over the counter by agent banks in overseas financial centres when the holder of the security presents an interest coupon. The agent bank is subsequently reimbursed and paid a commission by the Australian borrower. It is unlikely that the paying agent banks or agents could be persuaded to deduct and remit withholding tax for the Australian authorities, that is, act as tax collection agents. And even if such deductions could be arranged, the (anonymous) bond holders might have difficulty claiming a tax credit from their own tax authorities for Australian tax withheld. Moreover, there would be some difficulty in imposing the withholding requirement on Australian borrowers. In practice, companies borrowing by means of bearer bonds used to set up subsidiaries in countries which did not levy interest withholding tax. The subsidiaries issued the bearer securities and remitted the proceeds to the Australian parent. The parent would pay interest to the subsidiary to cover the cost of the borrowing. If the coupon rate were, say, 9%, the parent would pay a gross rate of 10% to the subsidiary, of which 1% went to pay Australian withholding tax. The exemption was introduced to do away with the need for this arrangement and the effect it was thought to have on the cost of borrowing. This relief puts Australian borrowers in a similar competitive position, regarding funds of this nature, to other international borrowers.

16.47 Foreign-owned financiers operating in Australia claim that they are thereby placed at a competitive disadvantage in servicing the needs of Australian borrowers — compared with their Australian-owned counterparts and foreign lenders **operating from overseas**, which are able to lend directly to ‘Australian entities’ without incurring the interest withholding tax. Specifically they assert that:

- because of their standing in international financial markets they are often better placed to borrow overseas than their Australian-owned counterparts and Australian end-users;
- the business of borrowing overseas should be determined by the relative efficiencies of the various intermediaries in the open market; and
- although relief for Australian withholding tax paid may be obtained by the foreign-owned financier in its home country, there are often delays in receiving these rebates, which erode the commercial worth of such relief.

(ii) Australian-owned Financiers Intermediating Offshore Funds

16.48 When an Australian-owned financier which qualifies as an ‘Australian entity’ intermediates an overseas loan for a borrower which is **not** itself an ‘Australian entity’, the interest on that loan is not exempt from interest withholding tax.

16.49 It has been put to the Committee that Australian-owned financiers based or operating from overseas are thereby disadvantaged in relation to foreign non-resident financiers lending direct to the same type of borrowers (i.e. those who do not qualify for the Australian entity test). This is because:

- Foreign financiers can often obtain a tax credit in their own country for overseas taxes paid (although delays and uncertainties may reduce the benefit). Consequently they may be in a position to quote to supply foreign currency loans to Australian borrowers on the basis that they (the lenders) will absorb all, or part of, the withholding tax.
- Australian financiers based overseas would in principle have equal recourse to a tax credit but in practice they are less likely to be in a position to take advantage of this because they lack sufficient overseas profits against which to apply such credit.¹⁰

(b) Administrative and Compliance Costs

16.50 In respect of the exemption provisions, some of the particular complaints are that:

- It is a complicated and costly process to determine the ultimate ownership of a company, especially where degrees of ‘beneficial’ ownership have to be traced through a range and maze of stockholder and/or nominee companies. The problem is magnified where the company is only marginally eligible for exemption.
- Ownership has to be monitored throughout the life of a loan to record changes

¹⁰ It is understood that at present it is only in London that Australian banks have offshore operations of a sufficient scale to absorb withholding tax credit. However, it has been drawn to the Committee’s attention that a recent change in taxation policy by the UK authorities has meant that the credit for withholding tax is no longer available to Australian **and all other foreign banks** against the tax on the profits of their London operations.

that would disqualify the company from the exemption and make it liable for the tax.

- Where any part of the proceeds of a particular overseas loan has been on-lent directly to a company which subsequently loses its status as an Australian entity, the exemption is lost in respect of the whole of the original overseas borrowing.
- Because the foreign ownership test which disqualifies a company from the exemption is so strict (see Interim Report, paragraph 13.83), it has been difficult for many predominantly Australian-owned and controlled companies to qualify for the exemption.
- Because of administrative delays in obtaining the Tax Commissioner's decision as to whether a loan qualifies for exemption, Australian borrowers have not always been able to avail themselves of opportunities to raise loans when terms and conditions were most favourable to them.

B. CONSIDERATION OF THE ISSUES

(a) Rationale for Interest Withholding Tax

16.51 The case for interest withholding tax is that:

- the interest income earned in this country by non-residents should be subject to Australian tax; and
- a withholding levy is the most appropriate way of collecting that tax.

(i) Case for Some Australian Tax

16.52 The argument for taxing the interest income earned in Australia by non-residents from their financing activity is that income earned in this manner is, fundamentally, the same as interest income earned by residents, which is normally liable for tax. It could therefore be said to be inequitable if non-residents, deriving income from a similar financing activity in Australia, were not taxed.

16.53 The argument for such a tax may also be put in terms of enabling Australians to share in the benefits derived by non-residents from their lending activity in Australia. In the case of a country like Australia which is historically a net borrower, the interest income payable overseas can be substantial; if it goes untaxed, other taxes will have to be correspondingly higher and resident taxpayers will face a greater overall tax burden.

16.54 Although the interest withholding tax currently yields something less than \$50 million annually, its revenue importance extends beyond the amount of tax actually collected since it serves to discourage tax avoidance in respect of other categories of income derived by non-residents. For example, in the absence of a tax on interest, overseas parent companies would be given extra incentive to increase the proportion of subordinate and other parent loan funding when financing their Australian subsidiary operations, thereby converting dividends into interest; they would also be encouraged to lend funds to their subsidiaries at artificially high interest rates. Such arrangements could lead to a significant avoidance of Australian company tax and dividend withholding tax.

(ii) Case for Withholding Form of Tax

16.55 Collection of tax by withholding rather than by assessment has the merit of

simplicity. It is a final tax, and fully satisfies the liability to Australian tax of the overseas recipient of the interest.

16.56 The flat rate of 10% of gross interest set for the tax does not appear to be overly high and Australia's bilateral double taxation agreements with a number of foreign countries have been written on that basis. The authorities consider that the present rate is unlikely to exceed the tax that the foreign lender would have paid had he been taxed under the normal assessment process in his own country.

16.57 The implications of the interest withholding tax for overseas private borrowing are by no means self-evident. Whether a 'foreign lender' will choose to absorb the withholding tax will depend to a large extent on whether relief can be obtained for that tax in his own country. But even when such relief is obtainable, he has the option to choose whether to bear the Australian withholding tax and claim a credit in the home country or to endeavour to pass on the tax in the form of an increased interest rate to the Australian borrower. Factors influencing that judgment may include expected delays in obtaining the credit, level of taxable income, lending margins, tax rates in the home country and the degree of competition in the market.

16.58 Where there is a double taxation agreement between Australia and the lender's country, the latter will normally allow a credit for the Australian withholding tax, up to the amount of local tax applicable on the interest. **The effect of the interest withholding tax is that the Australian and not the foreign Treasury receives the revenue.**

16.59 The Government's program of negotiating double taxation agreements with additional countries will increase the scope for foreign lenders to obtain tax credits.

16.60 Where tax relief applies, it is normally available both to the interest on borrowings intermediated through foreign-owned financiers resident in Australia and to borrowings intermediated through Australian-owned institutions (such as banks) situated overseas.¹¹

(iii) Australian-based Foreign Financiers

16.61 The Committee recognises that there may be some substance to the complaints of foreign-owned financiers based in this country that they sometimes face considerable delays in obtaining rebates of Australian withholding tax in their own country.

16.62 This problem can of course only be resolved by the authorities in the financier's home country.

16.63 It is understood that the present exemption of provisions from Australian interest withholding tax were introduced with the aim of placing Australian entities (including intermediaries) on a more equal footing with foreign-owned resident enterprises (including financial) which, by reason of parent company funds or parent company contacts, might reasonably be expected to have easier and cheaper access to overseas capital sources.

16.64 Undoubtedly, however, the exemption provisions have the potential to

¹¹ The Committee has noted in the footnote to paragraph 16.49 that recent changes in taxation policy in the UK have introduced an exception to the general rule; this aspect is further discussed in paragraphs 16.71-73.

cause the flow of overseas funds to be intermediated through less efficient channels. They encourage Australian end-users to conduct their overseas borrowings through Australian-owned financial intermediaries, even though non-Australian financial intermediaries, because of their standing in the international money markets, may often be able to mobilise funds abroad on more favourable terms.

16.65 Moreover, the exemption provisions are open to criticism even as a means of encouraging funds to be channelled through Australian-owned financial intermediaries — should the authorities consider such encouragement desirable. For example, they may be thought to operate inequitably as between Australian-owned businesses with differing degrees of foreign ownership; in particular, businesses which just fail to qualify for exemption under taxation definitions but nevertheless regard themselves as Australian-owned and controlled could feel aggrieved. Also, it is possible that in their practical workings the exemption provisions sometimes have the effect, in jointly owned enterprises, of discriminating against the Australian component.

16.66 The pursuit of Australian ownership objectives through exemptions from interest withholding tax is thus likely to be only partly effective and to involve some significant efficiency costs.

16.67 To the extent that foreign-owned financial intermediaries have easier and cheaper access to overseas funds than their Australian-owned counterparts, any form of government initiative to enhance artificially the relative competitive standing of the latter will involve allocative efficiency costs which must be weighed against the social and other benefits to be derived from encouraging Australian ownership.

(iv) Australian Financiers Based Overseas

16.68 The tax credit provisions discussed in paragraphs 16.58–60 assume that the claimant has sufficient tax liability against which the tax withheld can be credited. This may not always be so with Australian financiers based overseas; Australian banks are said to be a case in point.

16.69 Essentially, the source of the problem for this group is not the withholding tax as such but the scale of the claimant's operations.

16.70 It is agreed that the growth and the capacity of these Australian offshore financial institutions to compete for business should not be unnecessarily impeded by taxation considerations. At the same time, if these institutions were exempt from Australian withholding tax it would amount to a subsidy to the offshore operations of a select number of Australian financiers. That in turn would introduce a new element of distortion into the financial system. Nevertheless, should the Government wish to assist Australian financial intermediaries in the development of their offshore operations, say on infant-industry argument grounds, more direct schemes would be available such as the provision of establishment grants paid annually for the first few years.

16.71 The Committee is aware of the Australian banks' concern that, in respect of their London operations, the recent changes in taxation policy in the UK might amount to their operations being subject to 'double' taxation.

16.72 The basic problem is one of international tax revenue sharing. The Committee has considered two options:

- (i) the exemption from withholding tax for Australian banks in London in respect of loans on-lent by them to borrowers in Australia which are not Australian entities; and
- (ii) the Australian Government to initiate bilateral discussion with the UK authorities to resolve the issue.

16.73 The Committee rejects the first option for the following reasons:

- In paragraphs 16.52–54 it acknowledges the case for some Australian tax in these cases.
- To operate equitably, the exemption would have to be extended to other Australian financial institutions operating offshore and thus be applied worldwide. Such a broad exemption would virtually amount to a complete abandonment of interest withholding tax as it could be expected that the bulk of overseas loans to non-exempt Australian borrowers would then be channelled through the overseas establishments of Australian financial intermediaries to avoid withholding tax.
- The problem is to a degree an organisational one in that some Australian banks have chosen to arrange their loan operations in such a way that the interest they receive from on-lending in Australia is derived as income of their foreign branch operations rather than as part of their Australian business. Australian banks are free to desist from such arrangements and instead channel loans arranged overseas direct through their Australian establishments; in that event, the interest withholding tax should, as the legislation originally intended, fall upon the foreign lender. Any 'agency fees' so earned by the foreign branches of Australian banks would of course be free of Australian taxes.
- Should the Committee's recommendation (see paragraph 16.77) for the withdrawal of exemption from interest withholding tax for private borrowings intermediated through Australian entities be accepted, the incentives for Australian banks to direct their overseas loan operations through their foreign branches would be greatly reduced.

16.74 The second option is favoured on the grounds that diplomatic negotiation is the appropriate channel for the resolution of a taxation revenue conflict that transcends national boundaries. It is recognised that concern about revenue loss (which could be substantial in the case of a leading financial centre like London) may have been a factor behind the UK authorities' decision to stop providing tax credits to all foreign banks operating in the UK for taxes withheld overseas.¹²

C. CONCLUSIONS AND RECOMMENDATIONS

16.75 The Committee concludes that various features of the withholding tax in its present form are non-neutral and inequitable. It therefore believes that withholding tax is an undesirable levy insofar as the workings of the financial system are concerned. Indeed, if this were the only consideration it would recommend its removal.

16.76 Nevertheless, the Committee is mindful of the role of the tax in ensuring that interest income derived by non-residents is subject to some Australian tax. It

¹² See for example T. Hindle, 'Interest in Withholding Tax', in *The Banker*, November 1979.

also accepts its role in inhibiting avoidance of Australian company tax. To ensure competitive neutrality and to minimise distortion to the allocative operation of the financial system, the Committee believes that there is a strong case for withdrawing altogether the exemption provisions relating to overseas loans raised by Australian entities.

16.77 The Committee *recommends* that the case by case exemption from interest withholding tax for private borrowings meeting the 'Australian entity' tests be withdrawn.

16.78 Should it be decided nevertheless to retain the exemption provisions, serious consideration ought at least to be given to having them simplified and rationalised; for example by:

- simplifying the requirements for establishing 'Australian entity' status;
- removing the requirement that ownership be monitored throughout the life of the loan and allowing exemptions to continue for specific periods of time, say five years, or the life of the loan, whichever is the shorter;
- permitting exemptions for part of a loan, if such part would have been exempt had it been a separate loan;
- relaxing the requirements that the relevant tax certificate must be lodged with the exchange control authorities before borrowing is permitted;
- seeking, through government channels, to secure a reduction in the delays which foreign-owned financiers based in Australia are said to face in obtaining rebates of Australian withholding tax in their own country; and
- seeking concessions, again through government channels, which would enable Australian financiers based in other countries where they at present do not receive credits, such as the United Kingdom, to do so. In others the right to carry forward unused tax credits in those countries against future tax liabilities might also be negotiated.

III TAXATION OF GAINS FROM DISPOSAL OF PROPERTY

A. BACKGROUND

16.79 There is no formal capital gains tax in Australia. However, in addition to imposing tax on profits arising from the carrying on of a business in the purchase and sale of various commodities including shares (s.25(1)), the Income Tax Assessment Act seeks to tax gains which arise from the disposal of investments in particular situations. The latter legislatively encompass:

- gains arising from the sale of any investment which was acquired for the purpose of profit making by sale or any profit-making undertaking or scheme: s.26(a);
- gains arising from the sale of an investment within twelve months of purchase (excluding sale of the principal place of residence as a result of a change of employment): s.26AAA.

16.80 Section 26(a) provides, for the purpose of taxation law, some legal definitions for establishing whether particular gains are of a revenue or capital

nature. The aim of s.26AAA was to introduce a degree of certainty and administrative simplicity into tax collection by dispensing with the need to distinguish between revenue and capital gains, earned during the prescribed period, viz one year.

16.81 A number of submissions have pointed to some undesirable features of s.26AAA:

- It discriminates in favour of longer term investments.
- It tends to discriminate more heavily against share transactions to the extent that these transactions are more often effected within a short term. It is said this may have been a contributory factor to the observed decline in the participation of the individual investor in the equity market.
- It automatically taxes gains realised within twelve months but with no relief for like losses.
- It does not add any clarity to the operation of s.26(a) with regard to the distinction between 'capital' and 'revenue' for realisations beyond one year.

B. CONSIDERATION OF THE ISSUES

16.82 In the Committee's view, it would be overly simplistic to suggest that the tax treatment of short-term 'capital' gains has been a major factor in the declining participation of the individual investor in the equity market. Other factors could have been more important; a fuller discussion of these is undertaken in Chapter 33.

16.83 Nonetheless, s.26AAA is perceived as having contributed to the decline. By discriminating against the short-term sale of assets, s.26AAA impacts more harshly on the share market than on most other asset markets (e.g. real estate), since shares, being more liquid, are more likely to be realised (for emergency and other reasons) in the short term. This disadvantages the many investors which have a strong preference for assets that can be turned into cash at short notice.

16.84 Moreover, s.26AAA has a distorting effect on share investment decisions. Investors in shares are encouraged to adjust their investment behaviour so as to make realisations, if a gain were involved, beyond the twelve-month limit, thus biasing judgments against any desired short-term realisation of assets.¹³

16.85 On the other hand, the removal of s.26AAA would return taxpayers to the earlier situation where the determination of whether proceeds from the disposal of shares or other property were assessable depended on whether they fell within the meaning of s.25(1) or s.26(a). The practical workings of those sections had drawn criticism that people intending to sell shares or other property could not be certain whether they were taxable or not on profits from sale.

16.86 Accordingly, the Committee sees a net advantage in retaining s.26AAA because it reduces some of the tax uncertainty for taxpayers. Moreover, it would be inappropriate to recommend the abolition of s.26AAA solely on the ground of its impact on one group of investors without regard for the wider taxation ramifications.

¹³ Some of the gains realised on the disposal of shares beyond the one-year period may be taxed under s.26(a).

16.87 Nonetheless there are in the opinion of the Committee two major anomalies with s.26AAA, namely:

- the treatment of s.26AAA losses; and
- the treatment of forced sales of equities.

16.88 While all realised gains within the ambit of s.26AAA are assessable, realised losses of a like nature are only available as a deduction for those deemed to be 'genuine' traders (who are taxed on all net profits from securities traded in any event). The Committee questions whether it is consistent with an efficient securities market (and an equitable and neutral tax system) to treat losses differently to gains for one category of investor. The Committee believes that s.26AAA losses should be permitted to be offset against s.26AAA profits arising in the same year of income in the first instance. Where there are insufficient s.26AAA gains in the subject year to absorb these losses, the taxpayer should be allowed to carry forward same against future s.26AAA profits up to a period of seven years. Such carry forward arrangements would be consistent with the present s.80 arrangements that apply to trading losses.

16.89 While s.26AAA makes provision to exempt taxpayers who sell their residence in consequence of a change of employment,¹⁴ no comparable provision exists in the case of a compulsory sale of 'minority' shareholdings in certain takeover situations. The Committee believes this anomaly unduly penalises 'minority' shareholders; in its view it should be removed;¹⁵ although appropriate provisions to safeguard revenue may need to be contemporaneously implemented.

C. CONCLUSION AND RECOMMENDATIONS

16.90 The Committee believes that s.26AAA provides certainty in the treatment of short-term profits arising from the sale of 'property' and, in the absence of a comprehensive capital gains tax, should be retained.

16.91 However, it *recommends* that:

- Section 26AAA of the Income Tax Assessment Act be amended to permit the offset of s.26AAA losses against s.26AAA gains arising in the same taxable year, with provision for any such losses that are unrecovered to be carried forward for up to seven years against future s.26AAA gains.**
- Provision be made for exemption from s.26AAA tax of gains arising from compulsory acquisition of shares consequent upon a takeover.**

16.92 The question of the appropriateness or otherwise of s.26(a) is more complex, and involves issues extending well beyond an inquiry into the financial system. These issues were explored by the Asprey Committee,¹⁶ which recommended the repeal of s.26(a) — a recommendation based in part on the assumption that a separate, broadly based capital gains tax would be introduced.

¹⁴ The Committee understands that depending on the particular nature of each individual case, the Commissioner may exercise appropriate discretion in exempting a s.26AAA assessment in cases of forced disposal brought about by undue personal financial hardship such as death in the family.

¹⁵ It could be argued that, in order to preserve complete neutrality between shareholders, this should be extended to cover all disposals of shares arising from takeover offers. However, the Committee recognises that this would open up too much scope for tax abuse.

¹⁶ Chapter 23, Taxation Review Committee, *Full Report*, AGPS, Canberra, 1975.

The Committee has not examined the latter possibility in any detail and hence is not in a position to comment on Asprey's proposal or to recommend on the future of s.26(a). It would point out, however, that if the Committee's proposal for an integrated system of company taxation were adopted (see Chapter 14), some portion of share gains — viz. that portion arising from retained earnings — would, in effect, be assessed for tax at the time of retention.

IV TAXATION OF FOREIGN EXCHANGE GAINS AND LOSSES AND RELATED TRANSACTIONS IN RESPECT OF BORROWINGS

A. PRESENT TREATMENT

16.93 The income tax consequences attaching to gains and losses on borrowings resulting from exchange rate variations presently depend on whether these are considered to be of a revenue or capital nature: gains and losses on **revenue** account are treated as assessable income and as an allowable deduction respectively, while gains and losses on **capital** account are ignored in calculating assessable income.

16.94 In applying the legislation, the Commissioner of Taxation relies on case law to determine whether particular gains and losses constitute revenue or capital.¹⁷ His present interpretation of the legislation may be summarised as follows:

- (i) With borrowing of a short-term nature, the use to which the borrowed funds are put needs to be considered:
 - if used to finance transactions on **revenue account** (e.g. trading stocks), the foreign exchange outcome of such borrowing is deemed to be on revenue account;
 - if used to finance transactions on **capital account** (e.g. infrastructure), the foreign exchange outcome is deemed to be on capital account.
- (ii) With funds borrowed on a long-term basis, the intention that the funds be retained in the business for an extended period qualifies such borrowing as being on capital account.
- (iii) Interest payments on capital account borrowing are considered a revenue item notwithstanding that exchange gains and losses attached to the principal remain a capital item.

16.95 The Commissioner of Taxation applies similar principles in determining the income tax liability of currency hedging and forward cover contracts in respect of borrowings:

- Gains and losses arising from these contracts would derive their tax character from the underlying transactions which necessitated the hedge or forward cover. Where the underlying transaction is on **revenue account** the hedging or

¹⁷ The official view follows the decisions of the High Court in *International Nickel Australia Ltd v. FC of T* (1977) ATC 4383 and *Commercial Acceptance Ltd v. FC of T* (1977) ATC 4375.

forward cover gains or losses would be treated as assessable income or allowable deductions (as the case might be). Conversely, hedging and forward cover gains and losses on **capital account** would be excluded from the calculation of taxable income.

- Premiums payable under hedging or forward cover contracts would be treated as assessable income in the hands of the recipient. Whether or not deductions would be allowed for the premiums paid by the subscriber would be determined by the same principles outlined in the previous paragraphs.

B. THE ISSUES

16.96 Submissions have expressed concern at the lack of clarity as to whether particular gains and losses resulting from exchange rate variations in respect of borrowings are revenue or capital items for taxation purposes; the conflicting judgments in a number of recent cases (with appeals pending) have contributed to this uncertainty.¹⁸ One result of this lack of clarity has probably been less than optimum reliance on overseas borrowing. It may also have discouraged borrowing in strong currencies (despite possibly lower interest rates).

16.97 The criteria used in practice by the authorities to decide whether an item is on revenue or capital account are said also to have had the undesirable effect of biasing the term of overseas borrowing.

16.98 To treat all exchange gains and losses in respect of borrowings as revenue — a suggestion made in a number of submissions — would be to acknowledge the economic fact that any such gains and losses cannot be sensibly separated from other borrowing costs such as interest charges which are treated as revenue items for tax purposes. It would also be consistent with the tax treatment of other foreign-sourced and denominated revenue.

16.99 From the point of view of the efficiency of the capital market, the Committee sees several advantages in treating these particular gains or losses as revenue items:

- it would remove an important element of tax uncertainty from foreign exchange borrowing transactions;
- it would increase flexibility in respect of funding sources;
- it would correct the bias in the term and source of overseas borrowing;¹⁹ and
- similar treatment of gains and losses from currency hedging and forward cover contracts would also facilitate effective hedging.

16.100 The Committee notes that the US Treasury Department has recently issued a discussion paper²⁰ canvassing a system for taxing foreign exchange gains and losses which is essentially similar in the particular respect to the one discussed above.

18 *AVCO Financial Services v. FC of T*, 1979 ATC 4560; *AVCO Financial Services v. FC of T*, 1980 ATC 4603; *Lombard Australia v. FC of T*, 1980 ATC 4151.

19 See paragraphs 16.96–97.

20 *Foreign Exchange Gains and Losses*, A Discussion Draft, United States Department of the Treasury, December 8, 1980.

C. CONCLUSIONS AND RECOMMENDATIONS

16.101 Despite possible revenue implications, the Committee can see advantage in moving away from the present system of taxing exchange gains and losses (and related transactions) in respect of borrowings, to one where all gains are taxable and all losses deductible.

16.102 It therefore *recommends* that the present tax treatment be amended such that:

- (a) All realised foreign exchange gains and losses in respect of borrowings are treated as revenue items, whereby gains are taxed and losses deductible.
- (b) Hedging and forward contract costs in respect of borrowings are deductible with any proceeds therefrom assessable.

CHAPTER 17: INFLATION AND TAXATION

A. INTRODUCTION

17.1 High rates of inflation, even in the absence of tax considerations, have a significant impact on financial choices.¹

17.2 These effects are likely to have a less disruptive impact on the efficiency of both the financial system as a whole and individual participants if that system were relatively unfettered and thus permitted to respond flexibly to changing conditions.

17.3 Although the financial system has demonstrated a capacity, with some lags, to adapt to an inflationary environment, it has been put to the Committee that the existing taxation system has acted as an impediment and this has complicated the general process of financial market adaptation. In this chapter the Committee examines present tax arrangements from this viewpoint.

B. EFFECTS OF INFLATION

17.4 There are two distinct aspects of the impact of inflation on the taxation of incomes:

- The tendency under a progressive tax rate structure for the real burden of tax to increase even though real income may be unchanged. This is due to inflationary increases in nominal incomes pushing taxpayers into higher marginal tax brackets. It could be regarded as a **tax rate** problem and does not bear specifically on the financial system; it does have indirect effects through various impacts on savings, the relative burden of company and personal taxes and other such broader considerations.
- The determination of assessable income in nominal rather than real terms. This could be called a problem of **tax base**.

17.5 The **tax rate** problem is capable of being resolved by indexing the deduction limits and the marginal tax boundaries under personal income tax, on the basis of changes in an index reasonably representative of inflation.

17.6 However, the question of how best to accommodate the **tax base** to inflation raises more complex issues.

17.7 In an inflationary environment, present tax arrangements based on nominal incomes impact unevenly as between investment income derived from financial

¹ This chapter concentrates on taxation matters. There is some discussion of the effects of inflation on financial choices generally in Chapter 43.

assets and that derived from physical assets. They also impact unevenly between borrowers and lenders. Distortions in the pattern of funds flows can result.

17.8 At present:

- Debt holders are taxed on the whole of their nominal interest income, even though a portion represents an inflation adjustment for the declining real value of the principal lent.
- Business borrowers, on the other hand, can claim a tax deduction for all of their interest payments even though a part is a payment to maintain capital value.
- Equity holders (shares, property etc.) are taxed on their nominal income from dividends, rents etc. To the extent, however, that share and real estate values rise with the rate of inflation, an inbuilt capital maintenance adjustment takes effect — which is generally not taxed upon disposal of the subject assets.

C. THE MATHEWS REPORT

17.9 The effects of inflation on the taxation of business and personal incomes were the subject of investigation and report in 1975 by a Committee chaired by Professor R. L. Mathews.²

17.10 On **personal taxation**, the Mathews Committee recommended that tax indexation be effected through the adjustment of marginal tax brackets and deduction limits for changes in the consumer price index. However, no recommendation was made in respect of tax indexation of interest receipts and similar incomes derived from financial assets, which have values fixed in money terms.

17.11 In recent years the Government has, at times and in varying degrees, 'indexed' marginal tax brackets and rebate limits on the basis of consumer price movements. There is, however, no evidence that the principle has been accepted on a full and ongoing basis.

17.12 On **business taxation**, the Mathews Committee recommended that a modified concept of assessable income be adopted based on a current value approach. The appropriate modifications could, it believed, be achieved by making two fairly simple valuation adjustments to the form of allowable deductions for tax purposes. These would involve permitting businesses to:

- reduce their assessable income to the extent that it merely reflected a rise during the year in the price of stocks and therefore in the cost of replacement ('cost of sales valuation adjustment'); and
- claim depreciation allowances on fixed assets on the basis of replacement cost, with a single replacement cost index to be applied to all depreciable assets ('depreciation valuation adjustment').

17.13 The Government implemented a variant³ of the cost of sales valuation adjustment known as the trading stock valuation adjustment (TSVA) in 1976, but

2 *Inflation and Taxation*, Report of Committee of Inquiry into Inflation and Taxation, AGPS, Canberra, 1975.

3 The TSVA scheme differed from Mathews Committee proposal in that the trading stock values were adjusted by the goods component of the consumer price index instead of by reported replacement prices.

on the basis of only 50% indexation. This concession was withdrawn in the 1979–80 Budget.

17.14 To date, a depreciation valuation adjustment has not been adopted. In 1976, however, an investment allowance was introduced for approved plant and equipment expenditure; although the size of the allowance has since been scaled down, it will be available until 1986. In 1979, the depreciation allowance was extended to income-producing buildings catering for short-term tourist accommodation. In the following year accelerated depreciation was introduced for **approved** plant and equipment acquired by a taxpayer under a contract entered into after 19 August 1980.⁴

17.15 A number of submissions have called for the adoption of the Mathews Committee recommendations in their entirety. There have also been requests for the reinstatement of TSVAs and for increased accelerated depreciation.

D. ASSESSMENT AND OPTIONS

17.16 The Mathews Committee approach has attracted criticism on a number of grounds. It has been pointed out that:

- To index the business income tax base without at the same time indexing the personal income base, particularly the interest income of debt holders the capital value of whose assets are fixed in money terms, would risk creating new distortions and inequities.
- To index trading stocks and fixed assets without corresponding adjustments for financial assets such as bonds and debentures, which have values fixed in money terms and feature prominently on the liability side of the business balance sheet, would involve a similar risk.
- To adjust trading stock values on the basis of the replacement cost of those stocks and fixed assets on the basis of an index of the replacement cost of capital equipment would run counter to the object of indexation, which is to allow for the effects of changes in the **general purchasing power** of money, not for the effects of changes in **relative prices** reflecting demand and supply forces in particular markets.

17.17 The Committee has not attempted a comprehensive examination of these criticisms but it notes⁵ that indexation of the tax base would only achieve complete tax neutrality if:

- financial as well as physical assets were covered;
- liabilities were treated in a similar fashion to assets;
- all investors earning the same real income were taxed at the same rate;
- only the real income component of interest receipts were taxed with a similar adjustment of deductions; and
- an appropriately broad measure of inflation were adopted as the basis of adjustment.

⁴ Or constructed by the taxpayer where construction commenced after that date. See s.57AG of the Income Tax Act.

⁵ See Appendix 17.1.

E. CONCLUSIONS

17.18 The Committee is mindful that any consideration of action to correct for the distortions imposed on the financial system in an inflationary environment cannot overlook the wider social and economic issues that may be involved, including the implications for:

- corporate balance sheet structures and the pattern of funds flows to business;
- the structure of the taxation system, particularly if a revenue shortfall were created and this has to be recovered through other taxes;
- wage determination rules and their consequences for the inflation outcome;
- flows of foreign capital into Australia; and
- the general investment climate.

17.19 In addition, and as noted in Chapters 34 and 43, the financial system has demonstrated a capacity, with some lags, to adjust to an inflationary environment.

17.20 For these reasons and the recognition that any action in this area cannot be pursued in isolation from the rest of the tax system, particularly the tax treatment of capital gains,⁶ the Committee makes no specific recommendations. Nonetheless, **the Committee urges the Government to review again the procedures for taxing income in an inflationary environment because of their important and wide ramifications for efficiency and equity in the financial system.**

⁶ The Committee has not attempted any comprehensive study of the taxation of capital gains in the Report other than discussions of specific aspects, e.g. s.26AAA, in Chapter 16.

A PROCEDURE FOR INDEXING THE INCOME TAX BASE FOR INFLATION

1 A study prepared for the Inquiry¹ has suggested the following procedure for adjusting the income tax base to allow for the effects of general inflation:

- (i) For trading stocks and net financial assets on which taxable trading and interest incomes are earned:
 - a reduction in company and personal tax liability by permitting a deduction against such incomes, in arriving at the tax base, of an amount equal to the lower of historic cost or beginning of period market valuation, multiplied by the percentage increase in the general index of inflation² for that tax year.
- (ii) For net financial liabilities on which interest payments are a deductible expense:
 - a corresponding increase in tax liability so that only the real rate of interest on debt is allowed as a deduction.
- (iii) For depreciable assets:
 - a reduction in tax liability by granting an increase in the historic cost depreciation allowance proportionate to the percentage increase in the general index of inflation since the purchase date (or, **equivalently**, full indexation, on the basis of movements in the general index of inflation, of the historic cost valuation which forms the basis for the annual allowance).

2 The study argues that no adjustment would be required for long-lasting, non-depreciable assets such as land and certain forms of real estate, since the value of such assets could be presumed to move upwards roughly in line with the general inflation rate. Similarly there would be no need to adjust rents and, to a lesser extent, dividends,³ since real estate and share prices tend to move upwards in line with inflation.

3 The Committee does not offer any particular comments on these suggestions.

1 P. L. Swan, 'An Optimum Business Tax Structure for Australia', in Australian Financial System Inquiry, *Commissioned Studies and Selected Papers*, Part 3, AGPS, Canberra, 1981.

2 For example, Swan, *ibid.*, proposed using the Consumer Price Index (CPI) as a general index of inflation.

3 Should assessable business income be adjusted for inflation and personal income be integrated for tax purposes with company income, the problem of adjusting dividend income for inflation would no longer arise.

PROTECTION OF INVESTORS AND BORROWERS

- Ch. 18 Investor Protection: General Approach
- Ch. 19 Investor Protection: Deposit-taking Intermediaries
- Ch. 20 Investor Protection: Long-term Savings Intermediaries
- Ch. 21 Investor Protection: Companies and the Securities Industry
- Ch. 22 Consumer Credit: Protection of Borrowers

CHAPTER 18: INVESTOR PROTECTION: GENERAL APPROACH

A. INTRODUCTION

18.1 This chapter seeks to lay down some considerations against which the objectives and methods of investor protection might be assessed, with particular regard to their impact on the operational and allocative efficiency of financial markets.

18.2 These considerations are designed to provide a common framework for the discussion of specific investor protection issues in Chapters 19 to 21. It is intended that the broad principles should be applied consistently, but not necessarily uniformly, in all circumstances; the Committee has taken account of the special characteristics of the intermediaries concerned in giving effect to these principles.

18.3 Greater attention has been given by governments in recent years to the protection of investors. Legislation designed to protect investors against fraud and malpractice has been tightened over the past decade. There have also been periodic expressions of government support for certain intermediaries, the development of new systems of official regulation and supervision, and government encouragement of industry-based liquidity and solvency support arrangements, at times involving co-operative or mandatory industry participation.¹

18.4 Intensified interest in protecting investors has been in response to a number of developments, including:

- the diversification of household savings from the relative safety of the banking system to higher yielding, but often less secure, investments with non-bank intermediaries;
- the occasional severe liquidity strains experienced by, and in some cases the failure of, certain non-bank financial intermediaries (NBFIs) during the 1970s; and
- the disclosure of some undesirable practices affecting securities markets during the mining boom of the late 1960s and early 1970s.

18.5 Depositors and investors face three distinct types of risk:

- **solvency risk**, which arises when the value of the assets of a financial institution falls short of its liabilities; this may be due to mismanagement, to ordinary business hazards, or to fraud or malpractice;
- **liquidity risk**, which arises when an otherwise sound institution is faced with demands for payment which exceed its immediate capacity to realise assets in an orderly manner;

¹ The trend towards increased prudential regulation is also common to many countries overseas.

- the risk of loss associated with **market imperfections**, which arises when investors are inadequately informed about prospects and contingencies.

18.6 Notwithstanding the need for investors to make their own assessment of risk/return relationships, governments have sought to:

- protect the small or less well-informed investor;
- protect long-term contractual savers;
- ensure a fair, well-informed and efficient securities market;
- promote a sound and efficient payments system; and
- ensure a relatively even flow of funds.²

18.7 Government involvement in the financial system with a view to protecting investors can have both positive and negative effects. Regulation that promotes investor confidence and a better informed market contributes to **allocative efficiency**. An example of how losses of confidence can impair the efficiency of financial intermediation — at least in the short run — is the disruption to housing finance flows that followed crises of investor confidence in permanent building societies in some states during the 1970s.

18.8 However, it is equally clear that regulation and government support, particularly in certain forms, may impair the **operational efficiency** of financial intermediaries and financial markets, and may reduce the range of risk/return options available to investors. For example, outright prohibitions on the holding of certain assets may impair the ability of intermediaries to respond flexibly to changing market conditions or to pursue lending or investment policies which might be best from the viewpoint of the community as a whole.

18.9 The costs of compliance with regulation may also be considerable, raising the ultimate cost of funds to borrowers and/or lowering the return received by investors. Equally, where government support is thought to extend to non-viable organisations, it may not only lead to a misallocation of resources, but also reduce the incentive for intermediaries to maintain adequate ongoing prudential disciplines.

B. CONSIDERATIONS

(a) Stability and Confidence

18.10 The stability of the financial system as a whole is of prime importance. The system could not operate effectively, let alone efficiently, unless investors at large had confidence in the underlying solvency of financial institutions generally and in the overall stability of financial markets. Governments therefore have a general responsibility to establish arrangements which ensure public confidence in the overall soundness of the financial system.

18.11 However, except where there are strong reasons for believing that the stability of the financial system would be impaired, it is in the interests of a competitive and efficient market that individual financial intermediaries be allowed

² During the past decade inflation has eroded the real value of deposits and other nominal interest rate investments. The role of governments in protecting investors against this form of risk (other than by way of a general anti-inflationary policy) is explored in Chapter 43.

to fail, in the same way as non-financial enterprises. There may nevertheless be a need for the authorities to facilitate the exit of an intermediary so as to avoid a loss of public confidence in viable but otherwise similar intermediaries.

18.12 At the same time, it should be recognised that 'failure' of an individual institution is not necessarily accompanied by widespread instability. In practice, failure may involve no more than loss of separate corporate identity and hence be of little consequence to the community at large; again, there may be little or no adverse effect on borrowers or investors other than shareholders. The possibility of failure serves a useful purpose: it provides an incentive for good management, while actual failure terminates mismanagement.

18.13 A stable monetary environment is necessary to underpin the stability of the financial system. This requires avoidance of excessive monetary fluctuations. Within the overall stance of monetary policy, the Reserve Bank should seek to ensure that the financial system as a whole is always able to meet its normal liquidity needs. However, in general, liquidity should be allocated to individual institutions through the market.

18.14 Monetary 'shocks' (unexpected by participants in financial markets, including the authorities) may sometimes occur and may adversely affect the liquidity of the system as a whole, as well as that of individual intermediaries — even those that are sound and well managed. Of course, prudently managed intermediaries should structure their holdings of liquid assets with due regard for their ability to cash those assets. The further development of secondary markets in financial assets (which is advocated elsewhere in this Report) should assist intermediaries to manage their portfolios in such a way as to meet any short-term liquidity needs without sustaining unacceptable losses.

18.15 The Committee nonetheless believes there should be a 'safety valve' available to intermediaries to moderate the impact of heavy financial shocks. As outlined in Chapter 5, in the Australian environment this 'cushion' might most appropriately take the form of a 'discount window' facility for **specified** government securities.

18.16 Of course, a persistent or widespread liquidity crisis, while having implications for the operation of monetary policy generally, might well require still more active official involvement (through the Reserve Bank) in individual liquidity support arrangements; the issue of contingency funding arrangements is also discussed in Chapter 5.

18.17 Extension of government protective arrangements to a wide range of intermediaries would tend to lead to a reduction in the diversity of investor choice. This means, in effect, that the community would bear the costs of regulation, with the possibility of benefits — in the form of a higher return (than may be justified by the degree of risk) — being enjoyed by a narrower group of investors.

18.18 If protection were to be achieved by constraints on the capacity of intermediaries to choose how they wish to operate, initiative would be discouraged; in time, this might result in the growth of other, less regulated, intermediaries to satisfy investors' demands for higher yielding assets, or it might lead to disintermediation. The Committee therefore believes that prudential regulation should seek to ensure that a reasonably full spectrum of risk/return combinations is available to investors. A wide risk/return spectrum does not, of course, preclude the provision of a 'safety haven' for small, unsophisticated investors.

18.19 For investors to be able to choose among assets carrying varying degrees of risk, it is essential that they should be capable of thoroughly evaluating that risk. For this reason, it is believed that governments have a responsibility to ensure that information in a form and content necessary for risk evaluation is disclosed by financial intermediaries and other corporate borrowers.

18.20 Confidence in the fairness of a market is necessary to attract and retain investors. A market characterised by fraudulent practices is likely to be prone to instability and unlikely to be efficient in mobilising resources.

18.21 It is therefore clear that governments have a responsibility also to ensure that the legal and regulatory framework offers reasonable protection to investors against fraud and malpractice and that a 'fair' market in securities is maintained.³

(b) Efficiency

18.22 Submissions have stressed the adverse implications that prudential (and other) regulation may have for efficient financial intermediation. The need for regulators to have regard for efficiency as well as investor protection was also outlined in the Rae Report.⁴ It is evident that excessive attention to investor protection objectives may impose costs on companies, discouraging recourse by them to the market. It may also restrict the options available to investors to a point where the efficiency of the market itself is impaired.

18.23 In developing and revising investor protection arrangements, it is important that governments should give explicit recognition to efficiency and cost considerations.

18.24 Official restrictions on the entry of new intermediaries have also involved a conflict between stability and efficiency. It is understood, for example, that some State Registrars of Co-operative Societies have been more interested in seeing mergers of existing institutions than encouraging new entrants. With regard to overseas-owned intermediaries, apart from pure ownership considerations, a major factor considered by the authorities has been stability. As a consequence entry requirements have, in a number of cases, tended to discourage new entrants; flowing from that has been a less competitive market.

18.25 It is desirable that licensing requirements should not involve discretionary judgments as to the optimum number of participants in an industry from an efficiency point of view. Such judgments can be quite subjective but, more particularly, are quite unnecessary for the achievement of stability objectives. If erroneous, they may impair the competitive efficiency of the market.

18.26 Even if the authorities were to prove correct in their assessment of the optimum structure of the market, a new intermediary may well turn out to be more efficient than existing intermediaries — in which case there would be gains to the community in displacing the latter with the former.

18.27 On efficiency grounds alone, therefore, it might be argued that, in general, an intermediary meeting prescribed minimum prudential requirements should be

3 A 'fair' market is one in which all parties participate on an equal basis. The disclosure of relevant information is the principal way governments seek to achieve this objective.

4 Australian Securities Markets and their Regulation, Report of the Senate Select Committee on Securities and Exchange, AGPS, Canberra, 1974.

licensed, even if there were reason to believe that such entry could lead to the exit of another intermediary.⁵

18.28 Where there already exists a large number of participants, appropriate regulation and supervision should do much to ensure the smooth exit of failing intermediaries, thus facilitating possible efficiency gains from new entry.

18.29 However, such a pure free market approach may need to be tempered to a degree when the nature of the industry — e.g. banking — is such that it is particularly sensitive to fluctuations in investor confidence. The case for phasing in new entry is strengthened where significant barriers to new entry in the past have created a heavy ‘backlog’ of potential new entrants. A sudden and total elimination of such long-standing barriers in these circumstances could have adverse consequences for stability. Nonetheless, the Committee urges movement, in the long run, to a situation where entry is basically unconstrained except for a need to meet appropriate prudential standards.

(c) Flexibility

18.30 Prudential regulation would do least harm to the efficiency of financial markets if there were minimal interference with the commercial/financial decisions of intermediaries and if it were framed in such a way as to allow intermediaries maximum flexibility to adjust to changing circumstances.

18.31 It follows that prudential requirements laid down and supervised by the authorities in a flexible manner are preferable to the formal specification of requirements in legislation. Among other things, the latter practice can mean lengthy delays in amending requirements that have become inappropriate in the light of changing circumstances.

18.32 Some existing forms of regulation prohibit or closely restrict the range of activities that may be undertaken by certain intermediaries. Restrictions on assets that may be held, or on the sources and maturity of borrowings, can inhibit the ability of intermediaries to adjust their balance sheets in response to changing market conditions. Such loss of flexibility may adversely affect the competitiveness of particular groups of financial intermediaries and contribute to inefficient financial intermediation. In extreme circumstances they may even give rise to instability.

18.33 Broadly, the same can be said of controls on the interest rates intermediaries may pay on deposits and/or charge on loans. Although these are considered by some to promote stability by discouraging ‘excessive’ competition for funds and the making of less secure, higher yielding loans and investments, there are strong reasons for believing that such controls can impair the efficiency of financial intermediation. They can also have perverse effects on stability in some circumstances. This issue is discussed further in Chapter 19.

18.34 A more flexible, less interventionist, approach would be to relate prudential requirements to the various degrees of apparent risk in an intermediary’s assets, while placing emphasis on disclosure and investor awareness and the improvement and maintenance of management standards and practices.

⁵ However, the Committee recognises that barriers to entry may be necessary to achieve other objectives, e.g. in relation to foreign investment. The arguments for and against such barriers are explored in Chapter 25 and elsewhere.

(d) Competitive Neutrality

18.35 The growth of new groups of financial intermediaries during the past twenty years and the greater integration of financial markets have brought competitive neutrality aspects of prudential requirements, and oversight generally, into sharper focus. Particular concern has been expressed about the competitive advantages that lender of last resort facilities and the depositor protection provisions of the Banking Act are said to have conferred on the banks. The merits of these claims are explored in Chapter 19. However, the relevant principle is clear — investor protection arrangements, including Reserve Bank liquidity support arrangements, should aim to involve minimum disturbance to competitive neutrality.

18.36 Within this broad principle, however, it is recognised that special protection arrangements may, in some instances, be necessary, e.g. having regard to the importance of banks for the stability of the financial system and their role as 'safety havens'.

(e) Consistency

18.37 A closely associated issue is the need for greater consistency in the overall approach to prudential regulation. For example, inefficiencies may arise from the present fragmented system of regulation of building societies and credit unions and the resulting segmentation of financial markets. This fragmentation is likely to give rise to wasteful use of resources in that intermediaries which might otherwise merge with others or exit entirely from the industry because they are less efficient are insulated from the normal tests of viability. For those desirous of operating nationally, fragmented regulation also imposes additional costs of compliance.

18.38 With the distinction between the financing activities of banks and non-banks (and even among non-bank financial intermediaries) becoming increasingly blurred in recent years, the Committee considers that competitive neutrality and efficiency considerations would be best served by regulating intermediaries undertaking similar lending activities in a consistent and comparable manner, i.e. by a functional approach to regulation, though having due regard for differences in the risks attaching to the operations of different intermediaries. This suggests a need for a national, or at the very least a more uniform, approach to prudential regulation.

18.39 While there are obvious practical difficulties associated with a broadly functional approach to regulation arising from our federal system, a special effort should be made to adopt such an approach because of its important implications for the development of an integrated, efficient financial system. An example of what can be achieved is the co-operative national approach to the regulation of companies and the securities industry which has been developed in the last few years.

(f) Industry Involvement

18.40 Industry groups may, at times, prefer government regulation to self-regulation, not least because of the government 'support' implied. Any close prudential supervision carries with it a public perception about the safety of the intermediaries concerned. The more stringent the official regulation and supervision, the more likely it is that investors will regard investments with the intermediaries concerned as safe, making it more difficult for governments to dissociate themselves from intermediaries experiencing financial difficulty.

18.41 Having regard to the need to maintain competitive balance among financial intermediaries, and to overall efficiency considerations, the Committee considers that governments should seek to ensure that prudential regulation does not, of itself, entail unintended direct or implied government support for the solvency of any group of financial intermediaries.

18.42 For similar reasons, liquidity and solvency support arrangements operated by financial intermediaries as a group are preferable to government-established and government-run arrangements — though it is acknowledged that there may be practical problems in implementing such arrangements. Direct government underwriting or other involvement in such arrangements will, in the absence of close regulation and supervision, tend to remove the discipline on financial intermediaries to pursue prudent policies. It is therefore desirable that the role of government should, as far as possible, be confined to the passage of establishing legislation, where this is necessary, for the commencement of an industry-run support scheme.

18.43 The Committee recognises the benefits, in terms of greater flexibility, that can be obtained from self-regulation. However, it is conscious that this can lead to conflict between the interests of the self-regulating body and those of the community in general. Such a conflict can be partly avoided by broadening the membership of the self-regulating body to include representatives of those groups affected by its decisions. On balance, the Committee generally favours co-regulation, i.e. self-regulation but with some limited government involvement to the extent necessary to ensure that the desired prudential objectives are achieved effectively and equitably.

(g) Disclosure

18.44 Earlier in this chapter, reference was made to the need for adequate and appropriate **disclosure to the investing public**. Apart from fostering investor confidence, this is particularly important if *caveat emptor* is to have any real meaning.

18.45 While disclosure requirements do not always represent a complete alternative to other forms of regulation, in many instances such a trade-off may exist. The scope for this depends importantly on one's judgment about the ability of investors to look after themselves, however much information is available to them and however clearly and simply it is expressed.

18.46 It should not be overlooked that disclosure requirements are another form of regulation, carrying not insignificant costs of compliance in many cases. The question is not necessarily one of **increased** information, but of how the quality of information can be **improved** so as to maximise its usefulness to investors, while minimising the costs to companies and financial intermediaries.

18.47 The concept of a trade-off between disclosure and other forms of regulation has limited relevance to secondary markets; here, increased disclosure is sought not only to improve risk assessment, and thus *caveat emptor*, but also to maintain a fair market. Such disclosure is important whatever other regulation there may be.

18.48 As a corollary to disclosure, it has been argued that governments should ensure that companies and intermediaries are fully accountable to their shareholders, policyholders and contributors. The Committee believes as a general

principle that shareholders etc. should have a meaningful opportunity to express their views on the policies of the companies in which they have invested.

18.49 It is also desirable that investors generally are well informed as to the nature of their investments, their rights and obligations etc. This issue is taken up in Chapters 19–21 and certain views put forward on the role of governments.

CHAPTER 19: INVESTOR PROTECTION: DEPOSIT-TAKING INTERMEDIARIES

A. INTRODUCTION

19.1 This chapter is primarily concerned with trading and savings banks, permanent building societies and credit unions, the principal institutions which take deposits from the **household sector**. Finance companies, although in competition with deposit-taking intermediaries (DTIs), are not subject to the same degree of regulation. Specific aspects of the regulation of finance companies are examined in Chapter 21, but the scope for integrating finance companies into the regulatory framework is explored briefly here.

19.2 The chapter also looks briefly at arrangements for the protection of investors with authorised dealers in the short-term money market and with money market corporations (merchant banks).

19.3 A distinctive feature of the current framework of prudential regulation is the diversity in methods of control and application both between groups of institutions and as between the States. This reflects the traditional division of responsibilities and an evolution of regulation along **institutional** rather than **functional** lines.

19.4 Some elements of the current regulatory structure are common to all principal DTIs. For example, all are subject to entry requirements and minimum balance sheet standards (e.g. reserve and liquidity requirements), though these vary considerably between institutional groups.

19.5 There are, however, striking differences in the regulation of interest rates and balance sheet structures. Similarly, only the banks and authorised dealers have direct liquidity support arrangements with the authorities, although contributory Reserve Funds established in some states for building societies and credit unions have a degree of government backing.

19.6. Details of these and other elements of the regulatory framework were outlined in Chapter 15 of the Interim Report.

19.7 The rationale for government intervention to protect depositors is centred on arguments about efficiency, stability and confidence, and the social benefits of protecting small depositors; these considerations need to be balanced against the costs of intervention — not least the costs of enforcement and compliance.

19.8 Prudential regulation can promote a more efficient use of resources by providing 'labelled' risk information for all depositors, thus avoiding duplication of information-search effort.

19.9 Prudential regulation of DTIs may also be seen as helpful to efficiency, to the extent that it underpins confidence and stability. If a group of intermediaries

were subject to periodic losses of public confidence (as indeed has happened in the past), whether as a result of concern about solvency or liquidity, the ability of these intermediaries to mobilise and allocate funds efficiently would be impaired. This might have particularly severe effects on those sectors of the economy (e.g. housing) which are most dependent on stable and substantial flows of credit from those institutions.

19.10 The Committee recognises that, as an important market discipline, **individual** institutions should be allowed to fail; the concern of the authorities should be with the promotion of **general** stability.

19.11 Particular importance is attached to a stable and reliable banking system; a banking collapse would create substantial disturbance in financial markets and thus in the economy as a whole. In this regard, a critical consideration is the central role played by the banks in the provision of key elements of the payments mechanism.

19.12 Governments have assumed a degree of responsibility for small depositors because of the belief that they are unsophisticated in financial matters, and many of them, being of modest means, would suffer hardship as a result of any major investment losses. The generally unsettled economic and financial climate since the early 1970s, and with it an increased exposure to risk, has increased the concern of governments for the protection of small investors.

19.13 This concern is understandable, and it suggests the need for at least **some** risk-free investment outlets within the system. But equally, it points to the desirability of educating depositors on risk awareness. It should not imply the elimination of all risk for all depositors.

19.14 The Committee believes that some form of depositor protection is important, for both economic and social reasons. However, it should be recognised that the closer the relationship of DTIs with the authorities, the more 'secure' they are generally perceived to be. This raises two further problems:

- If DTIs believed they would be 'rescued' whenever threatened with failure, they might have less incentive for prudent management; in turn, this might lead to even greater pressure for government protection; and
- if, in keeping with their secure image, DTIs were expected or required to adopt extremely conservative lending/investing policies, this might create a 'gap' in the supply of risk capital.

B. APPROACH TO REGULATION

19.15 The Committee believes prudential regulation of DTIs should have regard to the following specific considerations:

- Government protection of investors should not be extended to the point where it has adverse effects on prudent management, diversity of choice and the efficiency of financial markets.
- There should be much greater co-ordination and uniformity of regulation of DTIs across Australia.
- Competitive neutrality would best be achieved through a more **functional approach** to the regulation of DTIs. This involves a consistent approach to the regulation of all deposit-taking activities.

- Each industry group should be encouraged to participate in the regulatory process as far as possible.
- In particular, the Committee draws a distinction between **flexible regulation** — where DTIs are allowed considerable freedom as to the business they conduct, but with prudential requirements reflecting the nature of their balance sheets (e.g. involving the use of capital ratios to limit particular asset risk exposures) — and what might be called **structural regulation** (e.g. interest rate controls and asset restrictions). In general, the latter forms of regulation are most damaging to allocative efficiency and should be avoided.

19.16 The Committee believes that the present fragmented approach to regulation makes it difficult to achieve competitive neutrality, inhibits the development of nationally oriented DTIs¹, and may discourage desirable longer term rationalisation. Moreover, the perpetuation of past distinctions between different groups of institutions, each subject to different supervisory authorities, may well constrain the natural, flexible evolution of deposit-taking intermediaries in the changing competitive environment of the future. In short, continuation of the existing approach to regulation can be expected to entail major efficiency costs.²

19.17 Against this background, the Committee proposes that financial intermediaries soliciting funds from the public should, for purposes of prudential regulation, fall under five categories:

- banks;
- authorised dealers;
- non-bank deposit-taking institutions (DTIs) which solicit small deposits from households without issuing prospectuses;
- institutions which solicit small investments from households through the issue of prospectuses; and
- other institutions which **only** accept **large** deposits, predominantly from the business sector.

19.18 For reasons discussed in the following section, banks would remain in a special category for prudential policy and continue to be regulated under the Banking Act; but, in the view of the Committee, the basic approach to their regulation should be the same as for other DTIs.

19.19 Authorised dealers would remain a special category, given the nature of their relationship with the authorities.

1 If intermediaries such as building societies which now operate on a state basis were permitted to operate nationally, they would be able (through a national spread of operations) to adjust their lending patterns according to changes in demand.

2 In several overseas countries the distinction between different types of financial institutions has become less evident. In West Germany, for example, there used to be different licences for different financial groups. However, as a result of the diversification of different groups, the Government has, for some years, permitted all groups to undertake the full range of banking business. There is also a growing view among the authorities in the United States that the distinction between banks and non-banks will become less clear over the next few years. This is reflected, for example, in the establishment of a Federal Financial Institutions Examination Council to co-ordinate the prudential regulation undertaken by five federal agencies. In the United Kingdom, a broad range of non-bank institutions are licensed as deposit-taking institutions.

- 19.20** Non-bank DTIs would be brought under a nationally uniform regulatory framework, possibly along the lines of the co-operative approach to national regulation of companies and the securities industry. The common characteristic of such DTIs would be that they draw funds principally, but not exclusively, from the household sector. However, they might differ markedly in asset structure and in the range of activities undertaken. Moreover, it is proposed that any institution soliciting funds from households will have reasonable opportunity to choose whether it operates under the DTI legislation or under prospectus requirements.
- 19.21** Institutions which raise funds principally from the household sector other than by way of deposits (principally finance companies and unit trusts) would continue to be subject only to prospectus requirements. However, they could elect to come under the DTI legislative framework and be subject to the closer regulation of their activities that this would entail.
- 19.22** Other institutions which accept deposits predominantly from the business sector, such as merchant banks, would continue to be subject to requirements laid down by the National Companies and Securities Commission (NCSC). Of course, these institutions would need to meet prospectus requirements if they actively **solicit** funds from the public.
- 19.23** The Committee recognises that, in practice, certain rules may need to be established to distinguish this group, which can be said to be operating in the 'wholesale' market, from those DTIs that operate in the 'retail' market.³
- 19.24** The Committee therefore *recommends* that a national framework for the **prudential regulation of non-bank institutions which accept deposits primarily from households without issuing prospectuses should be developed, possibly along the lines of the co-operative approach to national regulation of companies and the securities industry.**⁴
- 19.25** Institutions, such as smaller credit unions, that operate on the **mutual principle** in a **meaningful** sense and do not solicit 'public' funds would have to be specially treated for regulatory purposes.
- 19.26** It is important, of course, that the process of reform should not lead to the laying down of detailed, inflexible requirements. A 'co-ordinating council' might lay down the broad objectives of prudential regulation and the main features, having regard not only to investor protection objectives but also to questions of competitive efficiency and neutrality.
- 19.27** It is not envisaged that the Reserve Bank would assume additional regulatory responsibilities in the context of the national scheme, except to the extent that it has supervisory responsibilities arising from its liquidity support arrangements with any industry-based instrumentality.
- 19.28** It would have, of course, an important input to the development of the national scheme, as indeed would the NCSC because of its responsibilities for finance companies, merchant banks etc.
- 19.29** Basic supervision of non-bank DTIs would remain essentially a state responsibility; it is suggested that a system of supervision might be developed

³ For example, a retail deposit may be defined as anything less than a certain specified amount.

⁴ The approach to regulation of institutions which solicit funds predominantly from households through the issue of prospectuses is discussed in Chapter 21.

comparable to that used increasingly overseas in respect of foreign banks, i.e. with non-bank DTIs being supervised predominantly by the authorities in their state of origin.

19.30 Although the approach adopted by the Committee is basically a functional one, much of the discussion which follows is expressed on an institutional rather than a functional basis as recommendations relate to suggested changes in the **existing framework** of regulation.

19.31 Section C discusses the regulation of banks. Section D covers building societies and credit unions which, possibly along with other institutions (e.g. trustee companies which accept deposits), would comprise the third group in paragraph 19.17. Section E touches on the regulation of finance companies, the principal financial intermediaries currently subject to prospectus requirements. (These requirements are discussed in more detail in Chapter 21.) Section F relates to authorised dealers, and Section G briefly discusses the regulation of merchant banks. The special position of unit trusts and trustee companies is discussed in Chapter 21.

C. BANKS⁵

19.32 There are a number of reasons why **banks** need to be put in a special category for prudential policy:

- trust is a pre-condition for an efficient payments system: cheque-clearing institutions must be able to deal confidently with one another;
- it is widely accepted that there is a need for a safety haven for small investors, a role that has traditionally been filled by the banks; and
- a banking collapse which involved depositors in significant losses could be expected to create substantial disturbance in financial markets and therefore in the economy as a whole.

(a) Entry Requirements

19.33 Written authorisation by the Governor-General is required under s. 9 of the Banking Act before a bank may carry on business in Australia. Approval is subject to 'such conditions as are specified in the authority' granted by the Governor-General.

19.34 The Committee is aware of only one application from Australian residents for a banking authority (i.e. a banking 'licence') under the present legislation (though a number of foreign banks are understood to have expressed a strong interest in obtaining a licence). In announcing that the Government had been approached regarding the establishment of a new bank, in April 1980, the Treasurer made specific reference to the importance of suitability of major shareholders, directors and management, and to the need for 'appropriate operational arrangements from the viewpoint of the satisfactory protection of depositors and consistency with current banking policies'.

19.35 Barriers to entry have been justified by some as preventing competition of

⁵ While this section is principally concerned with the prudential regulation of banks, the discussion develops many regulatory principles and 'rules' which have wider application to other DTIs.

a kind which might be destabilising, i.e. which could lead to the adoption of high risk portfolios and possible failures.

19.36 There is a danger that restrictions on entry designed to facilitate an 'orderly' market may unduly limit the scope for competition and delay the departure of the inefficient; both would involve efficiency costs. At the same time, such restrictions may encourage the development of other less regulated and less efficient intermediaries 'outside the fence'.

19.37 Nevertheless, careful consideration needs to be given to the impact of new entrants on stability, especially where barriers have been long standing and substantial. When there are strong grounds for believing that a sudden relaxation may cause unsound and destructive competition, there is a case for phasing in new entrants.

19.38 If the authorities wish to restrict entry for stability reasons, entry requirements should:

- be simple and straightforward;
- be publicly available; and
- minimise discretionary judgments as to the optimum number of banks from an efficiency point of view.

19.39 In particular, in connection with the last of these, the Committee does not generally favour tests based on 'economic need' or 'adequacy of existing services'. Such considerations are best left to the discipline of the market.

19.40 The Committee believes that the principal entry requirements that should be met by any domestic bank being established or any organisation gaining a banking licence are:

- that it have sufficient capital for the operations it proposes; and
- that it be under the effective control of people of good repute and sufficient experience.⁶

19.41 While the Committee does not seek to specify precisely appropriate minimum **capital** requirements, the special position of banks in the financial system warrants a bank being required to have a substantial paid-up capital at the outset. (The recently established Australian Bank has a paid-up capital of \$30 million.) The shareholders of a new bank should also be of sufficient financial standing to contribute additional capital if required in the initial years (though no formal undertaking that they should necessarily do so if the need arises is suggested).

19.42 In assessing the quality of **management** for a new bank, an important requirement is that it should appear capable of meeting the continuing prudential requirements laid down for established banks. Regard should be had also to the reputation and experience of the shareholders, particularly where these are relatively few in number and in a position to influence bank policies.

19.43 Provided they meet the specified entry and prudential requirements, the Committee believes there is a place for co-operative or trustee savings banks in the

⁶ A survey of entry requirements for domestic banks in other countries is included in Appendix 13, Table 9 of the Interim Report.

financial system. It envisages, for example, that some permanent building societies may, in time, acquire bank status either individually or as a group.

19.44 A further question to be considered is whether a banking licence should be granted by the Reserve Bank or the Treasurer. Overseas practice is not uniform on this matter. In the United Kingdom, for example, the Bank of England makes the decision, whereas in Canada the Minister for Finance has responsibility for the issue of bank licences.

19.45 Having regard for the central importance of banks in the financial system, the Committee believes responsibility for approving a new banking licence should rest with the Treasurer, but subject to appropriate consultation with the Reserve Bank.

19.46 The Committee *recommends* that **new domestic banks should be required to demonstrate that they have:**

- **an appropriate capital base;⁷ and**
- **management of an acceptable quality, including their capacity to meet prudential standards laid down for established banks.⁸**

19.47 The requirements for entry of foreign banks are discussed in Chapter 25.

19.48 Various reasons have been put forward in support of ownership restrictions under the Banks (Shareholdings) Act.⁹ An original justification was foreign ownership, which is now dealt with under the Foreign Takeovers Act.

19.49 It has been suggested that ownership restrictions are necessary to avoid undue concentration of ownership within the financial sector.¹⁰ Concentration of ownership is a more important issue where there are significant barriers to entry. In a more highly competitive, deregulated environment, market forces are likely (even allowing for significant economies of scale in some activities) to ensure that a small number of intermediaries does not gain a disproportionate influence over the financial system. Moreover, the Committee will argue later (in Chapter 32) that, if governments are concerned about the level of concentration, there are more appropriate alternative instruments available (e.g. the Trade Practices Act).

19.50 A related argument put forward in favour of the Banks (Shareholdings) Act is that management is more likely to be 'unduly influenced' by a small number of shareholders than by a widely diversified group. It is argued that ownership restrictions are necessary to ensure reasonable independence and continuity of management and thus confidence in the banks concerned.

19.51 It has also been suggested that ownership restrictions are necessary to

7 Reference here is to 'conventional' **proprietary capital**, i.e. the 'risk capital' committed by shareholders. In the case of existing banks, capital is also regarded as including accumulated **reserves**, arising in particular from undistributed profits and asset revaluations.

8 The Committee has earlier acknowledged that there may be a case for phasing in new entrants in special circumstances (see paragraph 19.37).

9 This Act limits individual or associated holdings in an Australian bank to less than 10% of a bank's voting shares unless the Governor-General fixes a higher percentage.

Restrictions apply in respect of bank shareholdings in some other countries, e.g. Canada, where single interests are limited to a maximum holding of 25% in a bank during the first ten years after its establishment and 10% thereafter; in the United Kingdom permission is needed to acquire more than 15% of a bank's capital. In other countries, permission is generally required for takeovers or mergers.

10 The issue of concentration of ownership within the financial sector is discussed in Chapter 32.

ensure that depositors' funds are not used primarily for the benefit of particular shareholders, and to prevent the transfer of ownership to new owners who may not themselves be of sufficient stature to obtain a licence. These concerns are valid and are taken up later.

19.52 The Committee is of the view, however, that a dispersion of shareholdings may give unwarranted security of tenure to management, which could inhibit efficiency and innovation. As well, if appropriate prudential requirements were in place (including, for example, disciplines in respect of loans to single customers and to shareholders and directors — see paragraphs 19.86–92), a change in management arising from a shift in patterns of ownership is unlikely to damage depositor confidence. Indeed, it may have the opposite effect if the quality of management has been a cause for concern.

19.53 Nor is the greater accountability of management to shareholders likely, in itself, to increase the concentration of financial power. Repeal of the Act would only mean a different distribution of effective power between managers and owners.

19.54 Ownership restrictions have also been advocated as a means of ensuring that, if substantial increases in capital were required, these could be met without imposing excessive demands on any one shareholder.

19.55 The Committee disagrees with this view. It believes that a few substantial shareholders are, in many instances, more likely to provide increases in capital than a much more diversified shareholding. As well, the backing of large prestigious shareholders tends to promote confidence.

19.56 The Committee does not believe, on balance, that it is necessary on prudential grounds to restrict the ownership of banks. Accordingly, it *recommends* that the **Banks (Shareholdings) Act should be repealed.**¹¹

19.57 It is nonetheless desirable that the Reserve Bank should be fully aware at all times of the identity of substantial shareholders in a bank and, consistent with the need to ensure the high quality of management of a bank, should be able to take appropriate action where the need arises.

19.58 The Committee therefore *recommends* that:

- (a) **The Banking Act should require that anyone acquiring a substantial shareholding in a bank (a beneficial interest in 10% or more of the voting rights attaching to a bank's share capital) or increasing an existing substantial shareholding notify the Reserve Bank within two business days of that shareholding being acquired.**
- (b) **The Reserve Bank should be empowered to order divestment of shares held in excess of the 10% benchmark where, in its view and in the view of the Treasurer, this would be in the best interests of depositors.**

(b) Asset Restrictions

19.59 It has been suggested that prohibitions on the activities banks may

¹¹ Later in this chapter, the Committee recommends the imposition of appropriate constraints in respect of loans to shareholders, directors and single customers. Repeal of the Banks (Shareholdings) Act would only be appropriate if some constraints were imposed in respect of such loans.

undertake or types of assets they may hold are necessary to protect depositors from the consequences of imprudent investment decisions. The Committee believes that, in general, such prohibitions result in segmentation of financial markets, and are incompatible with an efficient, flexible financial system. Nor does it see them as particularly helpful for prudential purposes; by limiting the ability of intermediaries to respond flexibly to changing market conditions, such restrictions can impair profitability and, in extreme cases, generate instability.

19.60 This is not to suggest that all types of activities or assets are equally desirable from a prudential viewpoint. However, the Committee believes that prudential objectives can be met most efficiently by the application of appropriate asset quality/capital ratios and other tests in respect of the activities of banks, rather than by outright prohibition. This approach is discussed below.

19.61 The Committee *recommends* that **there should be no official prohibitions (on prudential grounds) on the nature of financial intermediation undertaken by banks or on the kinds of assets they may hold arising therefrom.**

19.62 In particular, the Committee sees no place — on prudential grounds — for the prescribed assets ratios which savings banks are currently required to maintain.¹²

19.63 The Committee envisages savings banks being permitted flexibility in determining the composition of their assets, provided they meet appropriate prudential requirements. These would also include asset quality/capital ratio limits (or similar disciplines) and other tests in respect of particular asset exposures. Where a savings bank, however, is a subsidiary of another bank (such as a trading bank) these limits would be applied on a consolidated basis.

19.64 The Savings Bank Regulations also require that 7.5% of depositors' funds be held in deposits with the Reserve Bank or in Treasury notes. This may be viewed primarily as a **liquidity** requirement, and is discussed later in this chapter.

(c) Balance Sheet Ratios

(i) Capital Adequacy

19.65 As already noted, minimum capital requirements for the establishment of a new bank and the subsequent observance of asset quality/capital ratios (or such disciplines) and other ratios and tests are expected to play an important prudential role in the protection of depositors and creditors.

19.66 In recent years, particular emphasis has been placed by a number of regulatory authorities overseas (such as in the UK) on the creation and

¹² Savings banks are required to maintain an amount equal to their deposits in Australia in prescribed assets, including cash on hand, deposits with the Reserve Bank, government securities and loans for housing or other purposes on the security of land in Australia. Full details of the requirements are provided in the Interim Report, paragraphs 11.39–11.45.

The Commonwealth Banks Act (1959–1973) prescribes various ways in which the Commonwealth Savings Bank may invest funds (section 42).

The regulations under which savings banks are required to hold the bulk of their assets in government securities and housing loans should be viewed primarily as having captive market and sectoral assistance objectives respectively. Relevant aspects are discussed in Chapters 10 and 37 respectively.

maintenance of ratios based on 'free resources'¹³ and 'risk assets'.¹⁴ The first of these is designed to ensure that the capital position of a bank is regarded as acceptable by depositors and other creditors, the second is designed to test the adequacy of capital in relation to the risk of losses which may be sustained, and is regarded as the more important for supervisory purposes.

19.67 In Australia, the Reserve Bank has indicated that it has no specific statutory powers to prescribe capital requirements for banks. However, the Bank consults with each bank about its capital position.

19.68 The Committee believes that capital, being the last line of protection for depositors, should be seen as the cornerstone of prudential regulation, and that accordingly, banks should in future be subject to capital adequacy requirements specified by the Reserve Bank.

19.69 A uniform capital adequacy (or gearing) requirement for all banks, structured to protect depositors with the weakest banks, would lead to a lower return on the capital of the more efficient banks and may well discourage innovation and competition. If the efficiency of financial intermediation is not to be impaired, therefore, any capital requirements over and beyond the initial minimum capital requirement should be flexible and take into account the special circumstances of each bank.

19.70 The Committee has examined the 'risk asset' ratio used in recent years in the UK. This approach is appropriate where there is a substantial number of banks and where close liaison with bank management has been less practicable.

19.71 By comparison, the Australian banking system presently comprises relatively few banks, permitting — as a consequence — close liaison between management and the Reserve Bank. The UK approach would appear to be a little rigid (despite its intended flexibility) for the present Australian environment.

19.72 In the United States, the Comptroller of the Currency places the capital requirement into a broader prudential perspective, through the establishment of the so-called **camel** ratio, which takes into account:

- the adequacy of a bank's **capital**;
- the structure and quality of its **assets**;
- the quality of its **management**;
- its **earnings** performance; and
- the **liquidity** of its assets.

19.73 Under this scheme, banks are rated on a scale of one to five in respect of each criterion, with the better banks having a rating of one. Any banks which have an average rating of three or more are examined more frequently than the usual annual examination.

13 The 'free resources' ratio is the ratio of current liabilities (as defined) to capital resources (as defined). Current liabilities includes deposits and all non-capital liabilities including creditors. Capital reserves includes capital, reserves, general provisions and longer term loan stock, less investments in subsidiaries and associated companies, intangibles, equipment, premises etc.

14 The 'risk asset' ratio is the ratio of assets weighted for different types of risk to capital (as further defined). In this ratio, premises are not deducted from capital but are appropriately weighted within the asset basket.

19.74 Partly reflecting the substantial number of banks, the US approach to determining capital adequacy highlights the need for any assessment of bank soundness to take account of more than just its capital base relative to the volume of business undertaken.

19.75 On balance, the Committee believes that, **in determining the adequacy of a bank's capital**, the Reserve Bank should have broad regard to the criteria for assessing bank prudential performance adopted by the US Comptroller of the Currency.¹⁵ The desirable size of any minimum capital requirements and the resulting gearing ratios will be also influenced, no doubt, by such special considerations as:

- the extent use is made of 'free resources' and 'asset quality' ratios and other disciplines for specified 'risky' assets (see discussion below);
- the existence and size of any Bank Cash Reserve Ratio; and
- the existence and extent of any (industry-based) deposits insurance scheme.

19.76 In further consideration of prudential disciplines, additional approaches might be considered. For instance, the authorities may, in respect of each bank:

- set a minimum capital adequacy (or maximum gearing) ratio and, where breaches of the requirement appear likely to occur, require banks either to increase their capital or readjust their asset portfolio within a set time to ensure maintenance of the desired ratio;
- establish a capital adequacy ratio as a referral point for prudential supervision; a breach of this ratio would act as a 'trigger' for further, closer analysis by the authorities; or
- adopt a two-tiered approach, involving a combination of the two. The first tier might be based on a conservative capital adequacy ratio, to be used as a 'trigger' mechanism, while the second might involve an even lower ratio, based on a prescribed minimum and requiring an increase in capital or readjustment of a bank's assets whenever a breach occurred or was likely to occur.

19.77 The Committee considers that the third of these alternatives has much to recommend it. It would provide time for an assessment of a bank's position, having regard to the totality of its operations, by the Auditor-General (if deemed necessary) under s.61 of the Banking Act once the more conservative ratio was breached. At the same time, the discipline of minimum capital requirements in relation to the bank's overall business would be maintained.

19.78 In considering capital adequacy, together with the various ratios and tests which might be applied therewith (including definitions and terms), it should be noted that the Committee recommends later in this chapter that a bank and its subsidiaries should be **consolidated** for prudential purposes.

19.79 The Committee *recommends* that:

- (a) **Individual banks should be subject to appropriate capital adequacy requirements.**
- (b) **Consideration should be given to the introduction of a two-tier capital ratio.**

15 Whereas the Comptroller of the Currency assesses capital and the four other criteria **separately** and a prudential rating is established for each, the approach suggested here has regard for the **interrelationship** between the need for capital and the various other criteria.

- (c) **The ratios should have regard for the interrelationship between capital and other criteria such as the quality of a bank's assets, its management, earnings performance and the maturity structure of its liabilities.**

19.80 Consistent with the Committee's views expressed elsewhere in this Report about the need to encourage greater community awareness of the scope (and limitations) of prudential regulation, the Committee *recommends* that **the broad criteria used in determining the ratios should be publicly available, though the specific ratio for each bank should not be publicly disclosed.**

(ii) Risk Asset Limits

19.81 In paragraph 19.61, the Committee recommended against the use of asset restrictions. However, it also recognised the need to take account of the quality of assets when setting aggregate capital adequacy requirements.

19.82 Within this overall approach to asset quality, it is also proposed that certain risky types of assets should be specifically subject to 'risk asset limits' (RALs), i.e. limits expressed as a proportion of a bank's capital. Increases in a bank's holding of specified assets beyond a prescribed level would be permitted, subject to an increase in capital sufficient to maintain the required ratio.¹⁶ The effect of this approach is to protect depositors by ensuring that any increase in a bank's holding of 'risky' assets beyond what is prudent, having regard to its existing capital base, is matched by an appropriate increase in its capital, i.e. is financed from equity rather than depositors' funds.¹⁷

19.83 Particular examples of assets where a RAL might be considered preferable for banks on prudential grounds to outright prohibition (or to no limitation at all) include:

- loans of a particular size to single customers;
- investments in, or loans secured by, low or non-income-producing property of a developmental or speculative nature;
- investments in or loans to associated or related companies or shareholders; and
- net foreign exchange exposure.

19.84 There is a growing trend overseas towards the application of such limits to take account of the 'riskiness' of particular types of assets. (The UK approach referred to earlier is an example of the latter, where **all** types of assets are appropriately weighted for risk.)

19.85 The actual RAL to be applied to individual assets needs to be determined in the light of the overall experience of the banks. However, the ratios used overseas suggest some broad orders of magnitude which, in the absence of information about the experience of Australian banks, might be taken as a guide.

16 This approach is consistent with the flexible approach adopted in respect of investments by life and general insurance companies, i.e. where there is no prohibition on investments, but above a certain level they do not count towards any solvency requirements (see Chapter 20).

17 An aggregate capital limit may also apply to a grouping of 'risky' assets; e.g. in Hong Kong, banks may make loans or investments of up to 25% of their own funds for each of real estate, equity in other companies or in related companies, so long as such loans and investments in aggregate do not exceed 55% of capital.

Maximum loans to single customers

19.86 The regulatory authorities in a number of countries impose restrictions on the maximum size of loans to single customers or have reporting requirements; e.g. in Denmark, loans to a single customer may not generally exceed 35% of 'own funds' (i.e. capital); in West Germany, such loans may not exceed 75% of own funds and in aggregate the five largest may not exceed three times own funds. In the United Kingdom, details of large loans, including the customer's name, the maturity date and the amount, must be reported (large loans broadly comprise loans in excess of 5% of loans to other customers).

19.87 While the Committee does not advocate any specific figure, it believes that prescribed legal limits might offer the best protection to depositors. A reporting requirement offers less protection and at the same time would involve the Reserve Bank more directly in the supervision of individual loans, which the Committee believes is undesirable and unnecessary.

19.88 Accordingly, the Committee ***recommends*** that **loans by a bank to a single customer should not exceed a prescribed proportion of its capital, with a specified number of the largest loans, in aggregate, being limited to a prescribed proportion or multiple of bank capital.**

Investments in or loans to associated or related companies or shareholders and directors

19.89 Restrictions are also applied in some countries on lending to associated or related companies or shareholders. For example, in Hong Kong banks are permitted to invest a maximum of 25% of own funds in related companies. A high risk weighting is attached to 'connected lending' by the Bank of England, for the purposes of calculating the risk asset ratio of banks. (See paragraph 19.66.)

19.90 In Australia, no formal restraints are imposed on banks' equity investments; however, the Reserve Bank, amongst other things, has specifically limited banks' 'associations' with official short-term money market dealers, merchant banks and property subsidiaries.

19.91 The Committee sees no need for such limitations on prudential grounds¹⁸, or for restrictions on lending by banks to subsidiaries, provided they are consolidated for prudential purposes (see paragraph 19.178). However, the proposed abolition of the Banks (Shareholdings) Act underlines the need for such a requirement in respect of loans to major shareholders and directors to ensure that depositors' funds are not 'unduly influenced'.

19.92 The Committee ***recommends*** that **loans to 'controlling' shareholders and directors should be subject to a conservative risk asset limit.**

*Investments in, or loans on the security of, certain classes of property*¹⁹

19.93 The traditional volatility of property markets suggests the need for a cautious approach to bank involvement in certain classes of property. This is recognised, for example, in the United Kingdom.

19.94 Having regard to the recommendation that a RAL should be applied in respect of bank loans to a single customer, the setting of additional requirements in

¹⁸ However, see discussion of bank shareholdings in authorised dealers in Chapter 9.

¹⁹ Property investments and loans are of particular concern, for the reasons indicated, but the Committee would also be concerned about any undue concentration of bank assets in some other areas, e.g. equity investments.

respect of individual property loans is not advocated. There is a case, however, for imposing a RAL in respect of aggregate investment or lending in or on low or non-income-producing property of a developmental or speculative nature.

19.95 The Committee therefore *recommends* that **consideration should be given to the imposition of risk asset limits in respect of investments in, or aggregate lending on the security of, certain classes of property (such as low or non-income-producing property of a developmental or speculative nature).**

Foreign exchange exposure

19.96 At present, banks may only hold 'working balances' in foreign currency at the end of the dealing day; all other balances must be cleared by the end of the day. Banks' exposure risks arising from holding foreign currencies are thus restricted. The Committee understands that banks also typically have detailed in-house rules and procedures for managing foreign currency risk exposure.

19.97 In Chapters 7 and 8, the Committee has recommended a gradual relaxation of certain controls, which will have the effect of integrating Australia more closely into the international economy. It is important in this deregulated environment that banks should have the freedom to compete actively with overseas banks, although this will expose them to greater risks. These additional risks can arise from:

- holding foreign currencies as a consequence of dealing in the **spot** market;
- commitments to buy or sell foreign currencies arising from dealing in the **forward** market;
- lending and borrowing in foreign currencies; and
- the activities of subsidiaries or branches of the bank in foreign currencies.

19.98 The first two of these involve 'dealing' risk exposures; these are the most sensitive to short-term exchange rate changes and could put the stability of a bank at risk very quickly if the uncovered position were large. While the in-house rules of the banks themselves are important, the importance of a stable banking system warrants the setting of prudential requirements by the Reserve Bank to ensure that sufficiently high standards are maintained by all banks.

19.99 The application of an appropriate RAL rather than an absolute limit would provide banks with some flexibility — which is necessary if they are to engage in foreign exchange business in an efficient manner — but without putting depositors unduly at risk.

19.100 The Bank of England has recently proposed guidelines for foreign exchange exposure which effectively take the form of RALs. In December 1979, the Bank foreshadowed that the maximum acceptable position in any one currency should be 3.5% of a bank's capital base, with an aggregate position in all currencies not exceeding 10% of its capital base. Early in 1981, the Bank announced that a bank's net open dealing position in any one currency should not exceed 10% of its adjusted capital base for the purpose of the risk assets measure, with an aggregate position not exceeding 15%.²⁰

20 In Switzerland, the aggregate spot and forward positions of banks should not exceed 100% of their capital. In Germany, a bank's aggregate open position is limited to 30% of own funds, or 40% of maturities due within one calendar month. All other European countries have reporting requirements or limits of some form, although to date they have typically focused more on **absolute** dealing limits (e.g. France, Ireland, Italy) rather than ratios (to capital).

19.101 Different considerations arise in the case of the third and fourth sources of foreign exchange risk identified earlier. As noted by the Bank of England, these aspects of a bank's business generally change relatively slowly. Reflecting this, the Bank proposed:

to discuss with banks at the onset of these arrangements, and thereafter to review periodically, perhaps once a year, or whenever a major development occurs, the currency composition of its net assets which best reflects the capital needs of its business.²¹

19.102 The Committee agrees with such a flexible approach, particularly in the early years of a deregulated environment. As a general principle, however, it would expect banks to endeavour to cover their foreign currency assets with liabilities denominated in the same currency to the maximum extent practicable.

19.103 The Committee suggests that the Reserve Bank might consider the application of risk asset limits for banks in respect of:

- their spot dealing exposure in each individual foreign currency;
- the aggregate of these individual spot exposures;
- their forward dealing exposure in each individual foreign currency; and
- aggregate forward dealing exposure.

(iii) Liquidity

19.104 There are at present no formal prudential liquidity ratios in place for trading banks. However, the SRD/LGS mechanism — while primarily a tool of monetary management — has the effect of ensuring that substantial liquidity is held by trading banks. The requirement that savings banks hold an amount equal to 7.5% of depositors' funds in deposits with the Reserve Bank or in Treasury notes, and the 40% requirement, involve liquidity aspects; these can be seen as achieving a prudential objective.

19.105 Banks (and other DTIs) need to hold liquidity for a number of reasons:

- sudden and/or unexpected withdrawals of deposits or usage of overdraft facilities;
- timing differences in the maturity pattern of assets and liabilities;
- a shortfall in the cash flow from existing assets;
- unanticipated operating or capital expenditures.²²

19.106 The simplest approach to the determination of liquidity ratios is that typified by the LGS mechanism and the savings banks' 7.5% ratio: the setting of a fixed proportion of prescribed liquid assets to total liabilities to the public. (This kind of ratio is also typically applied in respect of other DTIs.) This approach has been justified on the basis that it is easily understood, monitored and enforced.

19.107 However, this approach does not systematically allow for the fact that a bank's liquidity needs are related to the structure of its balance sheet and, in particular, to the overall maturity structure of its assets and liabilities. Nor is

21 'Foreign Currency Exposure', Bank of England Consultative Paper, December 1980, p. 3.

22 The risk arising from such contingencies may be described as the 'funding' risk, i.e. the risk that banks may not have access to sufficient funds to meet their obligations at any given time. Another form of liquidity risk is the 'interest rate' risk where a bank engaging in maturity transformation experiences losses as a result of interest rate changes.

account taken of differences in the degree to which different types of liquid assets may be readily encashed. Finally, it does not allow a bank's liquid assets to be reduced below the prescribed minimum to meet its liquidity needs; such assets can therefore hardly be regarded as liquid.

19.108 An important function of banks (and other DTIs) is maturity transformation, usually taking the form of borrowing 'short' and lending 'long'. With a traditional yield structure, a bank's earnings reflect, in part, the difference between the cost of short-term funds and the return on higher yielding, longer term loans. The liquidity risk stems directly from this activity.

19.109 In a number of other countries the authorities have recognised the susceptibility of banks to liquidity risk by developing liquidity ratios which have particular regard to the **maturity structure of a bank's liabilities**. The following instances indicate the varying approaches that may be followed:

- *Canada* — banks are required to hold 3% cash reserves against time deposits and 10% against deposits payable on demand, subject to a minimum of 6% of total Canadian deposits.
- *Denmark* — banks must maintain a minimum of 15% of prescribed liquids to liabilities of less than one month, and 10% against total liabilities.
- *Switzerland* — banks' holdings of liquid assets are required to vary according to the proportion of current to total liabilities, as follows:

<i>Proportion of current liabilities in total balance sheet</i>	<i>Liquid assets required as % of current liabilities</i>
Up to 15%	6%
15–25%	12%
25–35%	24%
over 35%	36%

19.110 In the United Kingdom, the Bank of England has further developed this approach and has proposed a liquidity ratio which has general regard to the **maturity of a bank's assets and liabilities**.

19.111 Ideally, a prudential liquidity ratio should have regard to the maturity structure of the assets **and** liabilities of each individual bank. Such an approach allows a bank whose borrowings are concentrated at the short end of the maturity spectrum to maintain a relatively low liquidity ratio where its assets are similarly concentrated, but a higher ratio where the maturity of its assets is longer. The marketability of the bank's assets may also be relevant.

19.112 However, it is acknowledged that the development of a ratio to take account of the circumstances of each individual bank might not be cost-effective. In this event, consideration should be given to the application of a ratio expressed in terms of either current liabilities or two ratios applying to current liabilities **and** time deposits or total liabilities.

19.113 Whichever approach is adopted, consideration must be given as to whether a ratio should be:

- a fixed minimum requirement to be observed at all times;
- a minimum requirement to be observed but on an **average basis** over a prescribed period of short duration.

19.114 The first approach is unacceptable to the Committee; it would defeat the purpose of a liquidity ratio if the bank could not have access to its funds in times of liquidity need. Having regard to the Committee's recommended changes to the LGS convention²³, the desirability of permitting flexibility in bank operations, and the need for an appropriate minimum prudential standard to be maintained by banks, the Committee favours the second of these alternatives.

19.115 At the same time, the Committee recognises the dangers that are inherent in any averaging approach: banks may run a liquidity ratio below the prescribed level for much of the averaging period and bid up money market rates sharply at the end of the period so as to achieve their average. It should therefore be made clear by the authorities that they expect the liquidity ratio to be generally at or above the prescribed level, and that any material and persistent breaches would give rise to reconsideration of a bank's capital ratio.

19.116 The final issue which needs to be considered in connection with liquidity requirements is the assets which should be eligible for inclusion in a liquidity ratio.

19.117 The Committee believes that the range of assets eligible for inclusion in a prescribed liquidity ratio should be determined primarily by reference to their period to maturity. It is desirable that assets which have a long period to maturity should not be eligible merely because they are marketable, as the realisation of such investments may, on occasion, involve significant capital losses.

19.118 The special position of banks in the financial system requires that the eligibility of assets for a bank's liquidity ratio should also be of very high quality. Eligible assets would include short-term government securities (say, with a maturity of twelve months or less), deposits with authorised dealers (secured by government securities) and perhaps certain net investments with other banks. The Committee does **not** believe that assets comprising the variable BCR ratio (discussed in Chapter 4) should be formally included in the required liquidity ratio, as BCR assets would not be freely available to meet a bank's obligations.

19.119 The Committee *recommends* that:

- (a) **Each bank should be required to meet a liquidity ratio for prudential purposes.**
- (b) **The liquidity ratio should be generally maintained at or above the required level. An averaging process would apply over short periods.**
- (c) **The eligibility of assets for a bank's liquidity ratio should be determined having regard to their period to maturity and their quality.**

(d) Restrictions on Liabilities

19.120 Savings banks are not permitted to accept deposits from companies or other bodies engaged in profit-making activities; the intention of this restriction is to minimise the volatility of savings bank deposits. The interest rate arrangements relating to the terms for which trading banks may accept fixed deposits, particularly the minimum term of three months for deposits of less than \$50 000 and thirty days for larger deposits²⁴, and the requirement that savings bank investment

23 See Chapter 4.

24 Certificates of deposit were, until August 1981, subject to a maturity limitation of a minimum of three months; however, this has now been reduced to thirty days.

accounts be subject to one month's notice of withdrawal, may also be seen as having prudential objectives.

19.121 While in the past such restrictions may have sheltered banks to some degree from volatility in deposit flows, it is not clear they will necessarily always do so; in particular, they are unlikely to achieve their purpose as the system becomes more integrated. Removal of interest rate controls would be a more effective way of reducing volatile deposit flows. (See discussion below.)

19.122 The Committee believes that banks should be free to borrow from whatever sources and for whatever maturities they wish; such freedom encourages innovation and greater flexibility in financing arrangements, while any effects on the stability of deposit inflows are unlikely to be so great as to be a matter of concern once interest rates have been deregulated.

19.123 This reinforces the recommendation in Chapter 4 that maturity restrictions on interest-bearing bank deposits should be abolished and leads the Committee to **recommend that the restriction on sources of savings bank deposits should be removed.**

(e) Interest Rate Controls

19.124 It has been suggested that interest rate competition for deposits encourages banks to hold riskier, higher yielding assets, and/or operate on finer margins, with adverse implications for the stability of the industry as a whole. This has been used as justification for the prohibition of payment of interest on cheque accounts. The limitation on the rate of interest banks may charge on loans is also claimed to have a prudential aspect, by discouraging the making of 'risky' loans.

19.125 It is not clear that interest rate controls on bank loans do, on balance, have desirable prudential effects. Such ceilings may, in fact, actually **increase** risk by:

- impairing the flexibility of banks to adjust to changing market conditions; to the extent they are unable to increase the rate they can charge on a substantial proportion of their loans, their ability to compete for deposits is impaired; and by
- inhibiting their ability to charge fully for the risk inherent in various loans.

19.126 It is true that the profit margins of many banks may be adversely affected in a climate of freer interest rate competition. However, the stability of the industry as a whole need not suffer, so long as the **process** of exit is carefully controlled by the authorities.

19.127 Having regard to the above considerations, and the general efficiency implications of interest rate controls (which are discussed in Chapter 4), the Committee **concludes that there is insufficient justification for retaining interest rate controls as an instrument of prudential policy.**

(f) Disclosure Requirements

19.128 Compliance by banks with the accounting requirements of the Banking Act (and the Commonwealth Banks Act) is deemed to be compliance with the accounts requirements of the Companies Act.

19.129 While the extent of disclosure in banks' accounts is generally in line with the statutory requirements for other Australian companies, banks are not currently

required to disclose their provisions for bad and doubtful debts.²⁵ The main argument advanced for this has been that disclosure of fluctuations in such provisions would give rise to unnecessary and harmful speculation, affecting the stability of banks. Notwithstanding this argument, in July 1980 the banks indicated that they would voluntarily publish such information in their annual reports.

19.130 In line with its recommendation in Chapter 21 for consistent disclosure requirements for competing financial intermediaries, the Committee *recommends* that **banks should be required to maintain a standard of disclosure comparable to that applying to companies under the Companies Act, in addition to providing information that is particularly relevant to their financing activities.**

(g) Solvency Support Arrangements

19.131 The importance attached by successive Commonwealth Governments to the stability of the banking system is particularly reflected in the depositor protection provisions of the Banking Act; these include formal arrangements for the Reserve Bank to investigate the affairs of a bank or take control of a bank and carry on its business where there is a likelihood of it being unable to meet its obligations or be about to suspend payment (s.14).²⁶ For this and possibly other reasons, there is a strong public perception that the private banks have a large measure of government support.

19.132 In considering what solvency support arrangements might most appropriately apply to banks, the Committee has considered the following options:

- abolish the depositor protection provisions but require the banks to establish an industry-based deposits insurance scheme;
- provide a formal government guarantee to all bank depositors; or
- retain the *status quo*, i.e. continue to rely on the depositor protection provisions, which provide depositors with substantial safeguards against loss but no certainty that they will not lose in the event of bank failure.

19.133 The **first** option is consistent with the Committee's view that the protection of investors would best be achieved through the development of industry-based arrangements, with a minimum of government involvement (see Chapter 18). At the same time, an insuring body could be expected to impose certain minimum standards. To the extent that it were to fulfil a self-regulatory role, there might be scope for a reduction of general supervision by the authorities and/or greater attention to problem areas; in the latter case, the overall **quality of supervision** might be enhanced without an increase in the bureaucracy.

19.134 This approach nevertheless has some serious drawbacks. To the extent that membership of the scheme was compulsory and the insuring body was free to

25 It has also been suggested that bank disclosure should be extended. The Australian Institute of Management (NSW Division) Adjudicators' Report in May 1981 on the Annual Report Award suggested that bank disclosure should include:

- major sources of profits;
- the contribution of non-banking activities to profits and assets;
- a presentation of highlights;
- a review of operations, e.g. how changes in monetary and fiscal policy affect lending or borrowing; and
- comment on the operations and performance of associated companies and their impact on bank policies.

26 The main elements of the depositor protection provisions are outlined in the Interim Report, paragraphs 15.136-139.

set its own membership requirements, these could be devised so as to discourage the entry of new banks. Furthermore, the notion of **compelling** sound, responsibly managed institutions to underwrite competitors which may be less well managed is not favoured by the Committee.

19.135 However, consistent with the view expressed in Chapter 18 that financial intermediaries should be actively involved in the framing of prudential requirements and/or in their administration, the Committee would support, in principle, any efforts by the banks to develop their own protection arrangements.

19.136 The Committee strongly opposes the **second** option. It represents an expansion of the role of government, which the Committee believes is undesirable and unnecessary, and is incompatible with the principles laid down in Chapter 18. Competitive neutrality considerations are particularly important; it would accentuate the difference between banks and other DTIs unless similar protection were provided to the latter. The extension of the range of government-backed investment opportunities might also adversely affect the supply of risk capital.

19.137 The Committee believes that, having regard to the 'safety haven' characteristics of banks (see paragraph 19.32) on the one hand and the desirability of minimising government backing for banks on the other, the most appropriate course of action is for retention, in essence, of the depositor protection provisions of the Banking Act.

19.138 It has been suggested that there might be an undue time lag between the emergence of problems and possible intervention by the Reserve Bank. The Committee notes that the Banking Act (section 14) imposes particular obligations on each bank to inform the Reserve Bank when it considers it is likely to become unable to meet its obligations or is about to suspend payment. The Act (section 62) also requires individual banks to provide the Bank with such information (other than that relating to the affairs of individual customers) as the Bank directs. There is also the power (section 61.2) for the Treasurer, on the recommendation of the Reserve Bank, to direct the Auditor-General to make an examination of the books, accounts and transactions of a bank at any time.

19.139 The Committee is conscious that these provisions alone may not give the Reserve Bank sufficient flexibility to move quickly once it is apparent that a bank is experiencing difficulties. However, the Bank does have general powers under sections 26 and 8 of its own Act. The Committee notes that, in the Bank of Adelaide-FCA case, for example, the Reserve Bank took action under these general powers rather than under the depositor protection provisions.

19.140 Although the Reserve Bank Act appears to give the Bank adequate flexibility, some may feel that if it were to rely, as a matter of course, only on the provisions of this Act it might open up the possibility of undue interference in a bank's affairs. Intervention in the affairs of a bank is clearly a sensitive issue and should only be undertaken after due processes have been observed. The need for an independent report by the Auditor-General²⁷ before the Reserve Bank can assume control of and carry on the business of that bank is an important precaution against unreasonable intervention. The safeguards under s.61 of the Banking Act are therefore important.

27 Other than where a bank itself has advised that it is unlikely to be able to meet its obligations or is about to suspend payments or such events have already occurred.

19.141 Later in this chapter the Committee suggests that consideration might be given to the use of internal and external bank auditors so as to lessen the burden of routine supervision on the Reserve Bank. Such an approach might also reduce the time lag between the emergence of any problems and appropriate action by the Reserve Bank under the depositor protection provisions.

19.142 The Committee concludes that no change to the depositor protection provisions of the Banking Act are necessary.

19.143 Consistent with the view expressed in Chapter 20, the Committee believes that, in the interests of public education and competitive neutrality, **the Reserve Bank Board, in its Annual Report, and the Governor in his public addresses, should seek to explain the extent of the Bank's responsibility to bank depositors.** In Chapter 21, the Committee suggests that the Reserve Bank might consider producing an information booklet for small investors. This booklet could also contain a similar explanation.

(h) Liquidity Support Arrangements²⁸

19.144 The lender of last resort (LLR) facilities have, in practice, been used very sparingly, but have been available to assist individual banks in the event of extraordinary liquidity difficulties. The existence of these arrangements is thought by some to have conferred a competitive advantage on the banks, by creating a perception of greater official protection.²⁹

19.145 The unquantifiable nature of the 'benefits' and 'burdens' suggests that no balance acceptable to all can reasonably be achieved. Nonetheless, the general principles laid down in Chapter 5 for the provision of central bank liquidity take account of the need for competitive neutrality.

19.146 Having regard for these principles, and for the need for a bank to take whatever action possible to meet its liquidity needs through adjustments to its balance sheet, the Committee *recommends* that:

- (a) Any official agreements or arrangements (such as the LGS convention), which might be viewed as providing an individual bank with access, at its discretion, to Reserve Bank liquidity in certain circumstances, should be avoided.**
- (b) Provision of liquidity support by the Reserve Bank to an individual bank (like any other DTI) should be provided only at the Reserve Bank's discretion and be subject to:**
 - **the Reserve Bank satisfying itself that the bank is viable and well managed, and that it cannot meet its liquidity needs (e.g. from the sale of assets) without jeopardising market confidence in its viability; and**
 - **the imposition of a substantial penalty, except where the circumstances involved are clearly beyond the influence of the bank.**

28 Arrangements under which the Reserve Bank provides liquidity support to ensure the stability of the financial system as a whole are discussed in Chapter 5.

29 The Australian Bankers' Association has indicated that 'the banks have never regarded this LLR as an important prudential back-up but rather as the punitive element in the system of ratio-based controls over the level of bank intermediary activity'. (ABA Response to Question B (ii) Prudential Management and Relationships with the Monetary Authorities, February 1980. (See AFSI *Commissioned Studies and Selected Papers*, Part 1.)) Nevertheless, it has provided banks with an assured source of funds and hence some specific protection against the full impact of market forces.

- (c) **Details of any liquidity support provided, including the size of the loan and associated terms and conditions, should be publicly disclosed, with a discretionary lag which would have appropriate regard for the potential impact of disclosure on confidence in the bank.**

19.147 As well, action should be taken to reduce the need for emergency Reserve Bank loans. Specifically, the Committee favours:

- the maintenance and development of present industry-based liquidity arrangements (e.g. interbank lending);
- the structuring of bank liquidity requirements to reflect the maturity of their assets and liabilities;
- the availability of a market-initiated 'cashing' facility for Treasury notes and certain short-dated bonds (see Chapter 5).

(i) Supervision of Domestic Banks

19.148 Supervision of operations and the ability to take remedial action to protect depositors are at the very core of the approach to the regulation of banks (and other DTIs). This is in contrast to the approach currently taken in respect of merchant banks, finance companies etc., where the emphasis is to a greater extent on disclosure and *caveat emptor*.

19.149 The fact that the Australian banking system comprises relatively few banks has enabled supervisory arrangements to develop along informal lines, involving close liaison between the Reserve Bank and bank management. While the recommendations in this chapter provide for the specification of more precise requirements than have applied in the past, they will vary according to the circumstances of each bank and thus involve continuing close consultation. Such an approach is essential to ensure that supervisory arrangements do not inhibit the natural evolution of financial intermediation (except, of course, where this is not in the best interest of depositors).

19.150 It is quite common overseas for DTIs to be charged a fee for supervision and examination; this reflects the view that DTIs — and thus their depositors — should, as the beneficiaries of prudential regulation, meet a significant element of the costs of supervision. However, against this it can be argued that, as most of the community benefit from the stability of the financial system, it is not inequitable — and probably more efficient — for the cost of supervision to be recouped from general revenue.

19.151 The Committee nevertheless believes that, having regard to the growth of the banking system in the future and the removal of a number of the restrictions on the activities of banks, consideration should be given to structuring supervisory processes so as to permit the Reserve Bank to put greater emphasis on periodic in-depth examinations as well as the resolution of special problems as they arise, with less emphasis on continuous detailed oversight.

19.152 One approach might involve the greater use of bank auditors in the supervisory process. An example of such an approach is the extensive use made of auditors by the Swiss Federal Banking Commission. Each bank has **internal auditors** who report to the Chairman of the Board regarding compliance with legal requirements, internal guidelines and business policy directives. **External auditors** are also appointed by a bank from a panel of twenty firms licensed by the Federal Banking Commission. They monitor its performance and check the relationship between the books and balance sheets and profit and loss statements,

as well as ascertaining that liquidity and capital ratios are complied with. They liaise closely with the Commission, which examines banks experiencing financial difficulties, but rarely get involved in the routine supervision or examination of individual banks.³⁰

19.153 The Committee recognises that such arrangements could be expected to lessen the burden of supervision on the Reserve Bank and could be worthy of further investigation.

19.154 The Committee believes that the Auditor-General, in performing his duties under s.61 of the Banking Act, should have assured access to the **full** reports of a bank's auditors.

19.155 Accordingly, the Committee *recommends* that:

- (a) **The supervisory efforts of the Reserve Bank should continue to involve close liaison with bank management and place particular emphasis on periodic in-depth examinations as well as the resolution of specific problems as they arise.**
- (b) **In performing his duties, the Auditor-General should have assured access to the full reports of a bank's auditors.**

19.156 Another dimension of supervision is **enforcement**. At present, the Reserve Bank largely relies on the co-operation of banks in meeting prudential requirements. The Committee believes that, in general, the Bank will be able to continue to rely on bank co-operation, notwithstanding the specification of precise requirements for individual banks.

19.157 However, it is possible that, from time to time, the Reserve Bank and an individual bank will be unable to agree on a particular prudential requirement. While the Treasurer has the ultimate sanction of withdrawing a bank licence, the Committee views this as an extreme response. It would be preferable, in such circumstances, for the Banking Act to provide for the making of regulations on the principal elements of prudential policy. However, the Committee stresses that, in general, prudential policy objectives would best be pursued in a flexible manner without recourse to formal regulations.

19.158 The Committee therefore *recommends* that **the Banking Act should provide for the capacity to impose prudential requirements by regulation, but in the expectation that formal regulation would not generally be used.**

(j) Supervision of Foreign Banks

19.159 In the discussion of the entry of foreign banks in Chapter 25, it was recommended that foreign banks be permitted to form banks in Australia — possibly in partnership with Australian shareholders. **The discussion in this section deals primarily with the prudential regulation of foreign banks which are permitted to operate in Australia as wholly foreign-owned entities.**

19.160 Two principal issues arise in respect of the prudential regulation of foreign banks:

30 Auditors are also used in Australia in the supervision of licensed dealers, although in a less formal way than in Switzerland. Under the Securities Industry Act 1980 (s. 79), auditors of licensed dealers (including merchant banks and stockbrokers) are required to lodge a written report with the NCSC within seven days of becoming aware of any matter which has adversely affected, is adversely affecting or may adversely affect the ability of a dealer to meet his obligations.

- whether it is more appropriate, from a prudential point of view, for a foreign bank to be admitted as a branch or as a subsidiary; and
- who is to be responsible for the prudential regulation of the foreign bank's operations in the host country.

19.161 Views differ considerably overseas as to the form a foreign bank's participation should take.³¹

- on the one hand, subsidiaries may be considered preferable to branches as they are legally independent of the parent and thus not as likely to be affected by the fortunes of the parent;
- on the other hand, the obligations of the parent to support a subsidiary that gets into difficulties are not always clear, particularly if it were to create difficulties for itself in doing so. However, this might be overcome if the parent were required to guarantee fully its subsidiary's obligations.

19.162 A subsidiary is also said to be easier to supervise than a branch. However, ease of supervision assumes less importance to the extent that reliance is placed on prudential supervision by the regulatory authorities in the parent country.

19.163 A branch has the attraction that the Australian liabilities of the foreign bank would be fully secured by the parent. However, there may be problems ensuring that they abide by requirements comparable to those domestic banks must meet, which raises questions of competitive neutrality. For example, while the authorities might require the branch of a foreign bank to meet a minimum capital requirement by requiring it to hold Australian assets in excess of its Australian liabilities, it is not clear that a risk asset limit in respect of certain classes of business would be meaningful.

19.164 While the Committee appreciates that there may be social reasons for requiring local equity participation, it should be recognised that the scope for backing by the foreign parent, and thus the solvency protection for depositors, will be reduced.

19.165 Having regard to the interests of depositors and others using their facilities, the Committee concludes that, in the event that foreign banks are permitted to operate in Australia in their own right, prudential considerations might point to the following order of preference in respect of their corporate structure:

- a fully guaranteed subsidiary
- a branch
- an unguaranteed subsidiary

19.166 In any case, the Committee *recommends* that **foreign banks should be subject to the same minimum capital requirements, risk asset limits, liquidity ratios and other prudential requirements as domestic banks.**

19.167 The Committee understands that there is an emerging view among the prudential authorities in the major Western countries that the supervision of a bank's total operations, including its overseas branches and subsidiaries, should be primarily the responsibility of the authorities in the parent's country. Of course,

31 However, it should be noted that most Western countries permit both branches and subsidiaries. A notable exception is Canada, where foreign banks may not establish as a 'branch'.

the branch or subsidiary, as an independent unit, would have to meet the local prudential requirements.

19.168 The Committee sees no reason to suggest a different approach, though the corollary of this should be noted — that the criteria for entry of foreign banks should include the adequacy of prudential supervision in the parent country.

(k) Treatment of Non-bank Subsidiaries

19.169 The existing relationship between banks and their non-bank affiliates is characterised by some uncertainty. Generally, the relationship is expected by the authorities to be on an ‘arms length’ basis. While they may give guarantees for specific transactions, they have been asked not to give letters of comfort, general guarantees etc., covering the repayment of their subsidiaries’ liabilities, except in respect of savings bank subsidiaries. The public perception of the relationship is that banks would not allow their subsidiaries to fail. Whatever the intention of the authorities, the Committee doubts that, in practice, any bank could stand by and watch a subsidiary fail without severely damaging its own standing in the financial community.

19.170 The importance of the relationship between a bank and its subsidiaries is reflected in the Bank of Adelaide–FCA case, where the troubles of the latter imposed problems for the former. The question of how a bank’s subsidiaries can best be handled within the supervisory framework is fundamental to the matter.

19.171 Several options are available. A bank could be required to:

- restructure its operations into a single legal entity;
- consolidate the operations of its subsidiaries, for prudential purposes only;
- form a holding company structure, with the bank as a subsidiary of the holding company in the same way as other non-bank subsidiaries; or
- limit its investments in NBFIs to ensure it does not have a controlling interest.

19.172 The Committee does not favour the first of these as it believes a bank should be free to determine its own company structure; such a requirement would reduce the flexibility of its financing operations.

19.173 However, it would see fewer difficulties if all the operations of a bank and its subsidiaries were consolidated **for the purposes of prudential regulation**, while retaining their separate existence (if that were the wish of management).³² This would mean a bank having to meet minimum capital and other prudential requirements on a consolidated basis.³³

19.174 The Committee on Banking Regulations and Supervisory Practices, which is a working party of central banks and banking supervisory authorities established under the auspices of the Bank for International Settlements, has undertaken work on the consolidation principle, which resulted in its acceptance by the central bank governors of the Group of Ten in Switzerland in May 1979.³⁴

32 Consolidation might also need to extend to companies which, while not technically subsidiaries, are nevertheless effectively controlled by a bank.

33 While the Committee sees no need for separate requirements to apply to the bank as well as the consolidated group, it may be desirable for the authorities to retain the power to do so should the need arise.

34 It has been suggested that consolidation is not only useful for the monitoring of solvency, but also in monitoring the maximum loans permitted to individual borrowers, the concentration of country risks, the extent of banks’ open foreign exchange positions and bank liquidity.

19.175 The holding company approach would enable the bank to divorce itself from the problems of other subsidiaries in the group, assuming appropriate limitations on lending between the bank and others in the group (see paragraphs 19.89–92). Any solvency or liquidity support arrangements, regulation and supervision would apply to the bank without regard for the stability of other subsidiaries or the holding company. In the extreme situation, even a bank holding company should be able to fail without the bank subsidiary necessarily failing as well.

19.176 While the arm's length nature of a bank's relationship with its affiliates could probably be assured in this way, it is doubtful if the public perception of the relationship would change significantly. The non-bank affiliates would inevitably continue to draw strength from their membership of the same group as a bank, and problems of competitive neutrality would continue to exist. The Committee does not, therefore, recommend the adoption of a holding company approach.

19.177 The Committee does not believe that the fourth option is a desirable alternative. As with the first option, it would constitute undue interference in a bank's operations, reducing its flexibility to arrange financing in the most efficient way. It would involve the unwinding of banks' existing subsidiaries (if the requirement were not to discriminate against new entrants), which could cause instability during the divestment period. It would also be difficult to determine the point at which a bank ceased to have a controlling interest in another intermediary, or at least an interest small enough for it to be able to stand aside if it were to get into difficulties.

19.178 Accordingly, the Committee *recommends* that, for the purposes of prudential regulation (and monetary policy), banks should be required to consolidate the operations of intermediaries which are subsidiaries. Minimum capital and other requirements should apply to the consolidated group.

D. NON-BANK DEPOSIT-TAKING INSTITUTIONS

19.179 While the primary focus in the previous section was on the protection of depositors with banks, many of the views expressed have application to non-bank deposit-taking institutions (DTIs). In the present section the Committee has sought to avoid unnecessary repetition by making cross-references to the earlier discussion where relevant. References to non-bank DTIs should be taken as referring to institutions other than banks which accept small deposits from the public, principally from households. At present, these mainly comprise permanent building societies and credit unions.

19.180 The Committee believes that the principles of prudential regulation applying to non-bank DTIs should generally be comparable with those applying to banks, but should be less rigorous.

(a) Entry Requirements

19.181 Licensing and entry requirements for permanent building societies and credit unions are set down by the respective state governments. The requirements for registration differ considerably among the States for both building societies and credit unions; generally a specified minimum number of persons is required, with no shareholder of a co-operative being permitted to hold more than 20% of paid-up capital. No capital requirement is specified for credit unions but for building

societies minimum capital requirements range from \$500 000 to \$2 million in 'share capital' of which a proportion may not be withdrawn in the first ten years.³⁵

19.182 It is understood that most State Registrars use their discretion in admitting new entrants, being influenced by judgments about prospects for growth and longer term viability and the ability of a building society or credit union to fulfil its stated objectives.

19.183 As with banks, the Committee does not favour a complex set of tests to be met before entry is permitted. Some state governments have conceded that entry requirements and the burden of ongoing supervision in the early stages of existence may act as a deterrent to prospective entrants. However, there is no evidence that the criteria applied by Registrars are excessively restrictive; indeed, the present minimum capital requirements and associated provisions are not considered by the Committee to be adequate in all states.

19.184 The issue of appropriate minimum capital requirements for permanent building societies and credit unions requires an understanding of the nature of their existing 'capital' base.

19.185 'Co-operative' building societies and credit unions do not have any substantial conventional, non-withdrawable capital although various reserve requirements apply in some states; typically, their 'share capital' is not genuine 'risk capital'. At the time of formation (in the case of building societies) or upon admittance of new members (in the case of credit unions), an initial share capital subscription is made. Thereafter, further investments are made either by way of conventional deposits or by further subscriptions of '**withdrawable** share capital'.

19.186 As indicated earlier, a proportion of the initial funds subscribed to the 'capital' of building societies' is usually non-withdrawable. This 'non-withdrawable' element may also include subordinated loans (with a time limit) which have some, but not all, of the characteristics of risk capital. The remaining liabilities of building societies are not subject to the same limitations as to repayment and cannot therefore be said to be risk capital, except to the extent that a society's rules may attach certain limitations.

19.187 While building societies have at least a small non-withdrawable capital base at the outset, credit unions do not. As credit union members can receive their share capital back when they cease to be members, this capital has no fixed nature.

35 The following minimum fund/capital requirements apply to the establishment of new permanent building societies:

- *NSW* — Minimum funds/capital of \$2 million of which \$1 million must be share capital and other funds of at least \$1 million of which \$500 000 must be non-withdrawable for ten years. In addition, a society may not commence business until at least ten members (including all the directors) have contributed \$5000 each in share capital; this may not be withdrawn within seven years, except with the written consent of the Advisory Committee.
- *Victoria and South Australia* — \$2 million in share capital of which \$1 million must be non-withdrawable for ten years.
- *Queensland* — \$2 million of which \$1 million must be members' share capital and \$500 000 lodged by a prescribed class of corporation (defined to include banks, insurance companies and the Queensland SGIO). \$500 000 must be non-withdrawable for ten years. The Governor in Council may reduce any of these amounts by not more than 50%.
- *Western Australia* — \$1 million of share capital of which \$500 000 must be non-withdrawable for ten years.

In most states the Registrar may allow 'non-withdrawable' share capital to be withdrawn **within** the specified period, under certain circumstances, where he is satisfied that there will be no adverse consequences for the society concerned.

19.188 The Committee believes that non-bank DTIs should generally be subject to less restrictive entry requirements than banks. However, it believes that prospective new entrants which intend accepting deposits from the public should be required to meet certain minimum standards including, in particular, minimum capital requirements, management of an acceptable quality, and the ability to meet, on a continuing basis, prudential standards laid down for established institutions.

19.189 As with banks, the Committee believes that 'true' capital (including reserves) plays an indispensable role in providing a margin of safety for depositors. The importance of capital lies in the existence of a buffer against fluctuations in trading conditions, particularly in the initial years until sufficient reserves have been established to protect depositors. Thus it is essential that new non-bank DTIs which accept deposits from the public should meet appropriate minimum capital requirements.

19.190 The Committee therefore *recommends* that **new non-bank DTIs (including those credit unions which borrow funds from the public) should be required to:**

- **have a significant non-withdrawable capital base;**
- **satisfy the authorities as to the quality of management; and**
- **be capable of meeting prudential standards laid down for established DTIs.**

19.191 The Committee accepts the need to take account of prospects for longer term viability and growth but, in keeping with the view expressed in respect of banks, the Committee would caution against judgments being made about the optimal number of institutions in the industry in forecasting future prospects.

(b) Asset Restrictions

19.192 Restrictions on the lending patterns of building societies and credit unions take two broad forms:

- restrictions on the types of assets they may hold within the state concerned, and
- limitations on lending interstate.

19.193 In the various states an extensive range of detailed restrictions apply to the assets of building societies and credit unions, particularly in relation to the security of loans, the investments they may hold, and the maturity of assets. Under the Income Tax Assessment Act, loans must also be made predominantly to members.³⁶

19.194 Although only in Western Australia and Tasmania does legislation specifically restrict building society lending to members in the state concerned, the requirement that societies lend on the security of land has generally been interpreted to mean land **within the state concerned**. Only in two states (NSW and Western Australia) are societies clearly permitted to lend to societies in other states (and then only if approved by the Advisory Council and Registrar, respectively).

19.195 On the whole, credit unions (and credit union leagues and associations) appear less restricted in lending and investing interstate, whether to other credit

36 See Interim Report, paragraphs 15.55-66 and 15.68-77.

unions or more generally, than are building societies; a number operate in more than one state. Only in the case of Queensland credit unions is lending interstate not permissible.

19.196 Consistent with the view expressed elsewhere in this chapter, the Committee believes that prohibitions on the type of activity intermediaries may undertake are, in general, incompatible with an efficient, flexible financial system. Moreover, the Committee believes such flexibility — by enabling non-bank DTIs to assist their counterparts in other states which may be experiencing financial difficulties — would reduce the need for government-established facilities. Prudential and efficiency objectives are best met by applying appropriate capital and asset quality-type ratios in respect of certain activities, rather than by outright prohibition.³⁷

19.197 Governments may regard asset restrictions as desirable on other (non-prudential) grounds, e.g. as a means of assisting housing. However, the Committee has (in Chapters 10 and 37) argued against the use of portfolio controls for sectoral assistance purposes.

19.198 Accordingly, the Committee *recommends* that:

(a) **Non-bank DTIs should be:**

- **unrestricted in the range of lending they may undertake and investments they may hold³⁸; and**
- **free to lend interstate, where they cannot already do so.**

(b) **If an existing DTI chooses to broaden substantially its asset structure, it should first seek the consent of its shareholders and, where appropriate, its depositors.**

19.199 In some states there is a constraint on the maturity of certain securities that may be held as investments by building societies or credit unions.

19.200 As such restrictions limit the ability of intermediaries to respond flexibly to changing market conditions, the Committee *recommends* that **non-bank DTIs should not be subject to restrictions on the maturity of their investments, other than in respect of those assets held to meet prescribed liquidity requirements.**

19.201 In respect of the limitations currently placed on the size of individual loans made by credit unions, the Committee suggests later that risk asset limits might be applied to single customers.

(c) **Balance Sheet Ratios**

(i) *Capital Adequacy*

19.202 Permanent building societies in all mainland States and Territories are subject to gearing ratios of some kind. For example, deposits with and loans to societies (i.e. as distinct from share capital) are not permitted to exceed four-fifths of loans outstanding to members in NSW or four times paid-up share capital and reserves in Queensland.

37 It should be noted, however, that to the extent that credit unions depart from the mutuality principle, their tax treatment would need to be reviewed (see Chapter 15).

38 An exception is that, in the case of a credit union based on an employment grouping, surplus funds should not be invested in the employer.

19.203 Various reserve requirements also apply to building societies. In three states, societies are required to maintain reserves ranging from 0.25% to 1.0% of their aggregate liabilities outstanding at the beginning of the preceding financial year. In two states, societies are required to transfer to reserves at the end of each year a proportion (2.0% and 3.5%) of the surplus arising in that year until the reserve reaches 7.5% of members' share capital plus deposits. Similar requirements apply in respect of credit unions.³⁹

19.204 Consistent with the preceding discussion of capital requirements for new entrants, the Committee believes these **requirements** are generally inadequate, as well as lacking uniformity among the States. Any ongoing capital requirements should relate to a capital base which comprises non-withdrawable capital and reserves.

19.205 It has been claimed that the capital base of building societies and credit unions often falls short of a prudent level. In 1980, the overall base amounted to 2.1% of assets; the corresponding figure for credit unions was 3.7%. It has been suggested that an appropriate minimum capital requirement might be typically of the order of 5% for building societies (resulting in a gearing of 19 to 1). The Committee believes that the precise percentage for individual societies and credit unions should depend on the circumstances of each institution.⁴⁰ Certain of the criteria discussed in relation to banks are relevant.

19.206 The Committee believes emphasis should be placed on the early attainment of prudent asset quality/capital ratios, notwithstanding the development of any deposits insurance arrangements (although such arrangements might influence the form and size of required capital ratios). The gradual accumulation of reserves through transfers from surpluses earned is unlikely, in most instances, to result in reserves being built up at a sufficient rate.

19.207 Consideration should be given to encouraging non-bank DTIs to acquire a more appropriate capital base, perhaps through the issue of subordinated loans. With the greater stability likely to be associated with the introduction of improved prudential requirements and possibly deposits insurance arrangements, it should be feasible to raise funds in this manner.

19.208 In this regard, the Committee understands that mutual savings banks in the United States have sought to develop their capital base through the issue of subordinated debt. At end 1978, forty-two savings banks in twelve states had US\$356 million in subordinated debt outstanding, though funds raised in this manner are regarded only as a supplement to the establishment of reserves through retained earnings. The 1980 Monetary Control Act in the United States also provided for the issue of 'mutual capital certificates' by savings and loans associations; the funds thus raised are subordinated to the claims of depositors and are deemed to constitute reserves. The issue of these certificates is subject to rules and regulations laid down by the Federal Home Loan Bank Board.

39 Details of these requirements are provided in the Interim Report in paragraphs 15.35, 15.37 and 15.41.

40 The capital requirement for building societies would reflect the inherent safety of mortgages and their practice of insuring high ratio (and thus more risky) loans. If building societies were to diversify their lending activities, the Committee would expect this to be reflected in changes to their capital requirements.

A higher capital component might be appropriate for many credit unions, reflecting their more diversified asset structure; although the common bond shared by members may tend to reduce risk, the importance of the common bond appears to be diminishing.

19.209 The Committee *recommends* that:

- (a) Non-bank DTIs should be subject to appropriate capital ratios.
- (b) The precise ratio for individual institutions should be determined having regard to the quality of their assets and management, the maturity structure of their liabilities, and their earnings performance.

(ii) Risk Asset Limits

19.210 Consistent with the discussion in respect of banks, the Committee believes that risk asset limits (RALs) should be applied in certain circumstances (e.g. in respect of loans to a single customer) in preference to asset restrictions. The rationale for RALs was discussed earlier, in relation to banks.

(iii) Liquidity

19.211 Permanent building societies in the mainland States are not permitted to approve loans unless they hold 'liquid assets' generally equivalent to 10% of the sum of paid-up share capital and deposits and, in some states, societies' unsecured borrowings.

19.212 The definitions of 'liquid assets' vary between the States, particularly in respect of:

- the allowable term to maturity of such assets;
- the inclusion by some states of standby arrangements;
- the exclusion by some states of bills of exchange;
- the basis of valuation of such assets;
- the exclusion by some states of undrawn loan commitments.⁴¹

19.213 Credit unions are required in most states to hold 'liquid assets' equivalent to a prescribed proportion of the sum of their share capital and deposits. In some states credit unions may not make/approve loans if their holding of liquid assets falls below the prescribed proportion.⁴²

19.214 Liquidity ratios have traditionally been justified as ensuring an intermediary's ability to meet sudden deposit withdrawals.

19.215 The earlier discussion of the liquidity requirements of banks is relevant also to non-bank DTIs. However, a few additional points should be noted here:

- Liquidity is of little use if it cannot be used to meet sudden demands on a DTI for funds. A ratio which cannot be breached, or can be breached only if an intermediary ceases lending, is insufficiently flexible to meet prudential objectives. The cessation of lending by a DTI may also generate a loss of investor confidence.
- The setting of a uniform figure for the whole industry, as at present, effectively penalises the more prudent intermediaries whose assets and liabilities are more closely matched and which would therefore have less need for liquidity. It may result in more funds than necessary being held in liquid form and thus unavailable for lending.
- The eligibility of assets for a prescribed liquidity ratio should be determined primarily having regard for their period to maturity and their quality.

41 See Interim Report, paragraph 15.34 and Table 15.1.

42 See Interim Report, paragraph 15.36 and Table 15.2.

- Consistent with the Committee's view that non-bank DTIs should be permitted to operate nationally, a uniform national approach should be adopted in determining the eligibility of assets for liquidity purposes.
- To the extent that a secondary mortgage market develops in the future, building societies which would otherwise have difficulty maintaining a specified liquidity ratio should be able to liquefy some of their assets.

19.216 The Committee *recommends* that:

- (a) The liquidity ratio of each non-bank DTI should have regard to the maturity structure of its assets and liabilities.**
- (b) The ratio should be maintained in normal circumstances at (or above) the required level. An averaging process would apply over short periods.**
- (c) The eligibility of assets for a liquidity ratio should be determined on a consistent national basis, and should have regard for their quality, their period to maturity and their marketability.**

(d) Restrictions on Liabilities

19.217 In several states, a building society's rules entitle it to refuse repayment of share capital or deposits at any specified date or time, e.g. at call.⁴³ (In practice, building societies do repay such funds on demand.)

19.218 In some states, credit unions may only receive deposits from members. They may also borrow from non-members up to a maximum of 25% of members' funds. In most states credit unions may not receive deposits except on terms whereby not less than one month's notice may be required before repayment.⁴⁴

19.219 The Committee believes that building societies and credit unions should be free to borrow on whatever terms and from whatever sources they wish⁴⁵; such freedom encourages innovation and greater flexibility in financing arrangements. In taking this view, the Committee nonetheless recognises that it would be desirable for DTIs to minimise their dependence on call deposits.

19.220 The Committee therefore *recommends* that **no notice-of-withdrawal requirements or restrictions should be imposed by governments on the right of a depositor to be repaid at any specified date or time.**

19.221 At present, building society shares rank behind deposits and many societies accept both, although the distinction and its implications in terms of ranking (on liquidation) are not, in practice, widely understood.

19.222 The Committee therefore *recommends* that, **if withdrawable funds deposited with non-bank DTIs are to be classified as 'shares', the distinction between 'shares' and 'deposits' should be made clear to investors.**

(e) Interest Rate Controls

19.223 In some states, the relevant Ministers have the power to set maximum building society borrowing rates although these powers have not always been fully

43 See Interim Report, paragraphs 15.83–89.

44 See Interim Report, paragraphs 15.91–99.

45 But see footnote 37.

used. In some states, Ministers also have the power to set maximum lending rates for building societies.⁴⁶

19.224 In several states, powers exist to set maximum credit union deposit interest rates and/or share dividends. In South Australia, the Minister has the power to fix a maximum rate of interest on loans.⁴⁷

19.225 The arguments for and against the use of interest rate controls to achieve prudential objectives were outlined earlier in respect of banks. Consistent with its conclusions in the light of this discussion, the Committee is of the view that **there is insufficient justification for retaining interest rate controls (including suasion) as an instrument of prudential policy.**

(f) Disclosure Requirements

19.226 Building societies and credit unions are formally subject to the disclosure requirements of the Companies Act, not having an exemption as do banks and life insurance companies. However, in practice, they meet the requirements laid down under the state legislation which regulates building societies and credit unions. The Committee has been advised that, while existing disclosure requirements fall short of those laid down in the Ninth Schedule of the Companies Act, State Registrars are currently moving to raise the standard of disclosure.

19.227 A building society must permit members access to its accounts, directors' reports and auditors' reports, either by way of copies held at offices or by distribution to members along with notice of the annual general meeting.⁴⁸

19.228 In some, but not all, states at the time of the annual general meeting a credit union is required to:

- send members a copy of the audited accounts and auditor's report with the notice of the annual general meeting; or
- if the rules of the credit union so provide, make these available for inspection and advise members of these rights in the notice of the annual general meeting.⁴⁹

19.229 The Committee believes it is an important discipline that DTIs should make available to their members all information needed for risk assessment.

19.230 Depositors should also be aware of the the extent of the responsibilities of the regulatory authorities. Specific action in this regard is proposed below.

19.231 Finally, it is also important that the information provided should be relevant to the needs of users and thus include information over and above the minimum requirements of the Companies Act, where necessary. In this regard, it should be noted that the Australian Institute of Management (NSW Division) Adjudicators' Report in May 1981 on the Annual Report Award suggested that each building society and credit union should disclose:

- the number of members and growth in comparison with previous years;
- a clear statement of the services provided; and
- a simplified statement for members on its financial position.

46 See Interim Report, paragraphs 11.67-75.

47 See Interim Report, paragraphs 11.76-81.

48 See Interim Report, paragraphs 15.112-115.

49 See Interim Report, paragraphs 15.116-119.

19.232 The Committee therefore *recommends* that:

- (a) **Non-bank DTIs should be required, at least annually, to publicise adequately an audited, simplified statement of financial condition or send copies of such a statement (together with the Annual Report) to all members and depositors.**
- (b) **Annual Reports should be available to all members and depositors upon request, and should maintain a standard of disclosure comparable to that applying to companies under the Companies Act, in addition to providing information that is particularly relevant to their financing activities.**

(g) Solvency Support Arrangements

19.233 Official reserve or stabilisation funds exist for building societies in Victoria and Queensland and for credit unions in NSW, South Australia and Victoria. Arrangements differ but they typically provide for the protection of depositors in the event of insolvency; some also provide for temporary financial assistance in the event of financial difficulties. Membership of each of the five funds is compulsory.⁵⁰

19.234 The Government has already announced the proposed establishment of a deposits insurance scheme for building societies. The Committee believes such arrangements should involve a minimum of government participation so as to avoid any disruption to competitive neutrality. The Committee earlier recommended total removal of all asset restrictions on existing DTIs. It would therefore suggest that consideration be given to eventually encompassing within the scheme **all non-bank DTIs** that come under the national supervisory framework recommended by the Committee.

19.235 It may also be possible for existing state government-sponsored, but industry-financed, reserve funds for building societies and credit unions to be incorporated into whatever private deposits insurance arrangements might emerge. This would contribute to a more uniform and neutral system of solvency support arrangements.

19.236 As indicated elsewhere in this Report, the Committee is concerned at the lack of public awareness of the true nature and extent of the responsibilities of the regulatory authorities. This view applies with equal force in the case of investors with building societies and credit unions. It is concerned that this lack of awareness generates pressures for government support when difficulties arise in respect of individual DTIs.

19.237 Consistent with the view expressed in paragraph 19.143, in respect of banks, the Committee believes that **State Registrars should, in their Annual Reports and public addresses, seek to explain the extent of their responsibilities for the protection of depositors.**

19.238 In Chapter 21, the Committee suggests that the Reserve Bank might be asked to produce an information booklet for small investors. The Reserve Bank might include in this booklet, after appropriate consultation with the relevant state authorities, a similar explanation of the extent of the Registrars' responsibilities for depositor protection.

50 See Interim Report, paragraphs 15.12–19 and 15.21–31.

(h) Liquidity Support Arrangements

19.239 Arrangements exist for the provision of liquidity support through the banking system to individual financial institutions which are responsibly managed and have adequate asset backing. The existence of those arrangements has given rise to two questions:

- Is it reasonable to expect banks to assist their competitors to the same degree as they would any other clients experiencing liquidity difficulties?
- How effective, in practice, are the present arrangements for ensuring adequate liquidity support for individual intermediaries?

19.240 These questions are not easy to answer with certainty. There are clearly advantages in using banks as 'agents' in channelling Reserve Bank liquidity to responsibly managed non-bank financial intermediaries which are experiencing liquidity difficulties, as they are best placed to assess their viability. However, the conflict of interest inherent in such arrangements is equally clear. It has been claimed that, on at least one occasion, support has not been readily forthcoming from a bank when this might reasonably have been expected in the prevailing circumstances.

19.241 Information made available to the Committee on a confidential basis has led it to conclude that there are, or could be, practical difficulties in the present arrangements which limit their effectiveness.

19.242 The Committee therefore believes that building societies and credit unions should be encouraged to establish their own liquidity support instrumentalities on a national basis by permitting certain funds lodged with such entities to count towards the prescribed liquidity ratio. Any such support facility might be associated with the proposed deposits insurance corporation.

19.243 Member leagues of the Australian Federation of Credit Unions Ltd already operate a centralised clearing and liquidity support facility for member credit unions. These arrangements might provide a possible basis for the development of a national industry-based liquidity support facility for credit unions.

19.244 The Committee believes that the Reserve Bank should, **at its discretion**, continue to have the power to provide loans to banks to enable them to stand behind non-bank DTIs in emergency situations; as well, however, it should be able to make loans to any approved industry-based liquidity instrumentality, which would in turn be responsible for making the necessary risk assessments and for accounting to the Reserve Bank for any funds provided. (In very exceptional circumstances, the Reserve Bank might make loans directly to individual DTIs — see Chapter 5.)

19.245 The Committee *recommends* that:

- (a) **The Government should explore with State Governments the feasibility of encouraging the establishment of industry-based liquidity support instrumentalities for non-bank DTIs by permitting certain funds lodged with such instrumentalities to count towards prescribed liquidity requirements.**⁵¹

⁵¹ See also the recommendation regarding interstate lending in paragraph 19.198. The capacity to lend to DTIs in other states would enhance the feasibility of an industry-based liquidity instrumentality.

- (b) **The Reserve Bank should be prepared to make loans, at its discretion, to any industry-based liquidity instrumentality, subject to conditions similar to those applying in the case of banks.**
- (c) **Any such instrumentality should be subject to supervision by the Reserve Bank and be fully accountable to the Bank for any liquidity support provided.**

E. FINANCE COMPANIES

19.246 Finance companies are not subject to the same wide range of prudential requirements as DTIs in respect of their day-to-day business operations and associated surveillance. However, they are subject to prospectus requirements in relation to their public borrowings. These requirements are outlined in Chapter 17 of the Interim Report.

19.247 A case can be made for compulsorily bringing finance companies into the regulatory framework within which non-bank DTIs operate, particularly as the lengthening of the maturity structure of many DTIs and the shortening in the maturity structure of finance company borrowing has brought them more directly into competition. However, the Committee does not favour this, as the extension of government regulation to too many types of intermediaries might create a 'gap' in the investment risk spectrum.

19.248 Finance companies have complained about their lack of flexibility (relative to that of DTIs generally) in attracting funds. The Committee believes competitive neutrality will be ensured in future by allowing individual finance companies the **option** to come under the DTI prudential framework. As well, certain changes have been proposed in Chapter 21 which should provide finance companies borrowing through prospectuses with greater flexibility in attracting funds.

19.249 The more important changes include:

- the ability to issue abridged prospectuses; and
- an easing of the restrictions on the advertising of prospectuses.

F. AUTHORISED DEALERS

19.250 Responsibility for the prudential supervision of authorised dealers rests with the Reserve Bank. The Bank does not accept responsibility for the repayment of a dealer's individual loans or for its solvency generally; it imposes no specific liquidity requirements, but provides lender of last resort facilities to enhance their ability to hold and trade in government securities. As well, authorised dealers are required to:

- limit their borrowings to 33 times shareholders' funds; and
- confine their assets to certain specified securities.

19.251 While they are specifically exempt from the prospectus requirements of the Companies Act, their fund-raising activities, and the categories of assets which dealers may hold, are subject to close supervision by the Reserve Bank. It requires dealers to report regularly and to provide it with a range of statistics on their day to day operations and other matters. The Bank also scrutinises proposed changes in

ownership of authorised dealers. These supervisory arrangements relate primarily to the market-making activities of dealers, but also have prudential implications.

19.252 Deposits with an authorised dealer are currently one of the safest forms of investment because of the security of dealers' assets: predominantly high quality government and bank paper. This security is enhanced by the close supervision of both management and ownership by the Reserve Bank.⁵² Rates paid naturally reflect this degree of safety. The business of being an authorised dealer does, of course, entail risk, since capital values can change significantly when interest rates change; the buffer between asset values and the value of deposit liabilities is provided by dealers' capital.

19.253 In evaluating the prudential aspects of existing arrangements, the Committee is conscious of the special nature of the operations of authorised dealers, their special relationship with the Reserve Bank and the fact that they do not ordinarily raise funds from unsophisticated investors.

19.254 Assuming that no significant changes are made to the assets authorised dealers are permitted to hold, the Committee believes the quality of these assets justifies a continuing high gearing ratio.

G. MERCHANT BANKS AND OTHERS

19.255 Merchant banks and like institutions do not ordinarily take deposits from unsophisticated investors, and are not subject to regulation.⁵³ However, in recent times, some merchant banks have shown a greater willingness to accept deposits from individual investors. **In future, if they solicit small deposits, merchant banks should be subject to the proposed non-bank regulatory framework or issue a prospectus. If, on the other hand, they deal only in 'wholesale' markets, the Committee sees no need for prudential regulation.**

52 Particular requirements exist in relation to the ownership of dealers by banks. These are discussed in Chapter 9; they do not have prudential objectives.

53 However, their dealer subsidiaries are subject to various requirements under the Securities Industry Code. See Interim Report, paragraph 17.73.

CHAPTER 20: INVESTOR PROTECTION: LONG-TERM SAVINGS INTERMEDIARIES

20.1 This chapter deals with the prudential regulation of institutions characterised by their long-term and/or contractual relationship with their policyholders and contributors. As well, some aspects of general insurance regulation are discussed.

I LIFE INSURANCE COMPANIES

A. BACKGROUND

20.2 Over the years governments have shown special concern for the stability of the life insurance industry because of its role in mobilising long-term household savings, traditionally in conjunction with the provision of death cover.

20.3 By its very nature, most life insurance involves a long-term commitment by the policyholder. For such a commitment to be made, the policyholder must have a high degree of certainty regarding the benefits he expects to receive when the policy is terminated. Regulation has thus been considered essential for policyholder confidence.

20.4 The Life Insurance Act is designed to lessen the likelihood of life insurance companies becoming insolvent, whether as the result of fraud or mismanagement, and to minimise losses that may be incurred in the event of a company being wound up.¹ It does not, however, guarantee that individual life offices will always remain solvent or that policyholders will never suffer any loss.

20.5 The existing approach to regulation of life insurance companies is broadly consistent with the general approach to prudential oversight outlined in Chapter 18. In particular:

- failure is not precluded (in the broad sense of a smooth exit from the industry);
- the liabilities of a life insurance company are not backed by government;
- actuaries employed by life offices have a significant prudential role, particularly in certifying premium scales to apply and in the valuation of policy liabilities; and
- the market is allowed to operate in a freely competitive manner.

¹ The requirements of the Life Insurance Act are set out in some detail in Chapter 16 of the Interim Report.

20.6 A key ingredient of present policy is the Minimum Valuation Basis (MVB) prescribed in the Fourth Schedule to the Act, which provides the means of testing the solvency of life offices at the date of valuation. Its purpose is to facilitate assessment of the financial strength of a company and to identify situations where it should come under closer control, investigation or direction.

20.7 Both Treasury and the Life Insurance Commissioner feel that the MVB provides an adequate basis for valuing policy liabilities and thus a safeguard for policyholders within which companies can carry out their day-to-day operations reasonably freely.

B. PROPOSALS FOR CHANGE

(a) Approach to Regulation

20.8 The industry feels that no change in the existing approach to regulation is warranted. It believes that, in seeking to protect policyholders, the Government should not restrain reputable life offices from carrying on business which they see as being in the best interests of their policyholders. Treasury would like to see a gradual reduction in government regulation and restrictions and the encouragement of greater self-regulation.²

20.9 On the other hand, governments in many other countries have gone further in protecting policyholders than is the case in Australia:

- some have sought to prevent failure by closely regulating the activities of life insurance companies, including such matters as their investments, policy conditions and premium rates (e.g. the United States);
- others have endeavoured to ensure that policyholders do not suffer major loss as a result of the failure of a life office, through the introduction of policyholder guarantee arrangements (such as exist under the Policyholders Protection Act in the United Kingdom).

20.10 So far as the first approach is concerned, the Committee believes that closer regulation would interfere considerably with the business decisions of life insurance companies and with the efficiency of the market, without necessarily guaranteeing the protection of policyholders. It might also adversely affect the competitiveness of these companies vis-a-vis other financial intermediaries and impair their ability to respond to changing market circumstances; regulation of this kind could thus generate the very instability it was designed to avoid. It would carry heavy administrative costs for the authorities and the life offices themselves and could be very subjective in its application.

20.11 The second approach, to the extent that it involves government sponsored policyholder guarantee arrangements, would also conflict in several important respects with the general approach outlined in Chapter 18. This issue is explored in some detail in paragraphs 20.37-43. Briefly, the Committee does not favour direct government involvement in policyholder guarantee arrangements. However, it believes life offices should not be discouraged from supplementing existing regulation by developing their own support schemes if, at any stage, this were considered desirable to enhance the stability of the industry.

² Treasury Paper No. 8, 'Regulation of the Insurance Industry', submission to the Inquiry, April 1980, p. 3.

20.12 In summary, the Committee sees no need for any fundamental change in the approach to the regulation of life offices. However, it does suggest that a more flexible method of valuing assets and liabilities for the purposes of the solvency test might be adopted. It is proposed that life offices should be permitted to value their policy liabilities at a rate of interest that is adjusted regularly to reflect rates prevailing in financial markets. One suggestion which the Committee believes warrants consideration is that the rate used should be determined automatically in relation to the Commonwealth long-term bond rate.

20.13 The interest rates used in valuing policy liabilities were last changed in February 1978 so as to bring them 'more in line with present-day conditions'.³ With the interest rate changes that have occurred since that time, further adjustments are clearly necessary.

20.14 Notwithstanding the failure of some smaller life offices to increase their bonus rates significantly following the substantial surpluses released as a result of the 1978 adjustment, the Committee believes that retention of an inflexible approach to the valuation of policy liabilities is an example of undue emphasis being placed on policyholder protection at the cost of efficiency. It should be left to the life offices to determine the rate at which surpluses should be released having regard to possible fluctuations in mortality rates, expenses or investment results.

20.15 The adoption of a more flexible approach should generate greater competitive pressures than might be expected from discrete changes at irregular intervals. This would be of advantage to policyholders, particularly if the recommendation in paragraph 20.61 regarding disclosure of life offices' past performance and policy in respect of bonuses etc. were adopted.

20.16 It will be important also for assets to be valued at current market prices as there must be a close relationship between the two sides of the balance sheet, particularly in relation to fixed-interest investments.

20.17 In the light of the foregoing, the Committee *recommends* that the life insurance industry and the Life Insurance Commissioner should consult with the objective of recommending amendments to the Life Insurance Act to provide for a basis of valuation related to current market rates of interest and current market values.

(b) Asset Restrictions

20.18 The proposal to extend the role and powers of the Life Insurance Commissioner over life office investments has caused the life insurance industry considerable concern.

20.19 The Life Insurance Act was amended in 1977 to provide for the Commissioner to impose restrictions on investments by life offices in related companies, other companies carrying on life insurance business, investment companies or undertakings and unit trusts.⁴ The relevant section of the Act has not been proclaimed and the Treasurer has stated that it will be amended, before it is proclaimed, in the direction of making the provisions less restrictive.

³ Press statement by the Treasurer, 28 February 1978.

⁴ The proposed restrictions are outlined in Chapter 16 of the Interim Report.

20.20 The Commissioner believes there are three main areas where some limitations on investments are necessary⁵:

- Investments in related companies or with related or associated persons. Here his main concern is with 'upstream' investments (i.e. investments with a parent or holding company), where the life office may not have independent control over its assets and the activities or investment policies of the parent may not necessarily be in the best interests of policyholders. He regards 'cross-stream' investments (i.e. in another company related to the parent) as raising similar problems.⁶
- Situations where all or a majority of a company's assets are given to somebody else to manage, e.g. investments in unit trusts or investment companies. This is understood to be common among small life offices in the United Kingdom; it is less of a problem in Australia, possibly due to the use of suasion by the Commissioner.
- Investments in enterprises such as joint ventures, where investors incur an unlimited liability. The Commissioner cites investments on a partnership basis — rather than through a company — as an example of this kind of situation; his concern is mainly with smaller life offices. He believes that no matter what steps are taken to limit liability, the legal nature of a partnership is such that a life office's liability could be unlimited in the final analysis.

20.21 The life insurance industry has criticised the proposed investment restrictions as not being in the best interests of policyholders or the efficiency of the capital market. However, the Life Insurance Federation of Australia (LIFA) acknowledges that life offices should not automatically enjoy the right to:

- invest in a company carrying on, or in a company related to a company carrying on, life insurance business, where control over its affairs would be obtained; or
- make 'upstream' or 'cross-stream' investments.

20.22 LIFA sees the proposed restrictions as posing a number of problems:

- the flexibility of life offices to arrange investments would be prejudiced by the operation of the various tests and procedures which might be laid down, placing life offices at a severe disadvantage in a competitive and changing investment environment;
- indiscriminate limitation on investment in related companies would inhibit the establishment of subsidiary companies as a technique for consummating investments; and
- restrictions on particular legal forms could have unfavourable taxation implications and other disadvantages.

20.23 It follows from its earlier comments on the need to avoid an interventionist approach to prudential regulation that the Committee believes that the Life

5 While the Commissioner does not have formal powers to regulate investments in these areas, as the relevant section has not been proclaimed, it is understood that he seeks to discourage such investments.

6 'Downstream' investments (i.e. in subsidiary companies) pose different problems: while life offices have control over their subsidiaries' activities, the Commissioner does not and this may constrain his ability to protect policyholders. For example, while the assets of a statutory fund may not be mortgaged, no such restrictions apply to the assets of a wholly owned subsidiary of a life office.

Insurance Commissioner, with certain limited exceptions referred to below, should **not** have overriding powers in respect of life offices' individual investments or investment strategy. There is no reason to expect that the Commissioner would be any more successful than life offices in ensuring the safety of their investments. As the UK Department of Trade has observed:

We are not investment experts, we would get it wrong just as the insurance companies sometimes get it wrong, but if we got it wrong we would be responsible, and I think we would be putting policyholders unfairly at risk.⁷

20.24 While LIFA believes that life offices 'have a very keen sense of the need for asset diversification'⁸, consideration needs to be given as to whether the Commissioner's responsibilities would best be discharged by ensuring that life offices spread their investments. This can be done in one of three ways:

- outright prohibition on the holding of individual assets, the value of which exceeds a specified percentage of total assets;
- the setting of limits on the holding of individual assets for the purpose of meeting the solvency test; or
- disclosure to the Life Insurance Commissioner where the holding of individual assets exceeds a specified percentage of total assets.

20.25 Consistent with the views expressed above and the principles set out in Chapter 18, the Committee does not favour the first of these. On the other hand, it feels that the third alternative is not sufficient to ensure that the Commissioner can satisfactorily discharge his prudential responsibilities.

20.26 The Committee therefore favours the setting of percentage limits on **any individual investment**, for the purpose of meeting the solvency test. While it would be possible for the limit to be exceeded, the requirement that the life office meet the solvency test means that policyholders would, in fact, be less 'at risk' than if there were no such limitation.

20.27 This broad approach is followed in the United Kingdom, where detailed limitations are imposed on the extent to which certain assets can be taken into account in determining a company's solvency.

20.28 The Committee does not believe, however, that there is a need for prescribed restrictions on **classes** of investments, so long as there are constraints on individual assets and life offices disclose fully to their policyholders the sectoral 'spread' of their investments, as is recommended later by the Committee.

20.29 Having regard to the comparable limitations recommended in respect of investments by superannuation funds and general insurance companies, and the desire for reasonable balance between flexibility in life office operations and the need to protect policyholders, the Committee **recommends** that:

- (a) **For the purposes of actuarial solvency valuations, the value of any**

⁷ Mr P. A. R. Brown, Deputy Secretary, Department of Trade, in evidence to the Committee to Review the Functioning of Financial Institutions (Wilson Committee), 12 December 1978 (p. 45); Second Stage Evidence, Volume 5; HMSO, London, March 1979.

⁸ Supplementary submission by LIFA to the Inquiry, 26 June 1980, p. 16.

individual asset (including 'closely related assets')⁹ should be taken into account only up to 5% of a life office's total assets.

- (b) Where the value of an individual asset exceeds this figure (arising, for example, from an asset revaluation or a change in the market valuation of an investment), a life office should be allowed a period of twelve months to conform with the applicable solvency test discipline in respect of that asset.¹⁰
- (c) Where any of a life office's assets exceed the 5% limit at the time these arrangements are implemented, an exempt period of three years should be permitted.

20.30 While it is acknowledged that any limit imposed may impact more heavily on the smaller life offices, the Committee considers that it would be imprudent for any exception to be made (other than that suggested in footnote 9). Any easing of this requirement for smaller life offices could put policyholders 'at risk' just as much as it would in the case of larger life offices.

20.31 Although this approach would appear to lessen the need to apply investment controls, the Committee acknowledges that there could be a case for imposing a further ceiling — in terms of acceptability for the solvency test — on upstream and cross-stream investments in related companies or with related or associated persons.

20.32 In summary, the Committee believes that the interests of policyholders are best served by allowing life offices considerable flexibility in determining their asset portfolios, while protecting policyholders against the 'fringe operator'. This will be ensured by the approach recommended above, coupled perhaps with some disciplines in respect of 'upstream' and 'cross-stream' investments.

(c) 30/20 Requirement

20.33 It has been argued that, to a degree, the 30/20 requirement may have helped maintain the quality of the assets held by some life insurance companies, particularly the smaller ones. If a policy with a twenty-year run to maturity is matched by government securities of similar maturity, it is suggested that fluctuations in the market price during the time to maturity are immaterial.

20.34 The Committee does not accept this view. The matching of assets and liabilities by term would be of little comfort if, in times of high interest rates, large numbers of policyholders sought to surrender policies backed by government securities issued in the past at low interest rates. It should also be recognised that, by forcing life offices to accept something less than a market rate on a substantial proportion of their investments, the 30/20 requirement has impacted adversely on the competitive position of life offices in financial markets. This may, in at least some instances, have led them to undertake more risky but higher yielding investments.

⁹ This recommendation is concerned primarily with investments in any single company or project (or related group of companies or projects). So as not to discriminate against smaller life insurance companies, the value of a life office's own office building might be excluded from this test (or accepted up to a higher percentage for the purpose of the test). It is not intended that holdings of government securities and debt claims on banks and authorised dealers should be subject to this test.

¹⁰ However, the twelve-month exemption should not apply in some special cases, for example where the excess comes about through deliberate portfolio acquisitions.

20.35 The recommendations and suggestions in Section (b) above would, in our view, provide adequate safeguards for policyholders.

20.36 The Committee *recommends*, therefore, that the Government's decision on whether to abolish the 30/20 requirement should not be influenced by the prudential implications for the life insurance industry.

(d) Policyholder Guarantees

20.37 In its discussion paper on 'Insurance Contracts'¹¹, the Law Reform Commission suggested that there was a need for policyholders to have guarantees at least as extensive as those afforded policyholders under the Policyholders Protection Act in the United Kingdom. This Act provides that, when an authorised insurer fails, its liabilities to policyholders will be secured to the extent of 90% from a levy on other insurance companies. Levies are calculated on premium income, subject to a maximum levy of 1% in any one year.

20.38 The Wilson Committee generally endorsed the existence of a 'safety net' of this kind, rejecting the argument that properly effective supervisory arrangements would make it unnecessary. It considered that no system of regulation could prevent failures altogether, particularly where institutions were permitted to compete fairly freely among themselves.

20.39 The Wilson Committee acknowledged that such a 'safety net' reduced the level of competition in terms of the combinations of risk and return offered to customers, and that 'requiring sound businesses to underwrite the activities of their less sound competitors was a thoroughly bad principle'.¹² However, it believed that the externalities involved in ensuring public confidence were of paramount importance.

20.40 Given the implementation of other recommendations in this chapter, there should be no need in Australia for such a 'safety net' — or at least one established under government auspices and with an element of compulsion. The present Life Insurance Act is in part predicated on the need for confidence of policyholders in the stability of life offices, but not to the extent of guaranteeing life offices against insolvency or policyholders against loss. It is believed that the benefits of competition and diversity of choice are most likely to be preserved where some degree of risk is retained.

20.41 While a degree of risk may be preserved, in theory, by extending guaranteed cover to something less than 100% of a life office's liabilities (as in the United Kingdom), in practice the Government or stronger members of the industry may still be called on to meet the liabilities of an insolvent life office. If the Government were to become involved, important questions of competitive neutrality would arise. If it were the industry whose support were compulsorily required, one has to consider the fairness of the arrangement for the stronger and better managed life offices and, indeed, its possible impact on their stability. More generally, the existence of a 'safety net' may reduce the incentive for responsible, prudent management, and thus constitute a 'moral hazard'.

11 *Insurance Contracts, Discussion Paper No. 7*, The Law Reform Commission, October 1978, p.16.

12 This view was expressed by the Committee of London Clearing Bankers to the Wilson Committee. Report of the Committee to Review the Functioning of Financial Institutions, HMSO, London, June 1980, p. 294.

20.42 Accordingly, the Committee concludes that **there is no need for government involvement in any arrangements along the lines of those provided for in the Policyholders Protection Act in the United Kingdom.**

20.43 Nevertheless, it is of concern to the Committee that the general public may not be fully aware that existing regulatory arrangements do not guarantee solvency. The Committee therefore considers that **the Life Insurance Commissioner should seek to explain, in his Annual Reports, the extent of his responsibility for the protection of policyholders.**

(e) Disclosure to Potential Policyholders

20.44 Section 77 of the Life Insurance Act requires life offices to 'submit to the Commissioner any form of proposal or policy ordinarily used by the company in Australia, or any form of written matter ordinarily so used and describing the terms or conditions of, or the benefits to be or likely to be derived from, policies'. It only empowers him to object to the use of such material where he believes that it is not in compliance with the Act or is likely to mislead a potential or existing policyholder.

20.45 The Commissioner has informed the Committee of the limitations to his powers that the present wording of this section imposes. He noted that while he can act on any positive statement made by a life office, he cannot require it to divulge anything that it does not wish to.

20.46 Section 77 does not permit the Commissioner to require life offices to disclose information on their past investment performance so as to enable potential policyholders to make comparisons. The Commissioner believes that comparison of returns on similar policies is long overdue in Australia. This view is shared by the Law Reform Commission, which suggested that the Commissioner be empowered to take steps necessary for the provision of such information to the public.¹³

20.47 In the opinion of the Committee, an essential ingredient of an efficient market in life insurance is that potential policyholders should be able to compare the terms and conditions of policies and past and expected benefits. This would reduce the incidence of 'twisting'¹⁴ and, more generally, reduce the level of forfeitures and surrenders of policies. For a number of reasons, these have been high and rising in recent years, as Table 20.1 shows.

20.48 There are, unfortunately, practical difficulties in making comparisons of the performance of different companies: the terms and conditions of policies are not uniform as between different companies, past performance is not necessarily a guide to future performance, and there are widely differing methods of valuing assets.

20.49 In view of these difficulties, the Committee does not believe it is feasible to make detailed comparisons of the performance of different life offices.

20.50 It understands that LIFA has made considerable efforts to communicate information on various aspects of life insurance to potential policyholders through the widespread dissemination of booklets and folders, including through schools

¹³ Law Reform Commission, *Insurance Contracts*, op. cit., p.10.

¹⁴ 'Twisting' is the cancellation of an insurance policy by a policyholder wanting to take out a different policy, generally with another life office.

TABLE 20.1: LIFE INSURANCE COMPANIES: FORFEITURE AND SURRENDER RATES (%)

Year ended 30 June	1973	1975	1977	1979	1980
<i>Forfeitures^(a)</i>					
Ordinary business	10.0	13.0	14.7	18.1	18.4
Superannuation business	0.7	0.9	1.5	2.2	2.5
<i>Surrender rates^(b)</i>					
Ordinary business	4.0	5.3	6.2	7.1	7.6
Superannuation business	8.8	10.6	11.2	10.7	9.6

(a) Policies written off as the result of non-payment of a premium before the policy has acquired a surrender value. Rates are expressed as the percentage of total annual premiums discontinued by forfeiture to new annual premiums.

(b) Policies written off but with a surrender value. Rates for **ordinary business** are expressed as the percentage of total annual premiums discontinued by surrender to the mean of the annual premiums in force at the beginning of the previous year and the year previous to that. Rates for **superannuation business** are expressed as the percentage of total annual premiums discontinued by surrender to annual premiums in force at the beginning of the year.

Source: 1980 Report of the Life Insurance Commissioner.

and adult groups. The Committee nevertheless believes that additional information could usefully be provided.

20.51 The Committee believes that LIFA and the Life Insurance Commissioner should work toward the development and maintenance of a document providing up-to-date information on:

- the role and responsibilities of the Life Insurance Commissioner;
- the distinguishing features of the various types of policies available within the life insurance industry; and
- how additional information can be obtained.

20.52 The usefulness of such a document would be considerably enhanced if there were also provision for a cooling-off period during which potential policyholders could cancel contracts without incurring any penalty.

20.53 It is noted that the Life Insurance Commissioner has already requested that life offices incorporate a note in all individually issued life policy documents providing for a fourteen-day 'free look' period. While the Committee understands that most life offices now include advice to this effect in their documents, it considers that this request should have legislative support.

20.54 The Committee therefore **recommends** that the Life Insurance Act should be amended to provide for a fourteen-day cooling-off period during which the policyholder may cancel his contract without penalty.

20.55 A related issue is whether a potential policyholder has sufficient information on the main characteristics of the policy he is taking out and on the operations of the life office.

20.56 LIFA has advised the Committee that Australian life offices are already increasing the extent of information freely disclosed to potential policyholders. Practice varies, but some form of written information is usually made available to prospective policyholders. This ranges from very comprehensive consumer buying guides covering a range of policies through detailed brochures explaining specific policies to short explanatory leaflets. The policy document is also a basic source of

information, outlining the rights and obligations of the life office and the policyholder.

20.57 The Committee welcomes this trend toward improved disclosure. However, the diversity of practice by life offices leads it to believe that there would be merit in extending such disclosure to include information on other matters of vital concern to policyholders, including such matters as the payment of bonuses, the surrender value of policies, voting in connection with annual meetings etc. as well as information on the structure and sectoral spread of its investment portfolio.

20.58 The Committee attaches particular importance to the disclosure to potential policyholders of information relating to surrender values. While a Select Committee established by the Life Insurance Commissioner, and comprising industry representatives, recommended in 1979 that certain information relating to surrender values should be included in policy documents, the Commissioner has only been able to **request** that this be done.

20.59 While **most** life offices are understood to be complying with this request, it is reasonable to assume that it will be the fringe operators which do not comply and that, in time, this may discourage compliance by others. The Committee therefore believes that there is a strong case for authorising the Commissioner to **require** that life offices disclose information on their policy in respect of surrender values.

20.60 Present problems could be overcome by amending the Life Insurance Act. However, as the changing practices of life offices and needs of policyholders are likely to generate demands for other disclosure in the future, the Committee believes it is preferable that the Commissioner have the flexibility to amend disclosure requirements as the need arises without formal amendment to the Act. On the other hand, some safeguard against the imposition of excessive disclosure requirements is desirable.

20.61 The Committee **recommends** that where life offices do not already do so, they should be required to issue new policyholders with a booklet providing information on past and current performance in respect of such matters as earning rates, bonuses etc. and in respect of surrender values.

(f) Disclosure to Existing Policyholders

20.62 Any person is entitled to obtain from the Life Insurance Commissioner copies of the annual accounts and actuarial returns which life offices provide to him under s.141 of the Act. Under s.53, these are also available to shareholders and policyholders from the company on request.

20.63 As well, policyholders often receive information about their life office with their premium renewal notices and most participating policyholders receive additional information with their annual bonus certificates.

20.64 The Committee has been informed that life offices are responsive to the demands for information by their different types of policyholders, and are providing such information as the return on funds employed in different categories of investment and major investments in which funds are employed. Nevertheless, it considers that policyholders of **all** kinds (including those with term insurance, which has no savings element) should be provided with a report annually, providing an overall view of the life office's activities. As well as providing information on performance, such a report should be designed to facilitate risk assessment.

20.65 Accordingly, the Committee *recommends* that, where life offices do not already do so, they should be required — in sending their premium renewal notices or annual bonus certificates — to provide policyholders with a short summary of their Annual Reports. These summaries should, at least, contain meaningful details of the investment spread of the relevant statutory fund.

20.66 Under the Companies Act, life offices are permitted to lay before the annual general meeting accounts which comply with the Life Insurance Act rather than with the Companies Act. As a consequence of the trend in recent times to require increased disclosure by companies generally, life insurance companies are now required to disclose less information at annual general meetings than other companies. For example, life offices are not required to disclose details of the market value of listed securities, although some life offices do provide such information in respect of broad groupings. Nor are life offices required to disclose loans to directors or details of the accounts in the immediately preceding year.

20.67 The disclosure requirements of the Life Insurance and Companies Acts have different objectives. The life insurance legislation returns are, of course, designed to assist the authorities to protect the interests of policyholders by enabling them to ascertain whether a company is complying with the relevant financial requirements. On the other hand, the accounts provisions in the Companies Act are designed primarily for the disclosure of information to shareholders, creditors and the public generally.

20.68 The Committee believes that life offices should be required to provide all relevant information in their accounts that other companies are obliged to disclose under the Companies Act. However, the nature of life insurance is such that it seems appropriate that life offices should continue to meet the special disclosure requirements laid down in the Life Insurance Act.¹⁵

20.69 Accordingly, it is *recommended* that life offices should continue to meet the special disclosure requirements laid down in the Life Insurance Act, but the requirements of the Act should be revised to ensure that life offices maintain a standard of disclosure not less than that applying under the Companies Act.

20.70 The Companies Act also exempts directors of a registered life insurance company from presenting a directors' report setting out prescribed information, although directors of a number of life offices, in fact, do present such reports to annual general meetings.

20.71 There no longer appears to be any clear rationale for this exemption, whatever may have been the original case for it. The withdrawal of this exemption would represent one further, if small, step towards greater life office accountability to shareholders and policyholders, and would impose a relatively light additional burden on life offices.

20.72 The Committee therefore *recommends* that the provision of the Companies Act which exempts directors of life offices from presenting a Directors' Report setting out prescribed information should be repealed. However, the nature of disclosure in such reports should reflect the special nature of life insurance business.

¹⁵ There may also be room for improvement in disclosure of information that relates specifically to life office activities, e.g. concerning the return to policyholders on different kinds of policies, the basis on which bonuses are determined etc.

(g) Voting Rights of Policyholders with Mutual Life Offices

20.73 Unlike life offices which have shareholders, policyholders with mutual life offices incorporated in Australia have the right to elect the boards of directors, to alter the Articles of Association and to pass motions at general meetings. Section 140 of the Life Insurance Act seeks to facilitate such participation by requiring mutual life offices to make provision for the establishment of a postal voters' roll of policyholders. However, the Act also authorises removal of the name of any member who is enrolled, but fails to exercise his right to vote by post on three consecutive occasions.

20.74 The percentage of policyholders currently on the postal voters' roll is very modest indeed, as Table 20.2 testifies. It should be noted, however, that while those on the roll might be small in number, those actually voting can represent a far greater proportion by value (e.g. superannuation trustees).

TABLE 20.2: MUTUAL LIFE OFFICES: VOTING BY POLICYHOLDERS, 1980

	<i>Ordinary policies on issue</i>	<i>Voters on postal voters' roll</i>	<i>Numbers voting at annual meeting</i>
AMP ^(a)	2 374 608	55 675	12 300
National Mutual ^(b)	1 112 566	6 525	(c)
T & G ^(d)	886 979	131	(c)
Colonial Mutual ^(a)	599 099	62	(c)
City Mutual ^(a)	199 922	19 500	(c)

(a) Figures as at 30 December 1980.

(b) Figures as at 30 June 1980.

(c) Policyholders not required to vote on any issue nominated in the Life Insurance Act. However, for City Mutual about 100 voted by show of hands.

(d) Figures as at 30 September 1980.

20.75 As indicated in the table, the percentage of policyholders enrolled with the different mutual life offices varies considerably. This reflects differing approaches to soliciting the interest of policyholders in voting.

20.76 The Treasury has crystallised the implications of the existing provision as follows:

Since a mutual company does not have share capital, it would be much more difficult for it to be taken over even where there was obvious potential for a more effective utilisation of assets. As the takeover mechanism is an important vehicle for the entry into and exit of companies from an industry, and a force operating for a more efficient allocation of resources, it could be argued that a mutual company is not subject to the same pressures to operate efficiently as are other companies.¹⁶

20.77 The Committee sees a competitive market and an informed consumer as providing the most effective incentive for mutual life offices to operate efficiently.¹⁷ Nevertheless, it views the conspicuous absence of policyholder participation with some concern and favours some tightening of s.140 of the Act to make the boards of mutual life offices more directly accountable to policyholders.

20.78 The need for such action is also suggested by the growing direct involvement of mutual life offices in major resource development projects and in

16 Treasury Paper No. 8, op. cit., p. 41.

17 Mutual offices claim that in a highly competitive environment, their market share has increased, compared with non-mutual offices.

the taking over of listed companies. The change in emphasis from an arm's length investment role to one with greater entrepreneurial and management responsibilities can be regarded as a normal and acceptable aspect of an efficient financial system. But it does underscore a need for the life offices concerned to be fully accountable to their policyholders.

20.79 In the Committee's view, the very large number of policyholders in each of the mutual life offices makes it impractical, for cost reasons, to send voting papers to each policyholder.

20.80 To ensure that policyholders have a more direct opportunity to participate in determining their life offices' policies, the Committee *recommends* that:

(a) Mutual life offices should be required to:

- send a formal application for inclusion on the voters' roll to all policyholders at the time they take out a policy;
- advertise their annual meetings prominently in the newspapers and include in the advertisement an application for registration on the roll and a voting coupon that policyholders may complete.

(b) The provision that the name of a policyholder who does not exercise his right to vote on three consecutive occasions may be removed from the voters' roll should be retained, but this action should only be taken if no response is received within fourteen days of notification of the life office's intention.

20.81 The Committee is very much aware that, as s.140 does not apply to overseas-based mutual life offices, the latter have no responsibilities to their Australian policyholders in this particular connection. In common with the Australian policyholders of Australian-owned or overseas-owned shareholder companies, these policyholders do not have the ability to influence management policies.

II SUPERANNUATION FUNDS

A. BACKGROUND

20.82 In this chapter the Committee is concerned only with the prudential aspects of occupational superannuation. It has not sought to address itself to all the major issues that were considered in the reports of the National Superannuation Committee of Inquiry (the Hancock Committee) in 1976 and 1977.¹⁸ In particular, the Committee has not considered issues relating to:

- a national compulsory superannuation scheme;
- the adequacy, as distinct from the security, of benefits; or
- schemes for government employees.

20.83 The first of these issues, although it has obvious implications for the volume and pattern of funds flows within the financial system, clearly falls outside

18 *Occupational Superannuation in Australia*, Final Report of the National Superannuation Committee of Inquiry, Part 2, AGPS, Canberra, March 1977.

All references to the Hancock Committee in this chapter are to the majority findings.

the Committee's terms of reference. In the discussion that follows, it has been assumed that a national superannuation scheme will not be introduced in the foreseeable future, bearing in mind the Government's rejection, in July 1979, of the Hancock Committee's recommendation.

20.84 Similarly, it is not believed that questions regarding the adequacy of benefits under private or government superannuation schemes are matters for this Inquiry.

20.85 Finally, issues relating specifically to superannuation schemes for government employees are not considered in this chapter as no prudential questions appear to arise. (Of course, some of the more general comments — e.g. in respect of disclosure — have application in respect of these schemes.)

20.86 Superannuation funds sponsored by private employers are of two basic types:

- *accumulation schemes* (also known as allocated funds), where employers and (usually) members contribute on a regular basis to fund members' retirement benefits and where each member's entitlement is ultimately represented by the accumulation of those contributions, together with the investment income earned therefrom; and
- *benefit promise schemes* (also known as unallocated funds), where the retirement benefit is related not to contributions but to pre-retirement salary. If required by the employer, a member contributes to the fund at a specified rate in the same way as with allocated funds. However, employer contributions may be adjusted periodically, usually after actuarial investigation, to determine the appropriate rate of contribution necessary to cover the residual cost of benefits after allowance has been made for employee contributions, investment income and expenses.

20.87 A 1972 survey by the Department of Labour revealed that some two-thirds of funds operated on the benefit promise principle and that there was a trend toward this form of superannuation, particularly among larger schemes. No later published data are available, but a survey in 1977 by the Association of Superannuation Funds of Australia (ASFA) of its member funds is understood broadly to confirm that larger schemes predominantly operate on the benefit promise principle.

20.88 Superannuation funds are generally managed in one of the following ways:

- Through direct investment by the trustees in particular assets, e.g. government and other debt securities, equities and property. This is often supplemented by group life insurance to provide death and disability benefits; such funds are generally referred to as 'self-administered' funds.
- Through the purchase of individual policies from life offices.
- By the payment of money to life offices under deposit administration contracts. The amount accumulated may be guaranteed by the life office or the trustees of a fund may nominate the proportions to be invested in different classes of assets, in which case their policy participates on a day-to-day basis in any movement in the capital value of the assets backing the policy. In either case, group life insurance is usually taken out.
- By the payment of money into pooled funds operated by institutions other than life offices. Gains and losses of the pooled funds are applied in the same manner as for linked life policies, and group life insurance is usually taken out.

20.89 A broad indication of the relative importance of the different approaches to investing the assets of superannuation funds can be gauged from the results of a survey undertaken by ASFA in 1980. This indicated that 32% of its member funds managed their own investments, 35% were invested through life offices and 33% managed by banks, merchant banks or other professional managers. The fact that ASFA members tend to be larger funds suggests that the latter two figures may considerably understate the position for all superannuation funds.

20.90 As noted in the Interim Report (paragraph 5.127) the assets of public and private superannuation funds increased from around 5% to 9% of the total assets of financial institutions over the two decades to 1970, and currently stand at about 8%. As a result, they are an important source of funds (especially equity funds) for business — an issue taken up elsewhere in this Report.

B. CURRENT APPROACH TO REGULATION

20.91 Superannuation schemes operated by life offices are included in their statutory funds; members and beneficiaries thus receive some protection under the Life Insurance Act.¹⁹ With this exception, such protection as is afforded contributors to superannuation schemes is by way of requirements under the Income Tax Assessment Act and through trust deeds and the activities of trustees.²⁰ Relevant details are outlined in Chapters 13 and 16 of the Interim Report; however, the following principal features should be noted:

- Any fund wishing to qualify for income tax concessions has to satisfy various discretionary tests imposed by the **Commissioner of Taxation**. The tests are designed to ensure that the schemes do not merely constitute tax avoidance by the employers; they are also designed to ensure that welfare objectives are achieved but without the untaxed benefits to employees being excessive. Prudential considerations tend to be of lesser importance.
- The great majority of private superannuation funds are administered by persons or companies acting as **trustees**: the essential nature of private superannuation schemes is the setting aside of money in a trust fund which is administered by trustees for the benefit of members. Trustees are usually appointed pursuant to the terms of the trust deed²¹ and frequently include one or more directors of the employing companies and employee representatives.
- While the powers of the trustees may be subject to the requirements of state trustee legislation, in practice superannuation funds usually have their own **trust deeds**. These commonly exclude the investment restrictions imposed by state Trustee Acts and are usually drawn in such a way as to give the trustees

19. Members' interests are protected to the extent that the Life Insurance Commissioner can take certain action in the event that a life office is unlikely to meet its liabilities. However, individual superannuation funds included in a life office's statutory fund are not normally supervised by the Commissioner. While the Commissioner requires each life office to send him a list of 'benefit promise' funds it administers, together with the actuarially calculated contribution rate, he has no power to require that any such rate is in fact paid — i.e. he cannot ensure that funding arrangements are appropriate to the benefit promised. This is a matter for the fund trustees.

20. In his 1980 report, the Life Insurance Commissioner reported an increasing number of complaints concerning the management of superannuation schemes by trustees, but noted that the management of such schemes did not come under his jurisdiction.

21. The terms and conditions of trust deeds vary from employer to employer in this and many other respects.

fairly wide discretionary powers. As well, the trustees are sometimes subject to direction by the employers on particular matters.

C. ALTERNATIVE APPROACHES TO REGULATION

20.92 Governments in other countries have generally chosen not to rely solely on self-regulation by superannuation funds but have sought to protect employees through the imposition of:

- (i) minimum requirements as a pre-condition for favourable tax treatment — with compliance supervised by the taxation authorities;
- (ii) tax-related requirements as in (i), but with compliance supervised by an independent authority; or
- (iii) prescribed minimum prudential standards (unrelated to the tax treatment of superannuation funds), compliance with those standards being supervised by an independent authority.

20.93 The first approach is that followed in Australia and, in part, in the United Kingdom. In the United Kingdom, to secure tax relief, a scheme must be approved by the Department of Inland Revenue. The conditions of approval include requirements that the fund be established under irrevocable trust, that its sole purpose be the provision of benefits to employees and their dependants, that the employer contributes to the scheme and that benefit provisions be observed.

20.94 In the United Kingdom the second approach also applies to a large number of schemes which have contracted out of the earnings-related benefits provided by the Government under the Social Security Pensions Act 1975. These schemes have to be approved by the Occupational Pensions Board (as well as by the Department of Inland Revenue). The Occupational Pensions Board is primarily responsible for the preservation of benefits legislation and other contracting-out requirements.

20.95 The second approach is also used in Canada, New Zealand and the United States. The third approach is used in West Germany.²²

²² In *Canada*, Federal and some Provincial legislation provides for the registration of superannuation schemes by a Pensions Board. To qualify for tax concessions, a superannuation scheme must be registered with the Department of National Revenue, which will only register schemes registered with a Pension Board or which conform to the investment requirements of the relevant Federal legislation.

In *New Zealand*, approval for favourable taxation treatment is a responsibility of the Government Actuary. Regulations made under the Superannuation Schemes Act 1976 lay down statutory criteria to be observed as a condition of approval by the Actuary. The Regulations set down various requirements, including a range of material that must be incorporated in the trust deed.

In the *United States*, superannuation funds must meet a range of requirements under the Employee Retirement Income Security Act to qualify for tax concessions. Responsibility for the control of occupational superannuation is divided between the Treasury, the Department of Labor and a Pension Benefit Guaranty Corporation. Sanctions, including liability for special excise taxes, apply if certain requirements are not met.

In *West Germany*, pension funds must be approved before they commence business, and are supervised and subject to requirements set by a Federal Supervisory Office under the terms of the Occupational Pension Act. Pensions must be insured against loss due to bankruptcy of the sponsoring company unless they are provided through insurance company funds or separate pension funds.

20.96 It should be noted that, under existing arrangements in Australia, members of superannuation funds (other than non-unit-linked funds managed by life offices) appear to have only a minimum of protection against possible diminution in value of accumulated funds; the trust deeds of most schemes permit employers to discontinue contributions. Notwithstanding this, the security of benefits of superannuants has not generally been a problem to date.

20.97 The Hancock Committee considered that compliance with specified standards should be induced by the granting and withholding of tax advantages. This approach was favoured because it represented an extension of existing arrangements, lent itself to flexibility, avoided the use of more cumbersome but possibly less effective penal sanctions, and was more likely to gain acceptance among those involved in administration of superannuation than more direct methods of control. Reinforcing this preference was greater certainty regarding the scope of the Commonwealth's taxation power under the Constitution than of its insurance power.²³

20.98 The Hancock Committee rejected the idea of the Commissioner of Taxation and Government Actuary sharing responsibility for approving superannuation schemes. It saw no justification for the creation of a new authority, or for transferring responsibility for superannuation schemes to the Government Actuary. However, it acknowledged that the latter might have been recommended had there been a strong industry preference for such a course.

20.99 Although the Hancock Committee favoured a continuation of the present approach to regulation of superannuation funds, it advocated various changes to the existing requirements of the Commissioner of Taxation. In particular, it proposed that the emphasis given hitherto to the protection of the revenue would need to be modified, with equal weight being given to securing compliance with certain minimum standards. It considered that the 'Taxation Office can and will make the necessary adjustments in its assumptions'.²⁴

20.100 The Committee does not share this view. It doubts whether the Commissioner of Taxation can reasonably be expected to be concerned about prudential, as opposed to revenue, considerations, particularly given the emphasis placed by government on the latter.

20.101 However, while the Committee sees a need for greater prudential oversight of superannuation funds, it does not advocate an approach to regulation totally comparable to that of life offices.

20.102 One alternative considered was for tax benefits to be subject to the registration (or approval) of superannuation funds by the Life Insurance Commissioner. This would involve regulation along the lines of approach (ii) in paragraph 20.92 and is similar to that in New Zealand; registration would be subject to the meeting of prescribed prudential criteria.

20.103 Such an approach would not be inconsistent with the principle of 'co-regulation' endorsed by the Committee in other chapters. On the contrary, the

23. The insurance power (section 51 (xiv) of the Constitution) explicitly excepts state insurance unless it extends beyond the limits of the state concerned. Legal advice received by the Hancock Committee suggested that some schemes established under state legislation would therefore probably not fall within the Commonwealth's insurance power.

24. *Occupational Superannuation in Australia*, op. cit., p. 56.

Association of Superannuation Funds of Australia (ASFA) could be actively involved in the development of minimum standards and in monitoring their adequacy. As well, there could be a continuing, and possibly strengthened, role for trustees.²⁵

20.104 However, while such an approach has its attractions, the Committee does not see any need to increase the overall level of ongoing government regulation and supervision in order to achieve the desired level of protection for members of superannuation funds.

20.105 The Committee has noted that there may be constitutional difficulties in regulating superannuation funds other than by way of the taxation power. It therefore favours an approach to regulation involving the taxation power and the use of auditors to ensure minimum prudential requirements are met.

20.106 This assumes, of course, that some tax concessions continue to be available to superannuation funds or their contributors. (In Chapter 15 the Committee recommends the adoption of a new basis for taxing superannuation funds, with any desired concession being provided through an additional tax rebate on individuals' contributions to superannuation schemes.)

20.107 Accordingly, the Committee *recommends* that:

- (a) Only contributions to an 'approved' superannuation fund should be rebateable (or deductible) for income tax purposes.²⁶
- (b) An 'approved' fund would be one that met certain minimum prudential requirements. These should be set (and reviewed regularly) by the Life Insurance Commissioner (who would *not*, however, have any ongoing supervisory responsibilities).
- (c) The requirements should be incorporated in the trust deeds of superannuation funds.
- (d) The auditor for each superannuation fund should provide the fund with a certificate each year confirming that the minimum requirements have been met.
- (e) The superannuation fund should lodge this certificate with its annual tax return; this would provide the basis for rebateability (or deductibility) of contributions.

20.108 The Committee believes that such an approach would have several advantages. It would:

- permit a reduced role for the Taxation Office in the oversight of observance of minimum prudential standards;
- make use of the experience and expertise of the Life Insurance Commissioner, but without adding to his ongoing supervisory responsibilities; in turn, this would ensure that regulation of all superannuation funds, including those operated by life offices, was on a consistent basis; and

25 In New Zealand many of the requirements for approval by the Government Actuary comprise broad requirements as to what should be included in trust deeds. If such an approach were pursued in Australia, trustees, auditors and (where appropriate) actuaries would have particular responsibilities for the observance of those standards.

26 If no tax concessions are offered to contributors, the Government might need to consider alternative legislative action.

- avoid a dispersion of regulatory responsibility between different government authorities.

20.109 In the above discussion the Committee has not sought to distinguish between funds contributed by members and employers and those contributed only by employers, as the beneficiaries need protection in both cases.²⁷ As well, while contributors to public funds are unlikely to be 'at risk', public superannuation funds should be required to abide by the same standards so that beneficiaries are treated on a neutral basis.

20.110 The Committee does not seek, in this chapter, to outline all the various standards and disciplines that might be required. However, it comments on some of the **specific** problems arising out of the existing arrangements, and points to the direction of change that is considered desirable.

D. SPECIFIC PROPOSALS FOR CHANGE

20.111 There are a number of areas where contributors to superannuation funds do not appear to be adequately protected. Although most of these have already been considered by the Hancock Committee, it is believed to be also necessary to deal briefly with them in this report.

(a) Employers' Commitment and Funding Standards

(i) Compliance with Actuarial Recommendations

20.112 As indicated in paragraph 20.86, actuarial investigations of benefit promise schemes are undertaken from time to time, with the actuary recommending a rate of contribution by the employer necessary to ensure that the accrued benefits are being fully funded.

20.113 However, while the actuary is required to advise the trustees on the appropriate level of contributions for each scheme, having regard to the benefits promised, responsibility for seeing that the scheme is adequately funded often rests with the trustees and, subject to the terms and conditions of the relevant trust deed, sometimes with the employer.

20.114 The Hancock Committee indicated it was not aware of any widespread failure by employers to comply with actuarial recommendations. Nevertheless, it thought it appropriate to make approval of a benefit promise scheme by the Taxation Commissioner subject to the receipt of an undertaking by the trustee that:

- benefits would be funded by a policy effected with a life insurance company; or
- the employer's contribution rate would be reviewed by an actuary at intervals not exceeding three years, with the employer being required to contribute at a rate certified by the actuary as appropriate.

20.115 The Committee does not favour such a proposal. In the case of benefit promise schemes the employer should be free to determine the level of contribution and benefit he feels is appropriate, subject, of course, to compliance

²⁷ It is recognised, however, that prudential safeguards are less necessary where the owners or partners of the firm are the sole contributors and beneficiaries. The comments and recommendations in this chapter do not generally apply to such funds.

with the trust deed. The imposition of requirements on employers as to minimum funding standards is likely to inhibit them from providing superannuation, especially of the benefit promise kind.

20.116 It is believed to be essential, however, that members should be aware of the level of funding by employers and the relationship of that funding to promised or indicated benefits.

20.117 Accordingly, the Committee *recommends* that, as a condition of qualification as an 'approved' fund, the trust deeds of superannuation schemes should require that members be kept regularly informed of the level of funding in relation to the obligations of employers under trust deeds.

(ii) Discontinuation of Employer Contributions

20.118 Employers are permitted under the trust deeds of most superannuation schemes to discontinue their contributions, subject to giving prescribed notice. As both members and employers contribute to **accumulation schemes** on a regular basis, members will still receive the entitlements which have accrued to that time if employers take such action. However, the Hancock Committee has drawn attention to the fact that, in the case of many **benefit promise schemes**, employers are not required to make up any shortfall that exists at the time notice is given so as to secure members' accrued benefits. Employers may simply terminate contributions, leaving the members of such schemes to bear any deficiency.

20.119 Employers should not, of course, be required to continue schemes that become too onerous. However, while benefits associated with **future service** should be revocable, it is believed that the same right should not apply in respect of benefits accrued in respect of **previous service**, except where the trust deed so provides. So long as the rights of employers and employees are clearly defined, it is not believed that any action by government is required.

20.120 It is possible that an employer will be unable to meet all accrued entitlements because of insolvency. In the United States a Pension Benefit Guaranty Corporation seeks to overcome this problem by providing plan termination insurance on a compulsory basis for allocated fund-type schemes. However, the Hancock Committee rejected the establishment of such a body in Australia because of the undesirable level of intervention that this would introduce.

20.121 The Committee believes it would be inconsistent with the general approach outlined in Chapter 18 for the Government to establish such an authority.

20.122 In the light of the above, the Committee *recommends* that **benefits accrued in superannuation schemes in respect of previous service should not be revocable by the employer, except where the trust deed so provides.**

(b) Asset Restrictions

20.123 The Committee has already discussed the possible application of restrictions on specific life office investments and recommended against them, although it suggested that, for the purpose of calculating the solvency test, the value of any individual investment should be taken into account only to the extent of 5% of a life office's assets.

20.124 The Hancock Committee recommended that no attempt be made to regulate the investment decisions of trustees and fund managers. While the Committee is not generally in favour of investment prohibitions, it is concerned that the security of members' benefits may be impaired if the value of any individual investment comprises an undue proportion of the assets of a superannuation fund. This is consistent with the view expressed in respect of life and general insurance companies.

20.125 Accordingly, it is *recommended* that, in order to qualify as an approved fund:

- (a) A superannuation fund (other than one administered by a life office or other pooled fund) should be required to restrict its investment in any single asset to not more than 5% of the total assets of the fund²⁸, both values to be current market values. A pooled fund should be required to observe the same constraint in respect of its overall portfolio.²⁹
- (b) Where the value of an individual investment exceeds this figure (arising, for example, from the revaluation of an asset or a change in the market valuation of an investment), the fund should be permitted twelve months to reduce its holding to the 5% level.
- (d) Where any of a fund's investments exceed the 5% limit at the time these arrangements are implemented, a transitional period of three years should be permitted.³⁰

20.126 Submissions have drawn attention to one area where the security of members' benefits may be seriously impaired in the absence of specific limitations, namely investment in the employer's business. Among the arguments put forward for imposing restrictions on such investments are that:

- if the company fails, the employees could lose their superannuation benefits as well as their jobs;
- the investment may not be at 'arm's length';
- the dominant motive for establishing and maintaining the relevant schemes may be to reduce the company's taxation and improve its liquidity rather than to provide benefits to the company's employees upon retirement.

20.127 The magnitude of this problem is not clear, but it would appear to arise more particularly with the smaller, private companies. While no statistical evidence is available, ASFA has suggested that such arrangements have been increasingly used in recent years as a method of financing such small businesses. ASFA endorsed the view of the Hancock Committee that no more than 10% of the assets of a fund, measured in book values, should consist of equities in or loans to the employer's business unless the investment asset is so secured that its value is not dependent upon the employer's survival.³¹

²⁸ A 'single asset' will need to be defined to include related investments. It is desirable that investments which constitute single exposure should be aggregated.

²⁹ This recommendation is concerned primarily with investments in any single company or project (or related group of companies or projects). It is not intended that holdings of government securities and debt claims on banks and authorised dealers should be included in the 5% requirement.

³⁰ The growth of the fund itself should facilitate a comfortable adjustment within this time frame.

³¹ *Occupational Superannuation in Australia*, op. cit., p. 105.

20.128 In line with the recommendation in paragraph 20.125, the Committee further *recommends* that, in general, not more than 5% of the assets of a superannuation fund should consist of an investment (equity and/or loans) in the employer's business.³²

20.129 To the extent that employers have turned to their superannuation funds as an important source of finance, it would clearly not be in the interests of members to require repayment over the short term; this could well precipitate collapses if such loans could not be refinanced elsewhere at acceptable rates of interest.

20.130 Whereas the Committee has advocated that superannuation funds be given three years in which to reduce their investments in any one company or project to the 5% ceiling, it believes that, to enable employers to rearrange their financing, a longer transitional period should be permitted, before the 5% ceiling is applied, than is proposed in respect of other investments. This might be as long as ten years where the investment is at present, say, 25%, with the discipline being progressively applied in accordance with a prescribed, but not inflexible, formula. The natural growth of the fund should generally ensure that this requirement does not impose an unreasonable burden on affected employers.

(c) Disclosure and Accountability

20.131 The Committee attaches considerable importance to the maintenance of close communications between the trustees of a fund and its members. It believes that, to a certain degree, disclosure by superannuation funds can serve as a substitute for regulation.

(i) Reporting Requirements

20.132 There are no specific requirements for superannuation funds to report regularly to their members (other than those imposed by their trust deeds) or to any government authority. The only reporting requirement is under the Income Tax Assessment Act, where notice in writing of the existence of employees' and dependants' rights must be given to an employee when contributions are made for the first time.

20.133 The Hancock Committee concluded that, while the day-to-day operation of superannuation funds must be left to trustees and administrators, their actions should be open to informed scrutiny. Specifically, it recommended the adoption of proposals made in 1975 by the Occupational Pensions Board in the United Kingdom regarding disclosure by funds.³³ Under these arrangements the trustees or managers would be required to prepare annual reports, to be made available on request to members and beneficiaries, comprising:

- (i) the funds's annual accounts, together with a report on the accounts by a professionally qualified auditor;
- (ii) the investments of the fund;
- (iii) actuarial statements (in the case of benefit promise funds) prepared at the most recent valuation showing:
 - the extent to which accrued benefits would be secured on the immediate discontinuance of the scheme; and

32 But see footnote 27.

33 *Occupational Superannuation in Australia*, op. cit., pp. 105-6.

- the rate of contribution recommended by the actuary, the basis used in making the recommendation and the level of funding which it was intended to achieve.

20.134 The Hancock Committee recommended that the annual report for an accumulation scheme should also include:

- statements of the methods used in valuing members' interests in the fund; and
- the accumulated benefits of each member.

20.135 For schemes where contributions are used to buy individual life insurance policies, the Hancock Committee recommended that the trustees be required to give each member annual statements of the sums assured and bonuses in force.

20.136 The Wilson Committee also saw disclosure as preferable to statutory controls. It proposed that there should be a 'clear and systematic' statement of the legal duties and obligations of employers, trustees and their advisers and that it should be made easier for members and their representatives to monitor a scheme's management and solvency. It recommended that there should be a clear statutory obligation on trustees to make regular disclosures to members.

20.137 The Committee accepts, in principle, the need for improved disclosure to members of superannuation funds. It notes that ASFA has published minimum reporting standards for superannuation funds.³⁴ These broadly follow the recommendations of the majority of the Hancock Committee and require, for example, that:

- the annual report of a superannuation scheme should comprise reports by the trustees and the actuary (where appropriate) as well as financial accounts and an auditor's report;
- members should be provided with an abbreviated report containing information on the financial position of the scheme expressed in a simple and straightforward manner; the report should include a table of investments of various types, at market value; and
- members should have access to a copy of the full report if they wish, and be provided annually with a statement of accumulated contributions and benefits.

20.138 However, there is no compulsion on ASFA members or other superannuation funds to adopt these reporting standards as normal practice. It is of concern that the funds least likely to conform to the standards may well be those where there is greatest need for members to be aware of their funds' operations.

20.139 Accordingly, the Committee *recommends* that **observance by funds of reporting standards, along the lines of those advocated by the Association of Superannuation Funds of Australia, should be made a condition of qualification as an 'approved' fund.**³⁵

34 *Superannuation Scheme Practice and Reporting in Australia*, the Association of Superannuation Funds of Australia, Booklet No. 10, December 1979.

35 The AFSA suggestion that the annual accounts should disclose details of investments in any one organisation which, in aggregate, exceed 5% of the fund's assets would, of course, be unnecessary if the recommendation at paragraph 20.128 is adopted.

(ii) *Participation of Members*

20.140 A related issue which the Committee believes warrants consideration is the participation of members in the running of their superannuation funds. The trustees of a fund are usually, but not always, chosen from the management of an employing company or its directors, and are sometimes subject to direction by the employing company on particular matters. Representation of members (other than managers) in fund management does not appear to be widespread. Of 703 schemes surveyed by the Department of Labour in 1972, only 118 (or 17%) made provision for non-managerial representation. Members elected some or all trustees in 70% of such schemes with the firm's management appointing at least one non-managerial employee as a trustee in the remainder. The 1977 ASFA survey indicated that 35% of its members made provision for employee participation in the management of schemes.³⁶

20.141 In a report published in 1975, the UK Occupational Pensions Board advocated the direct participation by member representatives.³⁷ The Wilson Committee also favoured the idea and proposed that the membership of governing bodies of funds above a minimum practical size be composed, in equal numbers, of company appointees on the one hand and of members and pensioners on the other.³⁸

20.142 The Hancock Committee thought that employees could contribute usefully to decisions taken by trustees on various matters, but felt that legislation to make member participation obligatory would be premature.

20.143 The Committee believes it would minimise potential conflicts of interest and strengthen the independence of trustees if one or more employees, including (but not only) management, were to become trustees of superannuation funds. It could also be expected to lead to funds being administered more clearly in the interests of members, and an improvement in communications between scheme administrators and members.

20.144 Accordingly, the Committee *recommends* that a condition of qualification as an 'approved' fund should be that the trust deed provide for the annual election of at least one representative of non-management employee members as a trustee of the fund.

III GENERAL INSURANCE COMPANIES

A. BACKGROUND

20.145 The general rationale for government regulation of general insurance companies is consumer protection: those seeking insurance cover would generally find it difficult to make reliable comparisons of the financial position of insurers. Chapter 16 of the Interim Report sets out the main features of the current approach to regulation of general insurance companies.

36 The higher proportion probably reflects the fact that larger funds tend to provide for employee participation to a greater degree than small funds, with the former predominating within ASFA.

37 *Solvency, Disclosure of Information and Member Participation in Occupational Pension Schemes*, Report of the Occupational Pensions Board, Cmnd 5904, HMSO, London, 1975.

38 *Report of the Committee to Review the Functioning of Financial Institutions*, op. cit., p. 325.

20.146 Without attempting an exhaustive coverage of the topic, the Committee has focused on three broad issues regarding the prudential regulation of general insurers:

- the adequacy of the *Insurance Act 1973* as it applies to general insurers;
- the lack of a uniform, consistent approach to regulation of insurance companies by the Commonwealth and the States;
- the appropriate method of regulating mortgage insurers.

B. ADEQUACY OF THE INSURANCE ACT

(a) Approach to Regulation

20.147 The Insurance Commissioner has expressed concern that premium rates are being set at levels which do not reflect sound underwriting practice and that, if this were to continue, the consequences for insurers and policyholders could be serious, particularly if there should be any significant natural disasters or a decline in investment yields.

20.148 The Treasury believes that increased disclosure of data provided under the *Insurance Act* would facilitate *caveat emptor*, and encourage companies with higher standards to publicise the fact, using it as a competitive weapon. Such action would lessen the need for increased government regulation.

20.149 The failure of one, or even several, general insurance companies is unlikely to cause widespread financial distress or threaten the stability of the industry to the same extent as the failure of one or more life insurance companies; the need for extensive regulation is accordingly diminished. However, the Committee is conscious that some of those with claims outstanding at the time an insurance company fails may well experience severe financial hardship. Thus, there is clearly a case for some government regulation.

20.150 Possible amendments canvassed in a Treasury Paper circulated to the insurance industry in late 1978 included an increase in the minimum paid-up capital required of an authorised insurer from \$200 000 to \$500 000 and an increase in the solvency margin so that the excess of an authorised insurer's assets over liabilities should not be less than \$1 million (\$100 000 at present) or a specified percentage of premium income (e.g. 20% compared with 15% at present), whichever is the greater.

20.151 The following table provides an outline of the position of general insurance companies in relation to the solvency margin.

20.152 It is clear that there has been a significant improvement in the solvency margins of insurance companies generally since 1975-76. Companies with solvency margins in excess of 30% accounted for 84% of the premium income of direct underwriters in the private sector in 1978-79 compared with only 22.3% in 1975-76.

20.153 Notwithstanding this improvement, the Committee endorses the suggestion that the minimum paid-up capital and the solvency margin of general insurers should be increased along the lines indicated, as it believes the present requirements may be inadequate to enable the Insurance Commissioner to achieve the objectives of the *Insurance Act*.

TABLE 20.3: DISTRIBUTION OF SOLVENCY MARGINS OF DIRECT UNDERWRITERS IN THE PRIVATE SECTOR

Solvency margin	Number of companies in each category				Percentage of total premium income written in each category	
	1975-76	1976-77	1977-78	1978-79	1975-76	1978-79
Less than 15% or less than \$100 000 (a)	3	5	4	5(b)	3.7	1.0(b)
Statutory minimum (\$100 000)	65	52	53	52	0.7	0.5
15-20%	32	14	8	6	33.8	5.0
20-25%	21	18	8	4	14.1	2.8
25-30%	19	14	10	10	25.4	6.7
30-40%	14	23	15	12	18.1	18.1
40-50%	5	11	17	16	2.8	17.1
50-100%	3	16	38	41	0.4	44.9
Over 100%	7	6	7	15	1.0	3.9
Total	169	159	160	161	100.0	100.0

(a) The figures in this row include companies that did not meet the minimum solvency requirements. Figures for the years 1975-76 to 1977-78 only include companies that had a solvency margin of less than 15%.

(b) Four of these companies subsequently complied with the solvency margin requirements.

Source: Annual Report of the Insurance Commissioner, 1979-80.

20.154 In coming to this view, the Committee is conscious that, in the event of a significant underwriting loss (e.g. as a result of a natural disaster) a 15% solvency margin may not provide sufficient protection against insolvency. In practice, it would expect that insurers would seek to maintain a solvency margin well in excess of the required level if they are to be certain of maintaining an adequate margin in the event of a major disturbance within the industry.

20.155 However, care needs to be taken in requiring adherence to a solvency margin. An increase in premiums, which might be necessary for the future viability of an insurer, will in fact reduce its solvency margin because of the way this is calculated.³⁹ Thus if an insurer is close to the minimum solvency margin, it may in fact be discouraged from increasing its premiums in case it breaches the solvency requirements. This highlights the desirability of distinguishing between a fall in the ratio that is caused by underwriting losses and one that reflects remedial action in the form of increased premium rates.

20.156 In coming to the view expressed above, the Committee has only looked at the implications of the amendments for the stability of the industry and the interests of policyholders in the light of the present objectives of the Insurance Act; it has not, for example, considered what impact they might have on the structure of the industry or on the level of Australian ownership and control in the industry. If it were true that many small Australian-owned insurers would be adversely affected (as has been alleged), a short-term conflict might arise between efficiency and other government objectives. However, such a conflict may, to a degree, be mitigated by a phasing-in period.

³⁹ If, as a result of an underwriting loss, an insurance company's solvency margin is only 20% and it then seeks to rectify the situation by increasing its premiums by 25%, its solvency margin will fall to 16% ($\frac{20\%}{1.25}$) until such time as its increased profitability is reflected in increased reserves.

20.157 It has been suggested by one section of the insurance industry that long-term stability in the industry could best be achieved by allowing a degree of self-regulation of premium rates — a practice not permitted under the Trade Practices Act. The Committee does not support this suggestion, even if rates were to be set after consultation with the Insurance Commissioner and he were to monitor pricing practices to protect the public interest.

20.158 The Committee believes that, **on efficiency grounds, self-regulation of premium rates should not be given special exemption from the Trade Practices Act. In any event, such action would set an unfortunate precedent for other industries.**

20.159 Consistent with the views expressed in Chapter 18, the Committee considers that insurers, like other intermediaries, should not be precluded from failing. This points to the need for greater risk-awareness on the part of policyholders. At the same time, the Commissioner has a responsibility to take prompt action to ensure that the failure of general insurers does not generate a loss of public confidence in the industry as a whole. On the latter question, the Committee notes the criticism by the liquidator of one insurance company concerning the inability of the Insurance Commissioner to take immediate action to investigate the affairs of an insurance company.⁴⁰

20.160 In the light of these considerations, and recognising that the Insurance Commissioner has implemented an early warning system to ensure that doubtful situations concerning an insurer's financial condition are brought to notice at the earliest possible time, the Committee's views can be summed up as follows:

- **the objectives of stability and industry rationalisation would best be achieved by encouraging increased disclosure by insurers and greater risk awareness among the insured;**
- **greater risk awareness might be promoted if insurers that observe high prudential standards were to publicise this fact and if information were included in policy documents on the role and responsibilities of the Insurance Commissioner, similar to that which the Committee has proposed in respect of the Life Insurance Commissioner (see paragraph 20.51);**
- **consideration should be given to amending the Insurance Act to enable the Commissioner to take prompt action to facilitate the quick exit from the industry of failing insurance companies — so as to minimise losses to policyholders and avoid adverse effects on public confidence.**

20.161 The Law Reform Commission has suggested a 'safety net' for policyholders along the lines of the policyholders protection arrangements in the United Kingdom.⁴¹ Broadly speaking, these involve arrangements similar to deposits insurance, with a government-established solvency 'pool' funded by levies on insurers, from which policyholders' claims would be met in the event of the failure of an insurance company. The arguments made against similar proposals in respect of life insurance (see paragraphs 20.40–42) apply equally in the case of general insurance companies.

⁴⁰ The procedures which must be followed by the Insurance Commissioner are outlined in paragraphs 16.71–74 of the Interim Report.

⁴¹ *Insurance Contracts*, Law Reform Commission Discussion Paper No. 7, October 1978, p. 16.

20.162 As with life offices, however, the Committee sees no reason why general insurance companies wishing to establish some form of post-insolvency guarantee arrangement to meet insurance claims against an insolvent insurer should not do so, **provided it is organised by the industry itself**. Such an arrangement might well enable the Government to **reduce** the overall level of regulation. Whether the potential benefits (including the lesser costs of complying with the requirements of the Insurance Act) outweigh the costs would, of course, have to be assessed by the industry. However, the experience of the American Insurance Guarantee Association suggests that the direct costs would be very small.

(b) Asset Restrictions

20.163 The financial relationships between insurance companies and insurance brokers bear substantially on the stability of the former. The Insurance Commissioner has noted that some Australian insurers are owed such substantial amounts by some individual brokers that the failure of even one such broker would almost certainly result in the liquidation of the insurers.

20.164 In Part IV of this chapter, the Committee considers the need for government regulation of insurance brokers. It now turns to consider whether some tightening in the prudential requirements of insurers is necessary to limit their exposure to the failure of insurance brokers, and the form this might take.

20.165 It is common practice for insurance companies not to require brokers to pass on to them premium income at the time it is received. Thus, in addition to commission income, brokers are able to invest funds for a period, which in the normal course of events would be passed on to insurers. The Treasurer has foreshadowed a possible amendment to the Insurance Act to circumscribe this practice.

20.166 The Committee understands that, in the context of the present highly competitive insurance environment, there has been pressure on insurance companies to extend the period brokers are permitted to hold premium income.

20.167 The retention of premiums by brokers and investment of these funds on their own account is clearly not in the best interests of policyholders or insurers. The lack of clarity in legal relationships between insurers and brokers also means that the liability of a policyholder where a broker has not passed on premiums to an insurer is unclear in the event of that broker failing.

20.168 One possible course of action is to require brokers to hold such funds in trust accounts. As discussed in Part IV of this chapter, the Committee supports the development of co-regulation in respect of such matters.

20.169 However, this may not be enough. Under the Insurance Act, unpaid premiums do not, at present, count as an asset for solvency purposes if they become due more than twelve months previously; the Insurance Commissioner's approval is required before unpaid premiums which become due more than six months (but not more than twelve months) previously are admissible.

20.170 For the reasons outlined above, the Committee believes this limitation should be replaced by a more stringent requirement. Accordingly, it is **recommended** that **premiums should not count as an asset for solvency purposes under the Insurance Act where they are unpaid three months after becoming due.**

20.171 The Treasury paper circulated to the insurance industry in late 1978 also raised the possibility of limitations on the investments of insurance companies. This reflected concern that some companies have invested in certain areas, particularly real estate, to an extent that the liquidity and financial stability of the insurers could be threatened. It was suggested that:

- (i) for the purpose of determining 'required assets', investments in the following classes that exceed in value the specified percentage of required assets should not be allowed:
 - any single item of real estate: 5%
 - real estate in aggregate: 15%
 - debts secured by registered first mortgage on real estate valued at more than the amount of the debts, in aggregate: 15%
- (ii) companies should be granted a reasonable transition period within which to comply with the proposed requirements.

20.172 In its discussion of the regulation of life insurance companies and superannuation funds earlier in this chapter, the Committee emphasised the desirability of spreading investments. While, in the case of general insurance companies, official concern is confined to real estate, the Committee believes that — as a general principle — all such companies should maintain a diversified investment portfolio. There is a particular need to avoid a concentration of 'upstream' investments in parent or holding companies or with associated persons, where the activities of the parent etc. may not be in the best interests of policyholders.

20.173 Having regard to these arguments and those expressed in the discussion of life insurance, the Committee **recommends that:**

- (a) For the purposes of calculating the solvency test, the value of any individual asset (including related assets) should be taken into account only up to 5% of an insurance company's total assets.⁴²
- (b) Where the value of an individual asset exceeds this figure (arising, for example, from an asset revaluation or change in the market valuation of an investment), an insurance company should be exempt for twelve months from the applicable solvency margin discipline in respect of that asset.⁴³
- (c) Where any of an insurance company's assets exceed the 5% limit at the time these arrangements are implemented, an exempt period of three years should be permitted.

20.174 Consistent with its view in respect of life insurance companies (see paragraph 20.28), the Committee does not propose any limitations on particular

42 This recommendation is concerned primarily with investments in any single company or project (or related group of companies or projects). So as not to discriminate against smaller insurance companies, the value of an insurance company's own office building might be excluded (or accepted up to a higher percentage for the purpose of meeting the solvency test). It is not intended that holdings of government securities and debt claims on banks and authorised dealers should be subject to this test.

43 However, the circumstances where the exemption applies should be narrow: the exemption should not apply, for example, in the case of portfolio acquisitions during the year.

classes of investment such as real estate, so long as adequate information is provided on the investment spread of the assets (see paragraph 20.65).

C. RATIONALISATION OF COMMONWEALTH/STATE GOVERNMENT REGULATION

20.175 The need for certain classes of insurance companies to comply with both Commonwealth and State government prudential requirements has been criticised because of the extra costs of compliance and because of anomalies and inconsistencies between the various requirements; state requirements are also usually more onerous.

20.176 The Committee would hope that any increase in the capital and solvency requirements under the Insurance Act would remove much of the pressure for state governments to develop their own requirements in respect of particular classes of insurance. In the Committee's view, it would be preferable for insurance companies to be subject **only** to regulation at the federal level under the Insurance Act.

20.177 The Committee is concerned about the tendency toward fragmentation of regulation of insurance companies because of the adverse implications this may have for efficiency and competitive neutrality. It therefore **recommends** that:

- (a) **Where State Governments impose prudential requirements in respect of insurance companies transacting business in their States, the Government should endeavour to secure their agreement to greater uniformity across the States and greater consistency with requirements under the Insurance Act.**
- (b) **To the extent that different arrangements continue to apply at State and Commonwealth level, the Government should seek to establish a consultative mechanism to co-ordinate regulation and supervision, so as to minimise costs of administration and compliance.**

D. REGULATION OF MORTGAGE INSURERS

20.178 The Insurance Commissioner believes that the Insurance Act does not contain any provisions appropriate for the satisfactory financial assessment of mortgage insurers for authorisation purposes or their continuing supervision, having regard to the long-term nature of mortgage insurance contracts. He has expressed concern about the potential losses that mortgage insurers could incur, particularly in times of severe economic downturn.

20.179 The Commissioner has put forward tentative proposals for amending the Insurance Act. He suggests that mortgage insurers should be subject to a number of statutory requirements relating to minimum paid-up capital, unearned income, contingency reserves etc.⁴⁴

⁴⁴ Attachment to letter of 28 June 1979 from the Treasury to all general insurance companies.

- 20.180** The Treasury, however, has advocated:
- self-regulation;
 - the exclusion of mortgage insurance from the ambit of the Insurance Act;
 - prohibition of mortgage insurers from undertaking general insurance business; and
 - the provision of financial and statistical returns, as prescribed.

- 20.181** The self-regulatory arrangements envisaged by Treasury would involve:
- the development of suitable financial standards to be observed on a voluntary basis;
 - the publication of standards and a list of companies meeting them; and
 - occasional reports by the industry body to the Treasurer on the operation of the arrangements.

20.182 It was suggested that standards governing the nature and terms of mortgage insurance contracts should be avoided and that, more generally, the arrangements should comply with the Trade Practices Act. Companies wishing to offer mortgage insurance cover without observing published standards would not be prevented from so doing.

20.183 Although indicating that they are amenable to either the statutory or self-regulation approach, private mortgage insurers have stressed that the crucial consideration in determining the form of regulation is the treatment of HLIC. They are prepared to observe higher prudential standards, provided these also apply to HLIC; however, they only see self-regulation as being feasible if HLIC were sold. The Government has now indicated its firm intention to proceed with the sale of HLIC. (See Chapter 30.)

20.184 The Australian Association of Permanent Building Societies commissioned a report on this subject from the former Australian Government Actuary, Mr S. W. Caffin.⁴⁵ Its main conclusions were that:

- (i) self-regulation would only be practicable where:
 - all mortgage insurers operate on a common basis in relation to pressures from government and the industry;
 - statutory recognition is provided for the self-regulatory measures;
 - adequate powers of enforcement exist;
- (ii) all mortgage insurers (including the HLIC) should be regulated under the Insurance Act, which should require:
 - a separate mortgage insurance fund to be maintained by each mortgage insurer;
 - a mortgage insurer to obtain an annual actuarial report on the adequacy of reserves, with a copy being provided to the Insurance Commissioner;
 - the completion of specially formulated statutory statistical returns and annual accounts;
- (iii) the Insurance Commissioner should also be given ample powers under the Act to deal with unsatisfactory features disclosed in the actuary's report or in the financial and statistical returns.

45 *Report on Regulation of Mortgage Insurance in Australia*, September 1980.

20.185 While generally favouring co-regulation, the Committee believes self-regulation may be appropriate for mortgage insurers because purchasers of mortgage insurance are financial institutions which should be expected to have sufficient expertise to evaluate the financial standing of a mortgage insurer. Nonetheless, Mr Caffin's proposed system of regulation should be considered, if that were clearly the course preferred by the industry.

20.186 The Committee notes the view of Mr Caffin in his report that disclosure in annual reports is inadequate for deriving one or more measures of the adequacy of reserves and provisions established against future claims or the profitability of the business. He also drew attention to the inadequacy of information relating to investments and the failure of one company to separate out claims from administrative expenses. Clearly, sufficient information must be available to enable a meaningful assessment to be made by the financial institutions concerned.

IV INSURANCE AGENTS AND BROKERS

A. BACKGROUND

20.187 There is little regulation of insurance brokers or agents in Australia and self-regulation has been fragmented.

20.188 Until recently, *Queensland* has been the only state which has provided for the licensing of brokers. In that state, requirements are laid down for the handling of premiums and the delivery of documents and the state Insurance Commissioner has powers of supervision extending to the suspension or cancellation of a licence. In other states the actions of both agents and brokers are constrained, by and large, only by common law.⁴⁶ (In August 1981, licensing requirements were introduced for brokers in *Western Australia*.)

20.189 The Law Reform Commission published its report on *Insurance Agents and Brokers* in September 1980. A number of its recommendations relate to issues which have been raised with the Committee or which bear on the stability and efficiency of this sector of the financial system.

B. APPROACH TO REGULATION

(a) Agents

20.190 The Law Reform Commission cites various state Consumer Affairs Departments/Bureaus as noting complaints in regard to misrepresentation by agents of:

- premiums payable for motor vehicle insurance cover;
- the size of surrender values for life insurance policies; and
- the type of life insurance policy being bought.

20.191 Neither common law nor statute are clear regarding the insurer's responsibility for the actions of their agents; this confusion has been compounded by attempts to exclude liability via contractual exclusions.

⁴⁶ Details of the requirements applying in Queensland and of the efforts of agents and brokers to regulate themselves are outlined in Chapter 16 of the Interim Report.

20.192 In its report, the Law Reform Commission recommended that insurance companies should be responsible for loss or damage caused by misrepresentation or other conduct of their employees, agents and brokers operating under a 'binder' which is relied on in good faith by an insured or intending insured in relation to any insurance matter.

20.193 The Commission recommended against the regulation of agents because the costs, particularly direct organisational and supervisory costs, and indirect costs resulting from inhibitions on the operation of free market forces, outweigh any possible benefits.

20.194 The Committee does not express a view on this subject. This should be a matter to be resolved through consultation between the industry and the appropriate authorities, having regard to the suggestions put forward later on insurance brokers.

(b) Brokers

20.195 A survey of insurance brokers conducted by the Australian Bureau of Statistics in 1977-78 showed that the brokers handled more than \$55 million in premiums for householders and house owners insurance and more than \$113 million in premiums in motor vehicle comprehensive insurance. These comprised 16.9% of all brokers' premiums paid or payable to authorised insurers in that year.

20.196 The Law Reform Commission pointed out in its Report that the insured may incur a loss:

- upon the insolvency of an insurance broker who has received premiums from his clients but not paid them to the relevant insurer;
- as a result of professional negligence when the broker has no professional indemnity insurance; or
- arising out of conflicts between their interests and those of their clients inherent in the form of remuneration of brokers.

20.197 The problem revolves principally around the relationship between an insurance company and an insurance broker and the broker and his client. Whereas an agent represents the insurer, a broker represents the insured; the broker is responsible for the payment of the insured's premiums to the insurer; if he does not do so, but is allowed by the insurer to invest the premiums on his own behalf, the insured is not, in fact, covered in the event that the broker fails.

20.198 The Law Reform Commission identified two main practices which increase the risk of insolvency of brokers and thereby expose the insured to risk:

- the mixing of funds received on behalf of the insurers (premiums) and on behalf of the insured (return premiums and claim proceeds) with a broker's general business funds; and
- the retention of premiums, often for lengthy periods, and their investment by a broker for his benefit.

20.199 It recommended that a system of statutory regulation be introduced for brokers. Under this scheme, brokers would be required:

- to register with the Insurance or Life Insurance Commissioner, as appropriate;
- to maintain an appropriate level of professional indemnity and fidelity guarantee insurance;

- to make good any shortfall where premium income is invested in prescribed securities but a loss made;
- otherwise to hold in trust accounts all moneys received in connection with their business as insurance brokers;
- not to invest, for their own benefit, funds received from insurers as settlement of claims or return of premiums;
- to submit to annual audits and be subject to possible inspection by a regulatory body; and
- to disclose to clients details of commissions received from insurers.

20.200 Representative industry bodies earlier advocated a scheme of 'self-regulation' backed by Commonwealth legislation, involving a broker registration body, the licensing of brokers and the establishment of an insolvency fund. (The brokers felt that a government-sponsored licensing system was necessary because self-regulation or voluntary accreditation would be too weak; the public would still be exposed to the risks of dealing with a non-accredited person.) However, more recently they have broadly endorsed the Law Reform Commission's recommendations.

20.201 In June 1981, the Treasurer announced that the Government did not believe that a clear need for Commonwealth regulatory legislation had been established. Losses from broker insolvencies were said to have represented less than 0.1% of premiums handled by brokers over the ten years prior to the Law Reform Commission's report, with businesses rather than individual consumers being predominantly affected.

20.202 The Treasurer suggested that the most effective approach was the development of sound and appropriate self-regulatory practices. He noted that the Confederation of Insurance Brokers of Australia (CIBA) and the Insurance Brokers Association of Australia (IBAA), which are thought to account for around 75% of all insurance brokers, impose membership requirements similar in a number of respects to the controls recommended by the Law Reform Commission.⁴⁷

20.203 The Committee has not sought to explore in full the issues pertaining to the regulation of insurance brokers. On the one hand, it is conscious that certain considerations point to minimal direct government involvement:

- the bulk of premiums handled by brokers is on behalf of businesses which should be in a position to evaluate risk;
- regulatory practices have already been established by the two principal bodies representing the industry (see above);
- regulation might be costly to administer; and
- wide-ranging statutory regulation of the kind proposed by the Law Reform Commission would interfere with competitive market forces by discouraging the exit from the industry of less efficient brokers.

⁴⁷ Members of both bodies are required to:

- keep a separate premium account into which all client moneys are paid;
 - maintain professional indemnity insurance; and
 - have references from other members attesting to their experience and professional standards.
- As well, CIBA members must present an auditor's report on their accounts to the Confederation each year, while IBAA members must present an annual certificate from an accountant stating that their assets (excluding goodwill) exceed their liabilities.

20.204 On the other hand, the Committee would not favour sole reliance on self-regulation. Governments clearly have a role in protecting individual consumers against fraud and misrepresentation.

20.205 The Committee also stresses the desirability of consistent regulation. This has been recognised by the Treasurer, who has expressed the hope that any state legislation will recognise the benefits of the existing self-regulatory arrangements and have regard to the advantages associated with uniformity in controls. He has indicated the Government's readiness to assist in achieving uniformity between the States in this area.

20.206 The Committee favours a system of 'co-regulation', with government legislation laying down the ground rules for an arrangement basically involving self-regulation by an appropriate industry body on which there would be some government representation. It believes early action should be taken by the Government to ensure that appropriate co-operative national legislation is developed. This could provide for the holding of funds in trust accounts in connection with their business as brokers, as recommended by the Law Reform Commission.

20.207 It is also desirable that guidelines for the disclosure of information by brokers to their clients should be developed, as this would facilitate *caveat emptor*. Such guidelines might cover disclosure of such matters as:

- the nature of any contractual relationship between an insurer and the broker; and
- the remuneration received by a broker from the insurer in respect of a client's business.

20.208 On the latter question, as the broker represents the policyholder, not the insurer, it is reasonable to expect that such information should be made available. As well, details of brokerage fees in other areas of the economy are invariably available to those using brokers (e.g. stockbrokers, real estate agents).

20.209 The Law Reform Commission has suggested that disclosure of such information would:

provide a concerned client with the information which is essential for a check to be made on whether the broker's remuneration appears unusually high, a fact which may itself suggest that a broker has been motivated more by his commission than by his client's needs. Disclosure would also encourage and promote informed assessment and, perhaps, questioning by the client of the cost of the services of an insurance broker. It might well lead to a client comparing the cost of the services of different brokers. There are limited opportunities for inquiry and comparison when the client is not told of the amount paid to his broker. As the amount of remuneration is already determined as between insurer and broker, disclosure to the insured would not itself involve significant costs and might in due course even encourage a reduction in the total costs of insurance. The market forces which operate in favour of competition can be most effective when the consumer is made aware of the cost of services rendered on his behalf.

20.210 The Committee endorses this view.

20.211 The Treasurer has indicated that consideration will be given to amending the Insurance Act so as to circumscribe dependence of brokers on what amounts to extended credit and to ameliorate the consequences of broker failure for insured persons and insurers provided this can be done without undue regulation or administrative cost. This issue has been discussed already in Part III of this chapter.

CHAPTER 21: INVESTOR PROTECTION: COMPANIES AND THE SECURITIES INDUSTRY

21.1 Government regulation bearing on the protection of investors in deposit-taking institutions and long-term contractual savers is discussed in Chapters 19 and 20. In this chapter the Committee examines the protection of investors who place funds either directly with corporations as debt or equity or indirectly through collective investment vehicles such as unit trusts; it also looks at the question of how to ensure that dealings in securities occur in fair and informed markets.

A. APPROACH TO COMPANIES AND SECURITIES INDUSTRY REGULATION

21.2 At the outset it is useful to consider the principal features of the regulatory framework for companies and the securities industry, and whether the present approach to regulation is appropriate.

(a) The National Companies and Securities Commission

21.3 The Formal Agreement executed by the Commonwealth and the States in December 1978 laid down a framework for a co-operative Commonwealth-State scheme providing a uniform system of law and administration regulating companies and the securities industry. The National Companies and Securities Commission (NCSC) is responsible to the Ministerial Council for the relevant legislation and its overall administration, but administration of the legislation within each State and Territory is delegated by the NCSC to the relevant state Corporate Affairs Commission (CAC).¹

21.4 The **aims** of the national companies and securities scheme may be summarised as being:

- to achieve greater uniformity in the law and its administration;
- to promote commercial certainty;
- to reduce business costs and increase the efficiency of capital markets; and
- to enhance the confidence of investors in securities markets.

21.5 The NCSC seeks to achieve these aims by ensuring that:

- information which is made available to investors in securities markets is sufficiently accurate, timely and objective to enable investors to make rational investment decisions;

¹ For details of the scheme and, in particular, the responsibilities of the NCSC, refer to Chapter 17 and Appendix 11 of the Interim Report.

- an open and informed stock market exists so that all shareholders have equal access to information bearing on investment decisions;
- the efficiency of securities markets will be encouraged by regulating the conduct of securities business to promote desirable market practices;
- high standards of corporate behaviour are maintained, and there are adequate remedies and penalties for breaches of company law.

21.6 The establishment of national legislation and the NCSC should do much to meet a major criticism by the Rae Committee² of the prevailing approach to regulation that the lack of uniformity in the law and its administration had hampered investigation of abuses in securities markets and enforcement of the law.

21.7 It is not always sufficiently well recognised that the regulation of corporate practices, whether by government authorities or by self-regulating bodies, may impinge on the efficiency of companies' operations or securities markets and reduce the potential benefits to investors.

21.8 As noted in Appendix 11 of the Interim Report, the NCSC has substantial discretionary powers.³ The Committee accepts the need for such powers (and indeed recommends their extension below in one important respect), as flexibility and speed in responding to developments in the market are essential for effective regulation of companies and the securities industry. However, it is important that the exercise of such wide and flexible powers should not lead to excessive regulation, and that the actions of the Commission should be subject to maximum public exposure and discussion.

21.9 Accordingly, the Committee looks to the NCSC to consult closely with companies and participants in the market in the development of investor protection arrangements.

(b) Self-regulation and Co-regulation of Securities Markets

(i) Stock Exchanges

21.10 General responsibility for the surveillance and regulation of the stock market has traditionally rested substantially with the individual stock exchanges and the Council of the Australian Associated Stock Exchanges (AASE).

21.11 A number of advantages are generally ascribed to self-regulation:

- it offers speed and flexibility in administration;
- regulation is initiated by, rather than imposed upon, the controlled group, increasing the likelihood of compliance;
- it goes beyond the 'letter of the law' by providing ethical standards of conduct and behaviour;
- it eliminates the need for large government bureaucracies, the self-regulating body being responsible for much of the routine administrative tasks; and

² *Australian Securities Markets and their Regulation*, Report of the Senate Select Committee on Securities and Exchange, AGPS, Canberra, 1974.

³ These discretionary powers include wide powers of inspection, the power to make certain orders including the suspension of trading in particular securities and other powers under the relevant Codes for which it is responsible.

- it allows the stock exchanges to draw on their collective skills and expertise, enhancing the effectiveness of the regulatory process.⁴

21.12 However, self-regulation has its shortcomings. Some of these were enumerated by the Rae Committee and, more recently, by the Wilson Committee in the United Kingdom. In particular:

- the lack of investigatory powers, appropriate sanctions or authority to enforce rules means that the success of self-regulation depends heavily on the voluntary acceptance of the power of the self-regulating authority;
- there is a possibility of self-serving, anti-competitive regulation or non-enforcement of rules;
- activities and organisations tend to develop outside the jurisdictional power of the self-regulatory body; and
- the increasing complexity of financial markets may be less amenable to informal, non-statutory methods of regulation, particularly by part-time committees.

21.13 It is in recognition of these shortcomings that the focus has shifted in recent years towards more direct government participation in the regulatory process, e.g. with the enactment of Securities Industry Acts and increased regulation of takeovers and other market practices. Essentially, what has developed — and is currently being extended by the NCSC — is a framework of **co-regulation** under which the stock exchanges are responsible for ensuring that requirements set under legislation or by the exchanges themselves are enforced.

21.14 Co-regulation offers many advantages that are not available either with a statutory or self-regulatory approach. Given the Committee's view that there should be close consultation with industry representatives in relation to the exercise of NCSC's discretionary powers, co-regulation should reduce the rigidities usually associated with legislative approaches. Moreover, meaningful participation by industry representatives in the policy-making process should encourage co-operation and thus reinforce the legal basis for the exercise of the NCSC's powers.

21.15 The Securities Industry Code provides that the Ministerial Council may approve the establishment of a new stock exchange, subject to it being satisfied as to its business and listing rules and that approval will be in the public interest (s.38). So far as existing stock exchanges are concerned, the authorities' power is more limited; the Ministerial Council may only **disallow an amendment** to an Exchange's business or listing rules (s.39). The Committee considers that this anomaly unduly limits the scope of co-regulation. While it is envisaged that the stock exchanges should continue to retain responsibility for their business and listing rules, the authorities should have the power to **require an amendment** to those rules if it considers this to be in the public interest.

21.16 The Committee therefore **recommends** that **the Securities Industry Act should be amended to provide the authorities with the power to require a stock exchange to amend its business or listing rules where this is considered to be in the public interest.**

⁴ See the Report of the Senate Select Committee on Securities and Exchange, op. cit., Chapter 16, for a detailed discussion of these points.

21.17 Even after this recommendation is implemented, the stock exchanges will retain significant responsibilities for the terms and conditions to which those participating in stock markets are subject. Some benefits, including greater impartiality, might be achieved from the greater involvement of other interested parties in the decision-making process.⁵ An extension of the number of outside directors of the AASE would be a move towards this. The Committee, however, makes no specific recommendation on the matter.

(ii) The Futures Exchange

21.18 The Sydney Futures Exchange was established in 1959 to deal in greasy wool futures. Currently, trading occurs on the Exchange in wool, live cattle, gold, boneless beef, interest rate and currency futures. The Exchange enables those dealing in these commodities, whether as producer or buyer, to obtain protection against future price fluctuations.⁶ As with a stock exchange, if there were scope for market rigging and other manipulative practices, the confidence of participants would be affected and the effectiveness of the Exchange would be impaired.

21.19 The regulatory framework of the Sydney Futures Exchange, while broadly similar to that of the stock exchanges⁷, is not as developed and has distinctively different features.

21.20 The Board of the Exchange is responsible for supervising and monitoring the conduct of members. Proposed new rules for the Exchange have recently been released. Subject to confirmation by members, the rules are to take effect on 1 January 1982.

21.21 The proposed new rules provide for:

- floor members to have net tangible assets of \$100 000, with associate members who deal with the public being required to have net tangible assets of \$50 000;
 - members to place clients' funds with certain approved corporations and, in particular, not to use these funds to finance their own trading or that of other clients;
 - members to meet regular reporting requirements;
 - the calling of deposits and margins from clients (margins are to be called when deposits are impaired by 50%); and
 - the Board to require members to contribute to a Fidelity Fund or indemnity insurance scheme.

21.22 The Committee believes that there should be a national approach to the regulation of futures exchanges. In the absence of such an approach, any efforts to regulate the Sydney Futures Exchange could be frustrated if this were to lead to the futures market being relocated in another state where there was no comparable regulation.

⁵ In the United Kingdom a Council for the Securities Industry was established in 1978, with a broadly based membership. It is responsible for co-ordinating self-regulation among all users and practitioners in the securities industry and endeavours to ensure that the supervision of the securities markets operates satisfactorily and in the public interest.

⁶ In essence, a futures contract is an agreement to buy or sell a particular commodity at some specified future date, but at a price determined now by competitive bidding.

⁷ Legislative support for the Exchange's business rules is provided under the NSW Futures Markets Act. Details of the relevant provisions of this Act and the thrust of self-regulation are provided in paragraphs 17.158-170 of the Interim Report.

21.23 The co-regulatory approach adopted in respect of the stock exchanges should also apply with futures exchanges, with the Ministerial Council or NCSC having similar responsibility for ensuring the adequacy of the Exchange's articles, business rules etc.

21.24 The Committee *recommends* that the Sydney Futures Exchange, and any other futures exchange that might be established, should be subject to an approach to regulation comparable to that applying to stock exchanges, with the authorities having responsibility for approving and requiring changes to the exchange's articles and business rules.

(c) Regulation of Market Practices and Participants

21.25 The Rae Committee detailed various instances of improper practices in securities markets. As a result of its work, greater emphasis has been placed on adequate and timely disclosure as well as on the regulation of a range of market practices. Examples of the latter include the introduction of:

- restrictions on insider trading and short selling;
- prohibitions of manipulative practices, such as market rigging⁸;
- takeover regulation; and
- licensing requirements for market participants and certain ongoing supervision by the Corporate Affairs Commissions in the various states.

21.26 Market practices should be as free of regulation as is consistent with the objective of maintaining investor confidence. So long as they are given the information necessary to make soundly based investment decisions, investors should be free to invest according to their risk/return preferences. While some regulation is necessary, an active, broadly based market and an informed public will do much to reduce the incidence of undesirable practices; an effective legal system should also provide investors with remedies against fraud and other malpractices where these do occur.

21.27 At present, some of the restrictions (e.g. the insider trading provisions) may not be fully effective; others (e.g. restrictions on short selling) may not be compatible with efficiency. A number of specific issues in relation to the present regulation of companies and market practices are discussed later in this chapter.

(d) Role of Disclosure

21.28 The principal method adopted in the companies legislation for the protection of investors with and creditors of companies is a required minimum level of disclosure through annual accounts and in connection with public borrowings.

21.29 In general, while disclosure protects investors and creditors by reducing the opportunity for fraudulent activities, it is also an account of the performance of the corporation. As such, it helps investors and other members of the community assess risks and make decisions. As noted elsewhere, accurate and timely disclosure also has an important role in the mobilisation of savings and the pricing and allocation of funds to efficient users.

21.30 However, the Committee recognises that, while there is some scope for substitution, direct regulation can never be fully replaced by disclosure.

⁸ See the Interim Report, paragraphs 17.82–122.

B. COMPANY REPORTING AND ACCOUNTING STANDARDS, AND ACCOUNTABILITY

(a) Reporting Standards⁹

21.31 The information provided by a listed public company influences trading in its securities and is thus essential for a fair market. It is also in the interests of creditors that reporting standards ensure that the 'true' financial position of a company is revealed in its accounts.

21.32 Information disclosed by companies may also be relevant to the decisions of others **beyond** the immediate group with a financial stake in these companies. Such information may, for example, have a bearing on government policy decisions in respect of industrial relations.

21.33 Some commentators have argued that there is a tendency for companies to take statutory requirements as the maximum reporting obligation. The Committee does not accept the generality of this statement; many companies in fact disclose considerably more than they are obliged to.

21.34 The Committee is aware of the significant progress voluntarily made by many corporations and institutions in this area under the auspices and influence of the Australian Institute of Management. Under that influence, corporations and others are encouraged to prepare and report information well beyond the statutory minimum. While indicative standards are set, the adjudication process is highly conducive to innovation. Awards are given for high reporting standards in respect of annual reports.

21.35 The Committee is conscious, however, of the number of corporations and institutions which do not respond to these influences. Reporting requirements imposed under the Ninth Schedule of the Companies Act, in some respects, may not represent desirable minimum levels of disclosure and may therefore usefully be expanded.¹⁰

21.36 It accordingly suggests that **the NCSC should confer with the Australian Institute of Management (and other appropriate bodies) on the need, or otherwise, for government action to improve the standard of reporting by public companies and like institutions.**

21.37 The provision of information cannot be viewed as purely a private matter that should be left to market forces. However, just as insufficient information imposes costs on the whole community, excessive reporting requirements may also impose substantial costs on those required to report, without necessarily benefiting those the information is designed to assist. In particular, there is a need to minimise the degree of duplication of reporting requirements to various authorities, trustees, investors etc.

21.38 The Committee believes that a flexible approach to reporting standards is highly desirable so that they can be readily revised when the need arises. For this reason, the Committee **endorses** the provision in the Companies Bill 1981 for

⁹ In this section, the Committee generally considers the question of disclosure standards (i.e. **what** is reported). The issue of accounting standards (i.e. **how** various items should be treated and the manner in which they should be disclosed) is taken up later.

¹⁰ The Ninth Schedule remains essentially unchanged in initial regulations to the Companies Bill 1981, Explanatory Memorandum, AGPS, paragraph 1298 et seq.

accounts and group accounts requirements to be prescribed by regulation (Clause 269(8)). This should enable the requirements to be kept in line with prevailing accounting practices and terminology as well as ensuring timely amendments in the interests of meaningful disclosure.

(b) Reporting by Financial Intermediaries

21.39 Financial intermediaries are subject to a range of disclosure requirements.¹¹ These requirements lack consistency, being imposed in different jurisdictions (State and Commonwealth) and administered by different authorities. For instance, the various state Acts which regulate building societies and credit unions impose disclosure requirements that may differ from each other and from those of the Companies Act; various Commonwealth Acts also impose differing disclosure requirements, e.g. the Banking Act and Life Insurance Act.

21.40 While differences in financial reporting practices can be justified in many cases because of differences in the nature of the business undertaken, in some instances variations appear to have no clear rationale, e.g. life offices are not required to give details of their accounts in the immediately preceding year.

21.41 While there is no way of assessing precisely the effects of differing reporting requirements, an element of non-neutrality is introduced into the investment decision-making process. The allocative efficiency of financial markets may thus be impaired.

21.42 Stability considerations should not prevent the disclosure of key financial variables, such as bad and doubtful debts. Indeed, the discipline of disclosure can contribute importantly to stability by encouraging intermediaries to take prompt and effective action to minimise and correct problems. Such action may not always be forthcoming if the problems and their effects can be hidden.

21.43 The Committee emphasises the importance of **consistent** disclosure requirements for competing groups of financial intermediaries.

21.44 Accordingly, it **recommends** that **all financial intermediaries should be subject to consistent reporting requirements, which should be prescribed in regulations to the relevant legislation.**¹²

21.45 The requirements of the Companies Act should serve as a benchmark, but with variations to allow for the specific nature of the business undertaken.

(c) Accounting Standards and their Enforcement¹³

21.46 Existing accounting standards, their development and their enforcement have been criticised on the grounds that:

- they lack sufficient precision and objectivity and thus permit the same transactions to be reported differently, so impairing the comparability of financial statements;

11 The major disclosure requirements to which various financial intermediaries are subject are summarised in Chapters 15, 16 and 17 of the Interim Report.

12 Specific aspects of disclosure by different financial intermediaries are discussed in Chapters 19 and 20.

13 Accounting standards in Australia are set by the Institute of Chartered Accountants in Australia and by the Australian Society of Accountants in a series of 'Statements of Accounting Standards' and hence do not have the force of law. Nonetheless, compliance with these accounting standards is generally regarded by the Corporate Affairs Commissions as prima facie evidence that accounts show a 'true and fair' view of the state of affairs of a company as required by the Companies Act.

- the progress of reform is slow because of inadequate research into standards and lack of agreement within the accounting profession;
- the standards are not effectively or consistently enforced, there being no single body to ensure compliance; and
- the standards can affect investment behaviour in the economy and should not therefore be left solely to the accounting profession to determine.

21.47 Critics point out that some major company collapses during the 1970s closely followed the publication of audited financial accounts (or prospectuses containing accounts) which showed the companies concerned to be solvent and even profitable.

21.48 The problem lies largely with the imprecise nature of accounting standards. The Sandilands Committee in the United Kingdom observed that:

... there are many different ways of measuring the assets and liabilities of a company at a particular date or the income arising during a particular period. Each may lead to a 'true view' of the company's activities from a certain point of view...¹⁴

Or, as the former NSW Corporate Affairs Commissioner noted in 1974:

there are as many true and fair views as there are viewers.¹⁵

21.49 As stressed elsewhere in this Report, it is important that information disclosed by companies should be meaningful to users of that information. Stringent reporting requirements will be of little benefit to users of accounts if accounting standards are so imprecise that the true state of affairs or a trend cannot be assessed.

21.50 The Committee has not concerned itself with the deficiencies of particular accounting practices. However, it makes the following observations in respect of accounting standards and their enforcement, and the present approach to self-regulation of accountants.

(i) The Development and Adoption of Accounting Standards

21.51. The report in 1978 of the Accounting Standards Review Committee¹⁶ concluded that Australian accounting standards:

- were not based on any explicit definition or interpretation of 'state of affairs', of 'profit' or of 'a true and fair view' of these, and therefore provided no safeguard against inconsistent treatment of the particular subject matters of specific standards;
- being based on the historical cost principle, did not provide valid indications of the state of affairs and profit of a company;
- permitted the mixture in accounts of the products of different kinds of calculation, as if they were information of the same kind; and
- were not demonstrably relevant to the decisions or appraisals of users of accounts.

21.52 That committee concluded that the latitude permitted by the Companies Act in respect of the use of a variety of asset valuations should be reduced. While

¹⁴ *Inflation Accounting*, Report of the Inflation Accounting Committee, Chairman F. E. P. Sandilands, 1974.

¹⁵ F. H. O. Ryan, 'A True and Fair View Revisited', in *The Australian Accountant*, February 1974.

¹⁶ *Company Accounting Standards*, Report of the Accounting Standards Review Committee, 19 May 1978.

the accounts and audit provisions could be simplified by a tighter specification in the Act of what should be required, the Accounting Standards Review Committee recommended adoption of a general accounting standard, with statutory or regulatory endorsement. The standard suggested provides for the valuation of assets on a uniform and up-to-date basis, and for the calculation of profit on a basis which takes systematic account of the effects of inflation on the affairs of companies.

21.53 An alternative approach suggested by others is that the NCSC should be involved in the formulation of accounting standards through the establishment of an Accounting Standards Review Board, charged with the review, design and adoption of accounting standards.

21.54 On the other hand, it has been argued that the present approach has the merit of flexibility; that, if used properly, it provides appropriate information; that the process of formulating and enforcing accounting standards is, on the whole, operating adequately; and that there is therefore no need for any government involvement in this area.

21.55 On the assumption that individual accounting standards will continue to be developed, the Committee considers that the **design** of such standards would be most appropriately left with the two professional accounting bodies as these bodies have the necessary expertise. If governments were to become involved in this process, there would inevitably be delays in the development of standards while the necessary expertise was developed; and it is questionable whether the standards would be as soundly based or as closely attuned to the needs of users of accounts as standards developed by those actively involved in accounting practice.

21.56 Nevertheless, the Committee believes that accounting standards should have legal backing in order to facilitate their enforcement; their adoption — which requires a balancing of the interests of different users — should not be left entirely to the accounting bodies. It would be more desirable for such decisions to be taken by a body on which government and other interested parties were represented.

21.57 The Committee therefore **recommends** that:

- (a) **The two professional accounting bodies should continue to be responsible for the design and development of accounting standards.**
- (b) **An Accounting Standards Review Board should be established with responsibility for deciding on the adoption of accounting standards, having regard to the needs of different users; the NCSC, professional accounting bodies and other interested parties should be represented on the Board.**
- (c) **Accounting standards recommended by such a board should be given legislative support.**

(ii) Enforcement of Accounting Standards

21.58 There is some evidence to suggest that insufficient attention has been given by the accounting profession to the enforcement of accounting standards. Of 2463 company accounts examined by the NSW Corporate Affairs Commission in 1979, 45% had not fully complied with accounting standards. Non-compliance was significant enough and/or disclosure of the reasons and financial effects of non-compliance were sufficiently inadequate in the case of 570 companies (23%) to warrant the Commission requisitioning them for additional information in respect

of 804 matters. Not all of those companies which had not complied had had their accounts qualified.¹⁷

21.59 The two accounting bodies appointed a committee in 1980 to determine whether the regulatory process was satisfactory. This committee recommended that cases giving rise to public concern because of the actions (or inaction) of accountants should be the subject of an inquiry by a committee on which the two accounting bodies were represented. However, it recommended against the representation at this time of lay members on the committee of inquiry or on a proposed joint disciplinary committee, on the grounds that this 'would not, of itself, satisfy the demands of the profession's critics or provide a practical solution'. The latter reflected the judgment that lay members would be perceived as simply reflecting the profession's viewpoint because of their close association.

21.60 Whether or not lay representation is desirable, the Committee believes there would be merit in providing for the representation of an officer from the relevant Corporate Affairs Commission on such committees. This would constitute an example of effective co-regulation and do much to allay public fears of a 'whitewash' approach to self-regulation. It would also facilitate decisions by the Corporate Affairs Commission about whether to initiate a prosecution. Most importantly, it would facilitate the development of appropriate government policies on matters, including accounting standards, relating to the accounting profession.

21.61 Where the relevant Corporate Affairs Commission did not seek representation, it should still satisfy itself that the scope, procedures etc. of such inquiries were satisfactory to allow an objective and fair examination of the issues involved.

21.62 The Committee therefore *recommends* that the **National Companies and Securities Commission should arrange with the two accounting bodies for representation of the relevant Corporate Affairs Commission, at its discretion, on any committee appointed to inquire into public interest cases, and on any disciplinary committee that may be established.**

(d) Presentation of Company Reports

21.63 It has been suggested that investors would benefit from the production of annual reports in an easily readable and understandable form. A dual system of reporting has been advocated — with a company producing a summarised version of its annual report for shareholders, highlighting the major aspects of a company's operations, while lodging more technical and detailed information with the appropriate authorities. The latter information would also be available to shareholders and interested parties on request.

21.64 The Committee has already indicated its support for action to improve reporting standards. However, it has reservations about the proposal for a dual system of reporting. The Committee would be concerned with any substantial reduction in the flow of information to shareholders. This would detract from efforts to improve the overall quality of reporting and could discourage individual investors from assessing the risk/return associated with an investment.

¹⁷ These figures take no account of whether non-compliance was of a major or minor nature (e.g. whether the breach involved lack of disclosure of an accounting method or complete non-compliance with a standard). Report of the NSW Corporate Affairs Commission, 1979, p. 79.

21.65 Accordingly, the Committee does not recommend the adoption of such a system of reporting to shareholders. In its opinion, it is not an appropriate substitute for the disclosure of information in a more simplified, readable form.

(e) Frequency of Reporting

21.66 It has been suggested to the Committee that investors would benefit from access to more timely information, and that listed companies should be required to make quarterly reports.

21.67 The 1974 Corporations and Securities Industry Bill, which lapsed with the change in government in 1975, contained a provision requiring the issue of quarterly, unaudited accounts in addition to annual reports of public companies. The quarterly report was to contain:

- particulars of the corporation's profit or loss and its turnover;
- details of any transactions or events of a material or unusual nature; and
- any other matters which may be prescribed by regulation.

21.68 It was intended that corporations should supply substantially less information in these quarterly reports than required in respect of annual reports. The issue was fully explored in evidence to the Senate Select Committee on the Corporations and Securities Industry Bill.¹⁸

21.69 In 1975 the AASE listing rules were amended to require half-yearly reports (which may be unaudited) — on a consolidated basis where applicable — providing such details as:

- turnover (as defined);
- investment and other (like) income;
- taxation, interest and depreciation;
- operating profit or loss;
- extraordinary items;
- material influences during the period or since;
- dividends;
- acquisitions and disposals of subsidiaries; and
- issued and quoted securities at end of period.¹⁹

21.70 Disclosure of information quarterly to the exchanges and to shareholders would contribute to a more informed market. Such reports might reasonably include the information contained in the current half-yearly reports required by AASE listing rules.

21.71 While companies are required to send annual reports to shareholders, no comparable requirement applies in the case of interim reports. Companies paying half-yearly dividends, however, would ordinarily enclose an interim report. The Committee considers that a more informed market would result (individual investors would benefit particularly) if listed companies were required to send interim reports, to shareholders. It recognises, however, that certain costs would be involved — especially for companies not paying dividends twice a year. It

¹⁸ Senate Select Committee on the Corporations and Securities Industry Bill 1975, Official Hansard Transcript of Evidence, Commonwealth of Australia, 1975.

¹⁹ AASE Official Listing Requirements Section 3B and 5, (Appendix 3).

believes costs would be lessened if reports were only required to be made available on request.

21.72 Accordingly, the Committee *recommends* that:

- (a) Stock exchange listing requirements should include provision for quarterly reporting.²⁰
- (b) The requirements of such reports should be less onerous than for annual reports.

(f) Role and Independence of Auditors

21.73 The joint accounting bodies require that auditors not only be independent but be seen to be independent. This is intended to preclude persons from acting as auditors in situations where their independence might be questioned. Nonetheless, the actual degree of independence of auditors from board and management has been questioned because:

- the fees and expenses of an auditor, while paid by the company, must be negotiated with the board (or management);
- auditors perform additional services traditionally associated with managerial functions and goals (e.g. taxation advice and management consultancies); and
- the relevant legislation makes no provision for the reappointment of auditors by shareholders or for the rotation of auditors.²¹

21.74 The role of the auditor as an independent ‘watchdog’ (or custodian) of shareholders’ interests in attesting the veracity of accounts has also been criticised following the failure of companies shortly after the release of unqualified audited accounts which showed the companies concerned to be solvent and profitable.

21.75 The fees of auditors for audit and other services are required to be shown separately in the accounts (or notes thereto). Shareholders can thus review the reasonableness or otherwise of such fees. While the present position has some obvious shortcomings, the Committee considers any change thereto would be generally impracticable (but see the recommendation below).

21.76 Auditors should not be prohibited from performing additional services, unless of course there are clear conflicts of interest. However, there may be merit in requiring auditors to declare each year in their reports to shareholders the nature of any other services provided. Alternatively, such a report could be lodged with the Companies Auditors Board and/or Corporate Affairs Commission.

21.77 With regard to the method of appointment, a company’s auditor is appointed at the first annual general meeting and usually holds office until his death, retirement, resignation, ineligibility or removal. An auditor may be removed from his office by a resolution at a general meeting of which special notice has been given. The independence of auditors was intended to be strengthened by

20 The establishment of a ‘Second Board’ on which smaller listed companies might be included (see Chapter 33) would enhance the feasibility of applying such a requirement to companies listed on the main board.

21 The issue of the independence of auditors is accentuated by the subjectivity of present accounting standards. A tightening of accounting standards so that auditors are called on to make fewer judgments about what is ‘true and fair’ would do much to reduce concern about their independence, though of course the need for discretionary judgments can never be entirely removed.

the legislative amendments which now govern appointment and continuity of office. However, some claim these have been perverse in their effect.

21.78 A somewhat novel approach to the question of independence is the suggestion that auditors might 'rotate' every five years or so. While this would do much to ensure auditors' independence, the Committee does not favour this because of the significant costs likely to be associated with the regular changes inherent in this proposal.

21.79 It is inevitable that there will be instances of disagreement between auditors and the board. If the integrity of auditors is to be preserved, such disagreements, by themselves, should not be the basis for removing auditors or requiring their resignation. This would defeat the whole purpose of an independent audit and weaken the position of the shareholder vis-a-vis the board. There is much to be said for the system in the United Kingdom where an auditor who resigns has the power to call an extraordinary general meeting to discuss the circumstances of his resignation.

21.80 The Committee *recommends* that:

- (a) Auditors should be required to declare each year in their reports to shareholders the nature of any other services provided to the companies concerned.**
- (b) Consideration should be given to amending the Companies Act to give auditors who resign the explicit right to call an extraordinary general meeting for the purpose of considering the circumstances of their resignation. Such a meeting should resolve whether the company or the auditor should bear the direct costs associated with the holding of the meeting.**

(g) Shareholder Participation

21.81 It has been suggested to the Committee that individual shareholders usually lack influence over the well-organised and tightly knit board and management of large companies. Some suggestions put to the Committee for increasing corporate accountability are:

- two-tier board structures (involving the creation of an additional supervisory non-executive board with powers of control over management)²²;
- the introduction of audit, salary and other subcommittees of the board, the composition of which would be principally non-executive;
- the election of non-executive directors to represent minority shareholdings; and
- the introduction of cumulative voting to allow minority shareholding groups representation on the board while still giving majority shareholders control.²³

22 The issue of two-tier boards is discussed in P. H. Davies, 'Equity Finance and the Ownership of Shares', Chapter 15, AFSI *Commissioned Studies and Selected Papers*, Part 3, AGPS, Canberra, 1981.

23 Unlike the 'first past the post' system currently in use, with cumulative voting, the voting power of each shareholder is determined by multiplying the number of his shares by the number of directors to be elected. Each vote is cast only once; however, a shareholder may cast all his votes for one candidate or divide his votes between several. The issue of cumulative voting is discussed in some detail in Davies, op. cit., Chapter 15.

21.82 While the NCSC might usefully include an examination of these and similar suggestions in its future work program, the Committee does not believe there are significant constraints at present on the ability of interested shareholders to participate in the affairs of their company. The Committee sees the problem largely as one of shareholder apathy — a problem that may partly reflect unfamiliarity with accounting and financial concepts and the complexity of the accounts themselves. The Committee has addressed itself to both these issues in this chapter (see in particular Sections B(a), B(c) and C).

21.83 It is true that a feeling that they can have little influence on a company's decisions may discourage individual shareholders from attending or participating in annual meetings. However, if shareholders are unhappy about the way a company is being run they can sell their shares; if a sufficient number do so, the price will fall and the company will have difficulty in raising new funds and become more vulnerable to takeover. In this broader sense, shareholders as a group can ultimately exercise significant influence on the board and management — although the influence might be more constructive if exercised at an earlier stage. The Committee also notes the useful function played by the Australian Shareholders Association in representing the interests of shareholders, particularly small shareholders.

21.84 The Committee believes that improved disclosure and accounting standards, which would permit comparison of the performance of different companies, would also reinforce the effectiveness of shareholder participation (in the broader sense suggested above).

C. EDUCATION OF INVESTORS

21.85 During its deliberations and through certain survey material made available to the Committee, it became apparent that some important gaps exist in the community's knowledge of basic principles governing investment and, more generally, the operation of the financial system.²⁴

21.86 The Committee is aware of some real lack of appreciation and knowledge in respect of:

- the relationship between risk and yields on alternative investments;
- the meaning and interpretation of published financial data (in annual reports and prospectuses);
- the nature of responsibilities assumed by governments in protecting investors (e.g. there is a widespread belief that bank depositors are guaranteed against loss); and
- the role of stock exchanges and their operating procedures.

21.87 Such inadequacies in the community's understanding of the financial system can significantly impede the efficient operation of capital and securities markets.

21.88 The need for a broadly based education campaign to encourage community understanding of financial concepts and market processes is widely recognised.²⁵

²⁴ The more general question of the availability of information to investors and information gaps is discussed in Chapter 44.

²⁵ See, for example, the submission by the Australian Consumers Association.

At the same time, the Committee's attention has been drawn to action already taken by various finance industry groups (e.g. the Life Insurance Federation of Australia, the banks and the stock exchanges) to inform the public on alternative forms of investment and possible pitfalls.

21.89 While the Committee appreciates that in many instances the material presented is not wholly objective, the **overall** effect of such education programs is to:

- raise the general sophistication of investors and assist investors to 'protect' themselves;
- encourage greater participation by Australians in industry and the development of resources; and
- encourage the development of competitive markets.

21.90 The Committee also believes that the media are playing an increasingly active role in public education, particularly through the regular publication of comparative information on alternative investments and the nature of risks involved with such investments.

21.91 Governments can assist in the education of investors and potential investors:

- through school and community education programs;
- by easing restrictions on the way certain financial intermediaries (e.g. finance companies and unit trusts) may approach the public; and
- by removing public misconceptions about the nature of government responsibilities for the protection of investors.

21.92 The Committee believes that the Reserve Bank is well placed to play a useful role in community education on financial matters. It notes that the Bank has already produced a booklet containing information on the types and sources of finance available to the business community, particularly small and medium-sized businesses.²⁶ **In the Committee's view, a comparable booklet for small investors may serve a worthwhile purpose.** Such a booklet might explain basic investment and financial concepts, the risk/return characteristics of different investments, and outline the various opportunities available for investment of small funds and how investors might gain access to them.

D. REGULATION OF MARKET PRACTICES

(a) Purchase by a Company of its Own Shares

21.93. The Committee received several submissions which recommended reform of the existing law (section 67 of the Companies Act) to permit companies to purchase their own shares.²⁷ The rationale for the present restriction is to protect both creditors and shareholders by preventing a company from:

- supporting the market in its shares, for example, to prevent a takeover;

²⁶ *Money for Business*, Reserve Bank of Australia, April 1980.

²⁷ Section 67 of the Companies Act provides that, in general, a company may not deal in its own shares nor give financial assistance to anyone purchasing or subscribing to its shares or, where it is a subsidiary, the shares of its holding company. (See Interim Report, paragraph 17.87.)

- assisting an outsider to take over the company; and
- reducing shareholders' funds at the possible expense of creditors.

21.94 The practice is permitted in a number of overseas countries and has recently been under consideration in the United Kingdom. A Green Paper issued in 1980²⁸ examined the proposal that public and private companies should be permitted to buy their own shares.²⁹ The Paper concluded that there was merit in the proposal:

- investment in **private companies** would be more attractive, as shareholders would have additional means of disposing of their shares, while permitting the remaining members to maintain ownership and control of the business;
- on the other hand, **public companies** could find it a useful method of returning surplus resources to shareholders rather than employ them in uneconomic ways.

21.95 Public limited companies in other European countries are generally permitted to repurchase their shares, though subject to strict conditions imposed by the EEC Second Directive on Company Law. These include requirements that:

- transactions may only be in fully paid-up shares;
- authorisation must be given, and the terms and conditions determined, by a general meeting of shareholders;
- details of purchases and the reasons for them must be set out in the annual report;
- a company must not hold or acquire more than 10% of its subscribed capital;
- the acquisitions must not have the effect of reducing net assets below the amount of subscribed capital plus undistributable reserves; and
- voting rights must be suspended in respect of the subject shares.

21.96 In the United States, companies are permitted to repurchase their own shares so long as they do so out of profits. There appear to be no limitations on the percentage of capital which may be acquired. Share repurchases become 'treasury shares' and are not entitled to dividends or carry voting rights. They are not cancelled, but are available for resale.

21.97 It has been suggested that the relaxation of restrictions on companies purchasing their own shares might:

- permit and facilitate corporate restructuring to meet changing circumstances; e.g. it would allow the early retirement of capital no longer necessary for the operation of a company after the sale of an operating division or subsidiary;
- make it easier for unlisted companies to attract outside shareholders — without the need for public listing — as shareholders wishing to sell their holding could, under certain circumstances, be bought out by the company if other shareholders were unable or unwilling to purchase the available shares; and

²⁸ *The Purchase by a Company of its Own Shares*, A Consultative Document, June 1980, HMSO, Cmnd 7944.

²⁹ In 1962, the Jenkins Committee in the UK, Cmnd 1949, also considered this issue, concluding that it was useful for a number of purposes and that it should be possible to devise uncomplicated but stringent safeguards.

- facilitate the development of stock option and like arrangements by enabling a company to purchase an employee's shares upon retirement.

21.98 The Committee has not examined this complex issue in detail. However, on the basis of available information, it believes that further study is warranted.

21.99 The Committee suggests that **the National Companies and Securities Commission should consider, at an early date, whether companies might be permitted to purchase their own shares, provided there are appropriate safeguards for shareholders and creditors.**

(b) Reduction of Share Capital

21.100 A closely related issue is whether companies should have greater scope to reduce their own capital.³⁰

21.101 To reduce its capital, a public company at present has to comply with procedures involving delays and substantial costs. As a result, companies tend not to resort to these procedures, so that funds are said to become 'locked up'.

21.102 Looking solely from the view of the efficient operation of the capital market, there is merit in simplifying s.64 to facilitate the ability of companies to reduce their own capital.

21.103 The Committee notes that Clause 123 of the proposed Companies Bill will introduce some flexibility by allowing resolutions to reduce share capital to have retrospective effect. The Bill provides for a company, if authorised by its articles, to reduce its capital in any way it chooses, but includes procedures to safeguard the interests of creditors who do not consent to the reduction.

(c) Issue of No Par Value Shares and Shares at a Discount

21.104 The Companies Act makes no provision for a company to issue shares without a par value, reflecting the requirement that companies should maintain their capital.³¹

21.105 Broadly, this requirement aims to ensure that:

- creditors of a limited liability company are made aware of the further liability of shareholders (being the amount uncalled or unpaid on the shares);
- creditors and other interested parties know that assets equivalent to the par value have been or will be made available for the company's use in pursuit of the objectives set out in its memorandum and articles of association.

21.106 However, it has been suggested that these aims are far from being fully realised, as:

- many shares issued have a low par value and are normally **fully paid up** on allotment; thus the uncalled capital element which existed to some degree in the past, and which was designed to protect creditors, often does not exist with the modern company;

³⁰ Under s.64 of the Companies Act, a company may only reduce its share capital if a special resolution passed by the company's shareholders is confirmed by the Court. (See paragraph 17.86 of the Interim Report.)

³¹ Section 59 of the Companies Act and Clause 118 of the Companies Bill sets out the procedures that must be followed by companies to issue shares at a discount, which include authorisation by a resolution of a general meeting of a company and approval by the Court.

- there is no requirement as to the minimum paid-up capital;
- the shares may have been issued at a premium;
- the par value is a historical figure and does not represent the current value of corporate assets;
- a company's fully paid capital may be dissipated in the course of its trading operations.

21.107 As well, a company's ability to raise equity finance may be impaired when the market price of its shares is less than its par value. The combination of par values and the requirement that shares should not be issued at a discount unless certain conditions are met restricts the opportunities of a company to raise capital and 'trade out' of its difficulties.³² The issue of no par value shares would, of course, eliminate the need for regulating the issue of shares at a discount.

21.108 No par value shares are allowed in certain countries, including the United States and Canada, apparently without any major abuses; there are also some overseas companies listed on Australian stock exchanges which do not have a par value. As well, two committees of inquiry into company law in the United Kingdom³³ have recommended the issue of no par value shares. More recently, the Wilson Committee in the United Kingdom suggested that the concept of par value lacked particular significance and its use was potentially misleading.

21.109 As the company law system in Australia is based on the concept of maintaining capital, an evaluation of the implications of abolishing the par value concept for the totality of company law and regulation and of accounting and disclosure standards would have to be made. In particular, it would be necessary to ensure that creditors and other shareholders were not disadvantaged. Moreover, there are taxation and other implications.

21.110 The Committee suggests that **the National Companies and Securities Commission should examine, at an early date, the feasibility of allowing companies to issue no par value shares and to convert existing shares to shares with no par value.**

(d) Short Selling

21.111 It has been suggested to the Committee that the liberalisation of existing provisions restricting short selling³⁴ would help to smooth fluctuations in market prices for securities.

21.112 Short selling is widely permitted overseas. In the United States short sales are usually prohibited only for certain 'insiders' and beneficial owners of large parcels of shares (although the New York Stock Exchange permits short selling on a rising but not a falling market³⁵). In the United Kingdom the role of the jobber or

³² The requirements include court confirmation. A company, of course, could partially cancel present capital (again with court consent) to overcome the problem. The restriction on issuing shares at a discount does not apply to no-liability companies (usually mining companies).

³³ The Gedge Committee (1954) advocated that only ordinary shares be issued with no par value; the Jenkins Committee (1962) extended the recommendation to preference shares.

³⁴ With certain limited exceptions, a person may not sell securities to a purchaser unless, at the time he sells them, he or his principal has a right to transfer the scrip to the purchaser (s.68 of the Securities Industry Act). (See Interim Report, paragraph 17.96.)

³⁵ Short sales on the NYSE are not permitted (a) below the last sale price on the exchange or (b) at that price unless it was higher than the last different sale price that preceded it.

professional trader in making a market is only feasible because of his ability to go 'short' as well as 'long'.

21.113 The Committee acknowledges that, in the absence of appropriate safeguards, short selling can create instability. The market for many shares in Australia is thin compared with overseas countries; short selling could therefore have a volatile effect on the prices of such shares in the absence of adequate disclosure. Short selling by relatively uninformed investors may expose them to excessive risk. General instability in the stockbroking industry could also develop in the event of the failure of a major short seller to meet his obligations.

21.114 However, short selling can contribute to the depth and stability of the market, if properly regulated. The options market already provides, in effect, an avenue for short selling in a selected range of securities without any apparent adverse effects on the rest of the securities market. Short selling is also an essential characteristic of the futures market.

21.115 It has been suggested that short selling might be permitted subject to the following requirements:

- it should be confined to companies which have a substantial market capitalisation, a widespread shareholding and an active market;
- all short sale positions should be disclosed at the time of the transaction; and
- the provision of a substantial cash margin. If, during the currency of a short position, the price moved against a short seller by more than 10%, an appropriate payment should be made to the broker to cover this liability.

21.116 The Committee believes that such requirements would be compatible with stability in the stock markets and the protection of investors. It therefore suggests that **the National Companies and Securities Commission should examine, at an early date, the feasibility of allowing short selling, subject to the imposition of appropriate requirements to discourage the development of a false market and to prevent the development of unfunded speculation.**

21.117 There should be advantages also in permitting short selling of government paper. Dealers' ability to 'make' a market would be increased, thereby enhancing the liquidity of government paper.

(e) Insider Trading

21.118 The object of restrictions on insider trading³⁶ is to ensure that the securities market operates freely and fairly, with all participants having equal access to relevant information. Investor confidence, and thus the ability of the market to mobilise savings, depends importantly on the prevention of the improper use of confidential information. The Committee is aware of the view that insider trading allows prices to adjust more quickly to the underlying value of particular investments. However, these 'advantages' are decisively outweighed by considerations of equity and likely adverse effects on investor confidence in the market as a whole.

21.119 It has been suggested that the operation of the existing insider trading provisions is creating uncertainty as to whether superannuation funds may deal in the securities of their sponsor company. In such cases, **disclosure** by the trustees of

³⁶ The insider trading provisions of the Securities Industry Act are summarised in paragraphs 17.99-104 of the Interim Report.

a fund to a stock exchange at the time a transaction is made would be an acceptable alternative to outright prohibition.³⁷

21.120 It has also been suggested that the existing provisions of the Securities Industry Act have proved largely ineffective in dealing with the problem of insider trading.

21.121 No detailed review of the insider trading provisions has been undertaken since the Eggleston Committee reported in 1970.³⁸ Given the changes in the structure and operation of financial markets since that time, and in particular the general increase in takeover activity, there is a need for an early review of these provisions.

21.122 In addition to any strengthening of the present provisions, the Committee believes that insider dealings should be made the subject of both criminal and civil action.

21.123 The Committee therefore suggests that **the National Companies and Securities Commission should, as a matter of priority, review the insider trading provisions of the Securities Industry Act, with a view to strengthening them. Consideration should be given to the inclusion of provisions that:**

- **permit superannuation funds to deal in the securities of a sponsor company provided trustees make appropriate disclosure to the stock exchanges; and**
- **make insider dealings subject to civil and criminal penalties.**

E. PROSPECTUS REQUIREMENTS

21.124 The general philosophy behind existing prospectus requirements has traditionally been to protect investors through disclosure. The objective is to promote public confidence in the securities industry and, more particularly, in companies issuing securities to the public, by ensuring that investors have all the information reasonably necessary to make an investment decision. There are also provisions prohibiting certain practices and requiring acceptable standards of behaviour.³⁹ Beyond such requirements and the general remedies at law for fraud, breach of directors' duty etc., the philosophy of *caveat emptor* is intended to apply.

21.125 However, the failure during the 1970s of some finance companies which had prospectuses on issue led to a tightening of prospectus requirements to a point where it is claimed that companies with 'mixed records and prospects' experience would have difficulty securing registration. The philosophy of regulation is thus claimed to have changed from *caveat emptor* to the provision of 'protective regulation' — though still without significant ongoing supervision.

21.126 A number of problems relating to the impact of prospectus requirements on the efficiency of public fund raising, as well as some suggested inadequacies in existing disclosure requirements, have been drawn to the Committee's attention.

37 In this respect it should be noted that in both Canada and the USA there is heavy reliance on disclosure by 'insiders' of their share trading activities.

38 Company Law Advisory Committee to the Standing Committee of Attorneys-General, *Fourth Interim Report*, February 1970, AGPS, Canberra, 1970.

39 The regulatory framework applicable to public fund raising was outlined in Chapter 17 of the Interim Report.

(a) Prospectuses and Efficiency of Public Fund Raising

21.127 The costs of issuing a prospectus in connection with a public issue are claimed to exceed considerably the costs of making a private placement — a cost differential of over 1% has been suggested.⁴⁰

21.128 However, the costs of public issues may be offset by other benefits, e.g. interest costs may be significantly less for a public issue as the borrower can tap a wider market. Decisions as to the method of raising funds will also depend on such things as funding techniques, the size and maturity of an issue, the need to maintain a presence in the market, the benefits of listing, improved marketability and so forth.

21.129 The process of preparing a prospectus and obtaining approval from a Corporate Affairs Commission can be lengthy, reducing the flexibility of companies with regard to the timing of public borrowings. This is said to be particularly important as compliance with prospectus requirements may mean that market conditions change significantly between the time when a decision to raise funds is made and the time the market is approached. Particular criticism has been levied at the emphasis placed on draft prospectuses and resubmissions thereof, and the pursuit of 'irrelevant' details which, it is said, create the impression that the CACs are giving an issue a detailed stamp of approval.

21.130 However, although there have been periods when, due to the number of prospectuses being lodged, there have been delays in registration⁴¹, ongoing borrowers have generally found the overall process to be relatively swift and efficient. The policy of the NSW Commission, for example, is to complete its examination of a prospectus of a finance company and convey any requests for additional information within six full working days of lodgment if it does not involve new or unusual features.

21.131 There have also been structural and timing difficulties associated with varying the **interest rates** and **maturities** on offer which can be time consuming and costly. Thus in times of frequent interest rate changes, finance companies were said to be at a marked disadvantage vis-a-vis banks, building societies and other intermediaries which do not have to issue a prospectus. However, due to changes in administrative policy earlier this year by the various Corporate Affairs Commissioners, in consultation with the NCSC, continuous borrowers are now permitted to:

- alter interest rates shown in a prospectus by use of a sticker or other means, and to
- include a removable application form with the prospectus, allowing rates to be

⁴⁰ See submission by the Australian Merchant Bankers' Association, 1979, p. 80, and its supplementary submission of 20 March 1981, p. 13.

⁴¹ For example, there were 321 prospectuses lodged with the NSW Commission in 1970 but only 62 in 1979.

altered by inserting a new application form, without requiring prior approval of the alteration and hence re-registration of the prospectus.⁴²

21.132 Other problems still remain — for example, the Companies Act lays down various requirements relating to the issue of debentures or shares to the ‘public’.⁴³ It has been submitted that the term ‘the public’ is difficult to interpret as the Act defines it in a partial and negative way. It has been proposed that the existing definition of public offers should be narrowed so as to exclude informed investors.

21.133 The Committee acknowledges the problems which prospectus requirements impose, and believes it is desirable that there be greater clarity in defining when an issue is a ‘public’ issue. But it should be recognised that these requirements are designed to ensure that investors have sufficient information to evaluate the merits of a company before making an investment. Hence issuers benefit because the prospectus requirements foster public confidence and interest in new issues.

21.134 Nevertheless, the Committee is concerned that the prospectus requirements may have discouraged many corporate borrowers from undertaking public borrowings.⁴⁴ These borrowers may have chosen, in preference, the unregulated route of borrowing by way of family issues, private placements and one-name paper⁴⁵, as well as through the intercompany market. If so, a loss in the flexibility of company borrowings has occurred.

21.135 The implementation of other recommendations contained in this Report, notably those relating to interest rate controls and captive markets, may mean greater variability in interest rates generally and hence an increased need for financial intermediaries to respond quickly and flexibly to changes in market conditions. The recent changes in administrative action should ease many of the problems that have existed in the past. Nonetheless, additional changes to the existing prospectus arrangements are considered necessary to ensure the competitive position of continuous borrowers and, more generally, to permit a flexible approach to public borrowings by corporations.

42 Specifically, the NSW Commission has stated that members of the Australian Finance Conference may:

- register a prospectus without an application form attached, provided a copy of the application form is submitted with each prospectus;
- provide investors with an application form separate from but together with a prospectus;
- alter the interest rates shown in a prospectus by use of a sticker, reprint or other means without prior reference to the Commissioner provided the altered prospectus or application form is identical in all other respects to the registered prospectus or application form originally submitted other than, possibly, a change in the colour of the cover. A copy of any such altered prospectus or application form must be forwarded to the relevant Commissioner.

43 The offering of shares or debentures to ‘the public’ is defined in the Companies Act (s.5(6)) to include an offer to any section of the public but to **exclude** offers to a person whose ‘ordinary business’ is to buy or sell shares or debentures whether as principal or agent, and offers to existing members or debenture holders of a corporation which relate to shares in or debentures of that corporation. The Companies Bill 1981 extends offers to the public to include offers to a **section** of the public, but otherwise does not seek to clarify the situation. (See Companies Bill 1981 Explanatory Memorandum, paragraph 63.)

44 Another disincentive, of course, has been the more onerous auditing requirements for ‘public borrowers’.

45 Promissory notes with a face value of not less than \$50 000 are defined as debentures in the Companies Bill 1981.

21.136 It needs to be determined whether investor protection objectives might not be achieved through some less costly, less time-consuming process than existing prospectus requirements. The Committee has considered several options.

(i) Prospectus requirements might be standardised

21.137 One suggestion which has been made is that the NCSC might issue a standard prospectus as a guide for those considering making corporate debt raisings, and that the relevant CAC should be required to approve a prospectus which complied with the standard within three days of lodgment. While this may be desirable in principle, it is doubtful whether, in practice, approval could be obtained within such a short period, particularly in the case of occasional borrowers.

21.138 Acceptance of a standardised approach and the less rigorous examination that would accompany it may become feasible eventually if the NCSC were prepared to accept the assessment of a company's rating by an independent debt rating agency as satisfying a substantial proportion of the existing requirements. However, acceptance of independent ratings as satisfying part of the regulatory requirements appears unlikely in the foreseeable future.

(ii) All borrowers might be permitted to issue an abridged prospectus

21.139 In essence, this proposal involves a two-tier approach to disclosure: a company borrowing from the public would be permitted to issue a prospectus containing details of a kind that the public is likely to need in making investment decisions; more detailed information likely to be of use to an investment analyst would be lodged with the CAC, and thus be on the public record, and would be available from the company on request.

21.140 This option needs to be assessed in relation to the philosophy of prospectus requirements. It might be argued that disclosure by way of prospectus is an essential corollary of the philosophy of *caveat emptor*, and that abridged prospectus requirements would impair the ability of potential investors to make assessments. However, it might also be argued that a lower level of disclosure would not expose the investor to greater risk so long as the Corporate Affairs Commissions are provided with information additional to that given to investors.

21.141 It also needs to be recognised that disclosure can be counter-productive where it is so complex that it obscures material which is likely to be of most use to the investor, and discourages him from reading the prospectus. In this regard, the Committee has some doubts about whether the greater emphasis on disclosure in prospectuses in recent years has always been of great assistance to investors.

21.142 The Australian Finance Conference has drawn attention to the fact that the US Securities and Exchange Commission now permits the inclusion of information in a prospectus in 'condensed or summarised form' with additional information being included, along with the text of the prospectus, in a 'registration statement' which is on the public record. New Zealand is also understood to be moving in the direction of two-tier disclosure.

(iii) Continuous borrowers only might be permitted to issue an abridged prospectus

21.143 This variation of option (ii) is based on the view that, because of the greater impact of the prospectus requirements on continuous borrowers such as finance companies, and because the latter have a 'track record', special consideration should be given to their position.

21.144 It is argued that the initial lodgment procedures are geared to the one-off public borrower; as a result, when a finance company is merely updating a prospectus, the detailed procedures are said to impose an unnecessary burden. Other perceived benefits include lower printing costs and the ability to provide a more readable document to potential investors.

21.145 One suggestion is that finance companies should be licensed as continuous borrowers, with renewal being consequent on minimum disclosure standards being met. An alternative is that **all companies** should be **eligible** for registration as continuous borrowers.

21.146 In the latter case, prerequisites for registration might be that:

- a company must have borrowed regularly over some predetermined period (e.g. at least twice in the preceding eighteen months); and
- a basic level of information would have to be disclosed in an abridged prospectus, with more detailed information being provided to the CAC and to those members of the public who request it.

21.147 As noted in paragraph 21.131, the Corporate Affairs Commissions have already given limited recognition to the special position of continuous borrowers. Also, Clause 109 of the Companies Bill 1981 gives the NCSC power to exempt a corporation from the prospectus provisions.

(iv) Less emphasis might be placed on prospectus requirements with greater emphasis being placed on the adequacy of trust deeds

21.148 This approach is broadly that followed in the United Kingdom. The Department of Trade is primarily concerned to ensure that the trust deed of a borrowing company is adequate to protect investors. There is little or no supervision of what is disclosed in the prospectus.

21.149 To the extent that the trust deed is included in the prospectus, there is not a great deal of difference between this approach and prospectus requirements in Australia. However, the UK Department of Trade is not concerned about information on interest rates and maturities on offer, or indeed any information that is disclosed in addition to that required to be included in the trust deed. Borrowing companies which do not change their trust deed between issues therefore have more flexibility in the timing of their approach to the market.

(v) Prospectus requirements for finance companies might be abolished

21.150 Banks and building societies are not subject to prospectus requirements as, unlike finance companies, their overall activities are subject to close regulation and supervision.

21.151 A move away from prospectus requirements for finance companies would only be appropriate if all finance companies were to be made subject to the same regulatory requirements as non-bank deposit-taking institutions, such as building societies. This would involve a fundamental change in the approach to the regulation of finance companies.

The Committee's assessment of these options

21.152 The Committee does not consider option (i) to be feasible at this time, for reasons explained earlier. While option (iii) would bring much needed flexibility to borrowings by finance companies and other continuous borrowers, it would do nothing to overcome the problems of others borrowing only periodically

from the public. Option (iv) has a certain appeal, but other proposals would achieve the same benefits without diverging to the same degree from the present arrangements for protecting investors. Option (v) is too radical a departure from the existing approach (but see paragraph 19.248); the Committee considers that the retention of prospectus requirements (albeit in modified form) is consistent with a functional approach to regulation which retains a spectrum of risk for investors/depositors.

21.153 The most desirable proposal is option (ii), i.e. that **all** borrowers should be permitted to issue an abridged prospectus with a more detailed financial statement being lodged with the relevant Corporate Affairs Commission.

21.154 As well, the Committee sees no reason why the recent administrative changes which permit alterations to interest rates and maturities on offer without the issue of a new prospectus should not be extended to others borrowing from the public. Together, these changes would do much to ensure an efficient and competitive environment for public borrowing.

21.155 The form and content of an abridged prospectus would need to be subject to strict disciplines so as to ensure that any reduction in the flow of information to investors was not of such a kind as to impair the ability of investors to make soundly based decisions. Information that would need to be disclosed in an abridged prospectus for a borrowing might well include:

- full details of the issue, including its terms and conditions;
- its purpose;
- the more material provisions of the relevant trust deed and the rights and security position of any subscriber thereunder;
- a recent summary of the company's financial accounts and the auditor's report thereon, with appropriate profit and other comparisons;
- any material events, factors or influences affecting the financial accounts before **and since** the relevant period; and
- information on its gearing ratio, interest cover, the nature and quality of its receivables and other assets, and the size and maturity of its liabilities.

21.156 The form and content should be approved by the CAC and occasional borrowers would, of course, need to make such additional disclosures as might be thought necessary by the CAC.

21.157 Consideration should also be given to requiring more frequent disclosure by companies issuing abridged prospectuses. The availability of, say, quarterly information to investors would enable them to make a continuing assessment of their investments and, with the development of secondary markets in fixed interest securities, they should be able to sell, if necessary, their securities more readily.

21.158 The Committee **recommends** that:

- (a) **All public borrowers should be permitted to issue an abridged prospectus, in a form and content approved by the relevant Corporate Affairs Commission, containing only the basic, essential information needed by investors. More detailed information should be made available to the Corporate Affairs Commission and to members of the public on request.**
- (b) **Consideration should also be given to requiring companies issuing**

abridged prospectuses to make more frequent disclosure to the authorities, the stock exchanges and investors (on request).

- (c) Occasional borrowers — like continuous borrowers — should be permitted to vary interest rates and maturities in prospectuses without having to issue new prospectuses.
- (d) The National Companies and Securities Commission should give early attention to clarifying the definition of public and non-public issues.

(b) Disclosure in Prospectuses

21.159 It has been suggested that existing disclosure requirements for prospectuses are inappropriate and inadequate in a number of respects:

- the prospectus may be on issue for six months and the accounts it contains may be for a period up to nine months prior to issue; the accounts as a consequence might be as much as fifteen months out of date before the prospectus is renewed (this problem has been raised particularly in relation to finance companies);
- unsubstantiated or subjective information in respect of the valuation of assets is sometimes included in prospectuses;
- inadequate detail is provided on the extent to which accounts receivable are secured and on doubtful debt provisions;
- there is inadequate disclosure in respect of the ability to service debt and other obligations; and
- some finance companies failed at a time prospectuses were on issue which gave no indication of any major problems.

21.160 The problems associated with variations in accounting standards, and in particular in the valuation of current, non-current and fixed assets, have also been raised in a number of submissions.

21.161 Many of these aspects are discussed elsewhere in this chapter, particularly in relation to company reports; the comments there are equally relevant for prospectuses.

(c) Advertising Restrictions

21.162 The restrictions on advertising by corporate borrowers of prospectuses on issue are set out in the Interim Report (paragraph 17.38). Broadly these provisions:

- require that only certain specified information may be included in an advertisement drawing attention to a prospectus; and
- prohibit activities by 'independent' media which would have the effect of circumventing this requirement.

21.163 The aim of these restrictions is to ensure that the prospectus provisions are not circumvented by advertisements or media articles providing material other than that contained in the prospectus.

21.164 The Committee believes these restrictions unduly inhibit the ability of financial corporations (e.g. finance companies) borrowing by way of prospectus to compete with building societies, banks and credit unions, which are not subject to comparable limitations. In the Committee's view, investors would be adequately protected so long as the advertisement complies with minimum standards of

accuracy, and funds may only be lodged on an application attached to a prospectus.⁴⁶

21.165 Accordingly, the Committee *recommends* that:

- (a) Existing restrictions on advertisements should be revised to permit any advertisement that:
- is not inconsistent with the prospectus or other material lodged with the relevant Corporate Affairs Commission;
 - is not likely to deceive, mislead or confuse investors; and
 - contains a statement that funds may only be lodged together with an application attached to a prospectus.
- (b) The National Companies and Securities Commission should be empowered to require a company to withdraw any advertisement which does not meet these requirements.

F. REGULATION OF UNIT TRUSTS

21.166 Concern has been expressed about the regulation of unit trusts under the Companies Act — particularly prospectus and other requirements designed primarily to apply to companies. It has been argued that various restrictions imposed under the Act unduly inhibit unit trusts' freedom to compete.

(a) A Separate Collective Investment Act

21.167 A number of submissions have suggested that all forms of collective investment on offer to the public should be regulated by an Act other than the Companies Act.

21.168 It is argued that many provisions of the Companies Act are inappropriate for unit trusts. These include the disclosure requirements associated with the issue of prospectuses and the disclosure requirements in advertisements (s. 40 of the Companies Act). These provisions, it is submitted, treat unit trusts as joint stock corporations rather than as trusts.

21.169 In several countries, collective investment institutions⁴⁷ are regulated under separate legislation to companies, e.g. United Kingdom, West Germany, Hong Kong. The OECD has recognised the need for separate regulation by publishing, in 1972, standard rules for the operation of collective investment institutions.⁴⁸

21.170 The Committee believes that the flexibility of such institutions would be enhanced if existing requirements to which they are subject were revised to take account of their special nature. This could be done within the context of the existing companies legislation but it would be preferable for there to be separate

46 The first two of these requirements are understood to have recently been adopted in New Zealand.

47 Collective investment institutions are institutions such as unit trusts, mutual funds and investment companies which mobilise funds for the public for the purpose of investment in certain specified assets. Note, however, that the latter two are incorporated.

48 See Committee on Financial Markets, *Standard Rules for the Operation of Institutions for Collective Investment in Securities*, OECD, Paris, 1972.

legislation so as to minimise the risk of unit trusts having to meet inappropriate requirements.

21.171 The Committee therefore suggests that **the National Companies and Securities Commission should investigate, at an early opportunity, the possibility of regulating collective investment institutions under a separate Act.**

(b) Regulation of Fund Raising

21.172 As noted above, existing prospectus requirements do not take account of the particular characteristics of unit trusts.

21.173 The Committee believes that unit trusts and other collective investment institutions should be subject to requirements comparable to those applying to other corporate fund raisers (i.e. they should be permitted to issue an abridged prospectus while making more detailed disclosure to the relevant Corporate Affairs Commission). However, because of the special nature of unit trusts, they should be subject to different information requirements.

21.174 The Committee is conscious that certain safeguards are afforded to investors by virtue of the fact that:

- the managers of unit trusts and their agents must be licensed under the Securities Industry Act; and
- the rights of unit holders are monitored by independent trustees.

21.175 The Committee **recommends** that **unit trusts should be permitted to issue an abridged prospectus. More detailed information should be made available to the relevant Corporate Affairs Commission and to members of the public on request.**

(c) Advertising Restrictions

21.176 The type of information which the Companies Act permits in advertisements of a prospectus is similarly said to be inappropriate to unit trusts. It is said that insufficient information is provided to attract the investor to this method of investment.

21.177 The matters which may be included in an advertisement published in connection with the issue of a prospectus are set out in s. 40 of the Companies Act. The section is clearly designed to provide information relevant to a corporate issuer — not to unit trusts, which do not have paid-up capital, directors (as distinct from trustees, managers) etc.

21.178 Moreover, it has been noted that, unlike the position in other countries such as the United Kingdom, indicative yields generally may not be advertised **unless** they are guaranteed (although non-guaranteed yields may be included in a prospectus). Other similar types of investments — e.g. equity-linked life insurance policies — are not subject to a similar restriction.

21.179 The Committee earlier expressed the view that restrictions on advertising by those raising funds from the public are unnecessary so long as advertisements do not contain information inconsistent with the prospectus and subject to certain other minimum requirements.

21.180 The same view applies in respect of unit trusts. It is undesirable to prohibit unit trusts drawing attention (in good faith) to their benefits, as this is part of the appeal of unit trusts to investors. Such a prohibition makes it more difficult

for unit trusts to market units in competition with equity-linked life insurance policies and others which are not subject to a comparable limitation. A question of competitive neutrality arises.

21.181 The Committee therefore **recommends** that **unit trusts should be:**

- **subject to the same general requirements in respect of advertising as those applying to companies raising funds from the public; and**
- **free to advertise an indicative yield, provided it is clearly stated whether it is guaranteed.**

(d) Marketing of Units

21.182 Section 374 of the Companies Act, which restricts the soliciting of investments from the public⁴⁹, reflects a concern for the small, unsophisticated investor who is not skilled in financial analysis or the assessment of investments without professional aid and who tends to be susceptible to the representations of salesmen. It is feared that, in the absence of such a provision, the intent of the prospectus requirements will be avoided. The Eggleston Committee recommended the tightening up of this section.⁵⁰

21.183 However, it has been pointed out that similar restrictions do not apply to the selling of equity-linked life insurance, which represents a similar form of investment. On competitive neutrality grounds, therefore, it is argued that s. 374 should be amended to permit door-to-door sales where a registered prospectus is presented to the potential investor.

21.184 It might be argued that, if the Committee's recommendations for abridged prospectuses were adopted, this would **strengthen** the need for section 374. At the same time the relaxation of restrictions on advertising which the Committee proposed earlier must be seen as enhancing the ability of unit trusts to attract funds from the public by advertising, effectively reducing the need for door-to-door canvassing.

21.185 Nevertheless, a major problem exists in respect of the ability of unit trusts to compete with the agents of life insurance companies who are permitted to engage in door-to-door selling. The Committee is not aware of the extent to which equity-linked life insurance policies — which are effectively in direct competition with unit trusts — are marketed in this way. It appreciates that there are certain safeguards for the investor such as the prudential disciplines over life insurance companies and the voluntary observance by them of a 14-day cooling-off period (which the Committee has recommended be given legislative support — see paragraph 20.54).

21.186 In the Committee's view, it is not practicable to prohibit this method of marketing insurance policies as it is the traditional method used in marketing life insurance. Unit trusts must therefore remain at a marketing disadvantage so long as they are subject to the constraints of s. 374. On competitive neutrality grounds, **some relaxation in respect of unit trusts would clearly seem desirable.**

⁴⁹ Except where certain conditions are met and ministerial approval is obtained, a person may not go from place to place offering shares or debentures for subscription or purchase to any member of the public (s. 374). The proposed Companies Bill extends this prohibition to units and provides the NCSC with the power to exempt any corporation from the operation of the provision (Clause 552).

⁵⁰ Company Law Advisory Committee to the Standing Committee of Attorneys-General, *Sixth Interim Report*, 1972.

21.187 However, the Committee is opposed, in principle, to any **general** relaxation of restrictions on share hawking. It sees section 374 as an important form of protection for unsophisticated investors against unscrupulous persons in all areas of investment. The Committee suggests that this matter be examined by the NCSC.

G. ROLE OF TRUSTEES, TRUST DEEDS AND TRUSTEE SECURITIES

21.188 A number of reservations have been expressed to the Committee about the usefulness of trust deeds for borrowing corporations. Submissions have suggested that:

- the present requirement for quarterly reports may not provide the trustee with sufficient information to assess the ongoing performance of the borrower;
- trust deeds are of little use in protecting investors;
- the practice of raising funds under trust deeds should be dispensed with in the case of finance companies, the operations of which should be regulated by the Reserve Bank;
- trust deeds should include standardised definitions of key financial variables to facilitate comparisons between companies.

21.189 The Committee is not in a position to assess the view that reporting requirements to trustees should be improved, but to the extent this were to happen, the arguments in support of permitting abridged prospectuses would be strengthened.

21.190 The Committee does not believe that trust deeds should be dispensed with in respect of finance company borrowings, or that finance companies should be regulated by the Reserve Bank. On the contrary, the Committee is satisfied that trustees play an important role in the investor protection process. With debentures, for instance, they act as mortgagee for the 'tenants-in-common mortgagors' (the debenture holders) and through the trust deed are able to intervene to protect the rights of those mortgagors.

21.191 Very clearly, standardised terminology for key financial variables would be helpful to the understanding of investors generally, and the Committee commends this thought for practical consideration by corporations, lawyers and relevant trustees. The NCSC might be prepared to take a lead.

21.192 Reservations have also been expressed about the fact that, while the more modern trust deeds of most superannuation and other trusts often include a broad definition of eligible securities, older trust deeds (generally relying solely on trustee securities) usually exclude reference to the more recent types of suitable and useful instruments.

21.193 The choice of investments acceptable for the purposes of trust deeds is, of course, a matter for those drawing up or having the power to amend trust deeds. However, the Committee accepts that state Trustee Acts (which prescribe investments which are eligible where trust deeds are silent or particularly restricted as to investment powers) ought to have regard for modern instruments of financing and investment.

21.194 There should desirably be arrangements for periodically reviewing trustee

securities to ensure that those which meet appropriate criteria are not excluded and that the retention of trustee status for others is desirable.

21.195 Finally, there are anomalies in the definition of trustee securities between the States. One consequence is that securities which may otherwise have very similar risk and return characteristics are viewed very differently by investors in different states. This may produce significant variations in the cost of capital in different states. Distortions in the process of resource allocation are the likely result.

21.196 The granting of trustee status to a security tends to create a special preferential market for it. The Committee sees no objection to the continuance of this practice, but — as suggested in Chapter 12 — it is desirable that consistent and sound criteria be applied throughout Australia.

21.197 The Committee therefore *recommends* that state Trustee Acts should be amended, where appropriate, to:

- bring their prescribed securities up to date with modern instruments of financing and investment;
- provide for a consistent national approach to the definition of trustee securities; and
- provide arrangements for periodically reviewing the status of trustee securities.

H. STATUTORY TRUSTEE COMPANIES

21.198 Apart from their traditional work as executors and administrators of deceased estates, trustee companies provide a wide variety of services including taxation counselling, accountancy, and investment management; in the course of providing these services they may accept deposits from clients and provide other financial services. Some trustee companies have subsidiary finance companies, permanent building societies and licensed real estate agents.

21.199 If deposits accepted by the trustee company are placed in the common funds⁵¹ they mingle with other trust funds and are therefore subject to the Trustee Acts and supervision (by the courts) in applying the law of trusts. However, funds may also be accepted from clients on a principal basis; provided there is no approach to the public for such funds, no prospectus is required. These funds are, in some instances, the credit balances in clients' accounts or amounts lodged as unsecured short-term or call deposits. They are not subject to the requirements of the Trustee Acts and may be freely invested in mortgages or in other ways.

21.200 For some trustee companies, deposit-taking has become a significant part of their operations. Ten trustee companies examined by the Committee had aggregate deposits of more than \$211 million at June 1980 or an average of four times shareholders' funds. In the case of eight trustee companies, deposits represented 70% of their liabilities, with the figure as high as 90% in three cases.

21.201 The Committee is conscious that trustee companies are not subject to any

⁵¹ Under the Trustee Company legislation, trustee companies are authorised to pool the funds of a number of trusts they administer and the funds of clients in a 'common fund'. Some common funds are restricted to trustee securities, others invest in a range of investments.

form of prudential supervision by state governments. Given the broad prudential framework outlined in Chapter 19, consideration will need to be given to extending to trustee companies the requirements that apply to other deposit-taking institutions, so as to ensure competitive neutrality as well as some prudential discipline.

21.202 The Committee notes that there is lack of uniformity in legislation which prevents trustee companies operating nationally. One trustee company has publicly advocated a national Trustee Companies Act.

21.203 While the Committee has not examined the issue in any detail, it is sympathetic to the general view that existing state trustee company legislation should be replaced by uniform legislation so that there is a common definition of trustee companies throughout Australia and trustee companies can operate nationally.

21.204 The uniform trustee company legislation should also contain criteria for the entry of new trustee companies. The Committee's attention has been drawn to the fact that there are only a small number of public trustee companies, and that no new trustee companies have been established for many years.⁵²

21.205 Because of the long-term nature of their responsibilities and the special confidence placed in them by the public, the trustee company legislation seeks to ensure that beneficiaries are adequately protected by requiring special provisions in the trustee companies' memoranda and articles of association and by:

- restricting individual shareholdings in a trustee company (e.g. to 5% in Western Australia and Victoria);
- requiring there to be unpaid calls on shares of between \$1 and \$12; and
- granting directors the right to refuse to transfer shares.

21.206 These restrictions provide a significant barrier to new entry and effectively protect less efficient management from takeovers that might be to the advantage of both shareholders and beneficiaries.

21.207 The Committee considers that these barriers to entry are excessively stringent and not compatible with efficiency. While a degree of supervision is undoubtedly necessary to ensure confidence in trustee companies and while some form of licensing may be necessary to ensure suitability of applicants, the Committee believes there is scope for the entry of additional public trustee companies without endangering the interests of beneficiaries.

21.208 In Chapter 19, the Committee proposes a relaxation of restrictions on the ownership of banks subject to certain disclosure requirements regarding changes in beneficial ownership. The Committee believes a similar requirement might be applied in respect of trustee companies. This would enable changes in ownership from time to time, which would act as a spur to efficiency, but at the same time would ensure that the interests of beneficiaries were not impaired.

21.209 Given the development of regulation of companies and the securities industry in recent years, which has resulted in greater protection being afforded to

⁵² While any corporation that meets the requirements of s. 74 of the Companies Act may act as a trustee company for debenture holders, only those companies that are specifically authorised under various state trustee companies legislation may act as executors to wills, obtain probate of any will and letters of administration and act as administrators of an estate.

investors and the maintenance of more informed markets, two other provisions for trustee companies are no longer considered necessary:

- the ability of directors to refuse to transfer shares is contrary to stock exchange listing requirements and may work against the interests of beneficiaries by protecting inefficient management; and
- the unpaid amounts on shares are relatively small, given the gearing of some companies, and are not an effective means of protecting beneficiaries.

21.210 The Committee therefore *recommends* that:

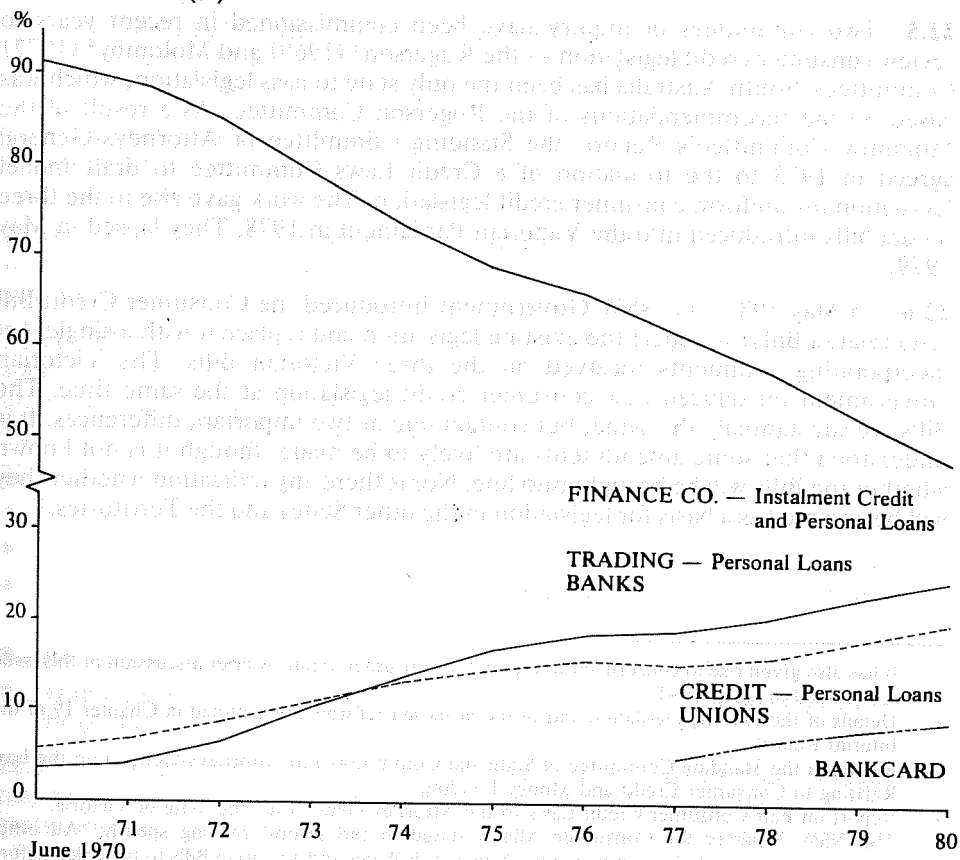
- (a) A uniform Trustee Companies Act should be developed; to the extent that trustee companies borrow from the 'public', they should be subject to prudential requirements consistent with those applying to non-bank deposit-taking institutions or institutions which borrow by way of prospectuses (see Chapter 19).**
- (b) The Trustee Companies Act should include criteria for the entry of new trustee companies and provide for some form of ongoing supervision.**
- (c) There should be no restriction on share ownership, but anyone acquiring a substantial shareholding in a trustee company (a beneficial interest in 10% or more of the voting rights attaching to its share capital), or increasing an existing substantial shareholding, should be required to notify the relevant state Minister within two days of that shareholding being acquired.**
- (d) The Minister should be empowered to order divestment of shareholdings under this test where, in his view, this would be in the best interests of beneficiaries.**
- (e) The right of directors to refuse to transfer shares should be abolished.**
- (f) The requirement for trustee companies to have partly paid shares should be abolished.**

CHAPTER 22: CONSUMER CREDIT: PROTECTION OF BORROWERS

A. BACKGROUND

22.1 The Interim Report (Table 2.2) outlined the strong growth in households' debt outstanding during the 1970s. The changing market shares of the principal institutions concerned are shown in Figure 22.1.

FIGURE 22.1: CONSUMER FINANCE — MARKET SHARES OF BALANCES OUTSTANDING (%)



Source: ABS Catalogue Nos. 5.1, 5.2, 5605.0, 5614.0, 5618.0

22.2 The growth of consumer credit in recent years has been accompanied by increasing concern about the protection of borrowers.¹ This has been reflected in efforts over a number of years to achieve uniform consumer credit legislation and the strengthening of a number of requirements to which credit providers are subject.²

22.3 Apart from the Trade Practices Act, the regulation of credit providers is largely under State and Territory Hire Purchase and Money Lenders Acts which do not extend, however, to building societies, credit unions, banks or other bodies lending money which are registered or licensed under separate legislation. The principal aim of existing consumer credit legislation is to protect the borrower by prohibiting:

- certain practices in relation to the provision of financial services which are regarded as undesirable;
- the charging of 'grossly unfair' interest rates;
- false or misleading advertising; and
- 'bait' advertising.

22.4 The Acts also establish government agencies to enforce the legislation, including the investigation of complaints from borrowers.

22.5 Two committees of inquiry have been commissioned in recent years to review consumer credit legislation — the Rogerson³ (1969) and Molomby⁴ (1972) Committees. South Australia has been the only state to pass legislation, which was based on the recommendations of the Rogerson Committee. As a result of the Molomby Committee's Report, the Standing Committee of Attorneys-General agreed in 1973 to the formation of a Credit Laws Committee to draft model legislation for uniform consumer credit legislation. The work gave rise to the three model bills introduced into the Victorian Parliament in 1978. They lapsed in May 1979.

22.6 In May 1981, the NSW Government introduced the Consumer Credit Bill (and related Bills) to repeal the existing legislation and replace it with a single Act incorporating comments received on the three Victorian Bills. The Victorian Government introduced new consumer credit legislation at the same time. The Bills are substantially the same, but contain one or two important differences. It is understood that some amendments are likely to be made, though it is not known whether the Bills will be brought into line. Nor is there any indication whether they will be accepted as a basis for legislation in the other States and the Territories.⁵

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- 1 It has also given rise to concern about the cost of consumer credit. A brief discussion of this issue is provided in Chapter 41.
 - 2 Details of the existing legislation and of the proposed reforms are outlined in Chapter 19 of the Interim Report.
 - 3 Report to the Standing Committee of State and Commonwealth Attorneys-General on the Law Relating to Consumer Credit and Money Lending.
 - 4 Report on Fair Consumer Credit Laws to the Attorney-General for the State of Victoria.
 - 5 The NSW Minister for Consumer Affairs stated in the second reading speech: 'All other Governments seem to be waiting for the New South Wales and Victorian Bills to be tabled before proceeding themselves. There is expected to be considerable industry pressure on them to follow the New South Wales and Victorian models'. Second Reading Speech, Consumer Credit Bill, Hansard, Legislative Assembly, NSW, p. 41.

B. THE ISSUES

(a) The Regulation of Credit Providers

22.7 Under existing consumer credit legislation, there is a marked lack of uniformity in the treatment of similar credit transactions between the States and Territories. Examples of this include:

- *Disclosure requirements to borrowers* — although all States and the Territories require some form of disclosure of relevant terms of contracts to be supplied to the borrower, the detailed requirements vary significantly;
- *Disclosure of interest rates* — there is no uniformity in the method of calculation of interest rate charges for disclosure to borrowers;
- *Advertising* — some states permit only a limited form of advertising by money lenders, e.g. some prohibit comparative advertising, others the sending of circulars;
- *Formal registration requirements* vary and there is no provision for the recognition of licences given in other states; and
- *Interest rate controls* — some states still retain interest rate ceilings on consumer finance contracts.

22.8 The lack of uniformity in the regulation of all credit providers between states is a source of inefficiency — it raises administrative and legal costs for those credit providers which operate nationally, thereby increasing the cost of finance to the ultimate borrower.

22.9 The Committee is therefore concerned at the delay in reaching agreement on uniform legislation and the possibility that governments might proceed to enact legislation independently of each other.

22.10 The Committee **urges the Government to take an active role in seeking to secure agreement among the States on a co-operative scheme to achieve uniformity in the regulation of consumer credit providers.**⁶

22.11 The Committee believes that borrowers should be protected by requiring appropriate disclosure and by providing protection against fraudulent and undesirable practices. At the same time, it draws attention to the need for legislation to balance the interests of credit providers and borrowers.

22.12 The extent and level of legislation should be such that:

- new entry is feasible;
- there remains effective and equitable competition among credit providers;
- there is full disclosure to borrowers of **relevant** information, particularly in respect of effective cost (interest and any other charges);
- the cost and availability of consumer finance are not impaired; and
- emphasis is placed on the development of consumer education and counselling programs.

22.13 Provided the above principles are observed, the overall effect of regulation may be to enhance the **demand** for consumer finance. In the same way as investor protection regulation may encourage investors to invest, properly constructed

⁶ The question of which credit providers should be subject to regulation is explored below.

regulation for the protection of borrowers, applied with an appropriate degree of restraint, may encourage them to make greater use of credit facilities.

22.14 Against this background, three features of the proposed legislation⁷ have been drawn to the Committee's attention which warrant particular examination:

(i) *Licensing of Credit Providers*

22.15 A Credit Tribunal is to be established in each state; one of its functions will be the administration of the licensing scheme. It will be required to satisfy itself that an applicant for a licence has appropriate financial backing and expertise, is likely to do business in an honest and fair fashion and is of good character and reputation.⁸

22.16 The proposed legislation requires that all **private** credit providers be licensed with the exception of banks, credit unions, building societies, insurance companies, licensed pawnbrokers and pastoral finance houses. It is believed by state governments that the activities of these institutions are already adequately supervised under existing legislation.

22.17 The Committee questions the basis for exemption of intermediaries such as banks and credit unions, which compete directly with finance companies in the provision of consumer finance. The Acts applicable to these intermediaries do not impose comparable requirements to those proposed under the consumer credit legislation.

22.18 Further inequities may arise through circumvention of the legislation. For example, if banks were exempt, they might decide to absorb their finance company subsidiaries (which now account for nearly 50% of finance company loans outstanding) into their own operational structure.⁹

22.19 The declining proportion of consumer financing to which the proposed legislation would apply can be seen from Figure 22.1. When the first moves towards uniform legislation were taken in the early part of the 1970s, finance companies provided more than 85% of consumer finance. At the end of 1980 finance companies provided about 46%, with the proportion continuing to decline steadily.

22.20 Here, as elsewhere, the Committee stresses the need for a functional approach to regulation. Legislation and its administration should be consistent in relation to the provision of consumer finance by different intermediaries.

22.21 The Committee therefore **recommends** that **credit legislation should apply to all institutional providers of consumer finance.**

(ii) *Security on Consumer Loans*

22.22 As drafted, the legislation proposes a change from the system of hire purchase. Under hire purchase, the lender has title to the goods being financed. In future, the buyer/borrower will obtain title, with loans being secured by chattel

7 It is not intended to discuss the proposed legislation in detail. Reference hereafter to the 'proposed legislation' should be taken to mean the NSW Consumer Credit Bill 1981, except where indicated.

8 Second Reading Speech, NSW Consumer Credit Bill, op.cit.

9 This may tend to happen, in any case, if the proposals for deregulation outlined elsewhere in this Report are adopted.

mortgage. Where a *bona fide* purchaser acquires goods which are mortgaged, he will be able to acquire unencumbered legal title to those goods, notwithstanding that mortgage.

22.23 There are dangers to credit providers inherent in the proposed change. An attempt has been made to overcome this in South Australia, where a chattel mortgage system was introduced in 1975, by the provision of title insurance. However, premium rates have risen significantly in recent times, ultimately raising the cost of consumer finance.¹⁰ Victoria, on the other hand, is moving towards a government-run registration of charges scheme in respect of motor vehicles. The lender will have the option as to whether to register a charge; if it does not do so it will not be protected in the event of default. If it does register the charge, the onus will be on a prospective purchaser to contact a government agency to check whether the goods concerned are encumbered. At this stage a title insurance scheme is proposed in New South Wales.

22.24 Consistent with the views expressed elsewhere on the desirability of a uniform approach to regulation, the Committee is concerned about the present lack of a uniform approach to this question. It also has some reservations about a change from hire purchase to chattel mortgage. However, if the latter system were introduced, it is the Committee's view that a registration of charges scheme is likely to be more cost-effective than a title insurance scheme. The matter certainly needs to be put to further cost-benefit assessment. Community education about the need to ensure that goods are unencumbered and awareness about how this can be done will be essential prerequisites to the achievement of the objective.

(iii) Linked Credit Providers

22.25 The proposed credit legislation contains provisions which will impose a liability on credit providers in relation to the supply of goods or services (and, in particular, their fitness and quality) where the credit provider has a substantial commercial link with the supplier of the goods or services. The liability of such a credit provider will be limited to the amount payable by the borrower under the loan contract.

22.26 The need for such a requirement is based on the view that the supply of credit is often the decisive factor inducing the consumer to buy a product or obtain a service. However, regard should be had to the likely impact of these obligations on the cost and availability of finance. It could lead to some financiers withdrawing from the provision of consumer finance through retailers. This would be accentuated if particular financiers or forms of financing (e.g. Bankcard) were excluded from the provisions.¹¹

22.27 The Committee *recommends* that **credit legislation should not include provisions which impose a liability on linked credit providers in relation to the supply of goods or services.**

22.28 In the Committee's opinion, the appropriate means of protecting borrowers is for suppliers (and credit providers) to disclose to borrowers whatever

10 Other factors, such as the particular economic conditions in South Australia, may not make this experience representative of what could happen if such a system were introduced in other states.

11 Bankcard and other credit cards are subject to the proposed NSW legislation, but exempt from the linked credit provider provisions of the Victorian Bill on the grounds that they do not have responsibility for the quality of goods provided.

information is reasonably necessary for them to understand the terms and conditions on which finance is provided. **To enable borrowers to take full advantage of such disclosure, a cooling-off period of 7 or 14 days might also be required.**

(b) Electronic Funds Transfer Systems

22.29 The provision of credit is likely to be increasingly effected through electronic funds transfer systems (EFTS) in the future. The development of such systems raises important questions on the rights and obligations of the different parties involved in credit (and other) transactions, and the appropriate form of regulation. Such systems were not anticipated when existing legislation was developed; thus, while the Bills of Exchange Act deals with paper-based instruments, it does not, for example, deal with the truncation of cheques. The Act is silent on the protection of users of EFTS; as well, the common law has not had an opportunity to develop precedents in regard to EFTS in Australia; precedents established relate only to traditional banking practices.

22.30 The Committee is also concerned that requirements imposed under existing legislation, if applied to EFTS, may hinder their development. For example, by requiring the physical presentation of a cheque at the drawee bank, the Bills of Exchange Act may hinder the introduction of electronically based cheque-clearing facilities.

22.31 The question of protecting users of EFTS has been the subject of investigation overseas. In the USA the National Commission on Electronic Funds Transfers¹² was established by Congress in 1974 to undertake a comprehensive review of EFTS as a basis for a national policy for the orderly development of these systems.¹³ One result of its work has been the Electronic Funds Transfer Act and more recently Regulation E of the Act, which sets out the rights and obligations of consumers using EFTS.

22.32 In 1978 the Law Reform Commission of Canada issued a working paper exploring the body of legal rules and principles governing credit transfers and the potential impact of EFTS.¹⁴ In 1978 new banking legislation was introduced which created a new Canadian Payments Association Act which, inter alia, established the rules and standards for the clearing of cheques. In the United Kingdom, new laws have been introduced governing the rights of users of credit cards.

22.33 No comprehensive examination of EFTS has been undertaken or is currently proposed in Australia although the Law Reform Commission has

12 National Commission on Electronic Funds Transfers, Final Report, *EFT in the United States: Policy Recommendations and the Public Interest*, 1977.

13 Among other things, the terms of reference required it to investigate:

- the need to preserve competition among the financial institutions and other business enterprises using such a system;
- the need to promote competition among financial institutions and to ensure government regulation and involvement or participation in a system in competition with the private sector was kept to a minimum;
- the need to prevent unfair or discriminatory practices by any financial institution or business enterprise using or desiring to use such a system;
- the need to protect the legal rights of users and consumers;
- the impact of such a system on economic and monetary policy; and
- the implications of such a system on the availability of credit.

14 National Commission on Electronic Funds Transfers, *ibid.*, p. 3 et seq.
14 Law Reform Commission of Canada, 'Payment by Credit Transfer', Working Paper No. 21, 1978.

examined the issue of the flow of information on individuals in the credit industry and the question of privacy.¹⁵ So far as the Committee is aware, no legislation encompassing the regulation of EFTS is envisaged at this time.¹⁶

22.34 There are two principal issues to be addressed:

- whether regulation and/or legislation to protect users of EFTS services are necessary and, if so, where responsibility for this should rest;
- if regulation were developed, what the overall policy approach should be.

22.35 On the first of these issues, the Committee has not undertaken sufficient work to assess whether there is a clearly demonstrable need for separate legislation. It acknowledges, however, that appropriately designed legislation governing unauthorised access to and dissemination of personal financial information and security against error and fraud will be necessary to facilitate the spread of EFTS by ensuring a necessary degree of public confidence.

22.36 To the extent that the development of EFTS centres on the banking system, public confidence should, in the view of the Committee, continue to be assured by the Banking Act. However, EFTS is likely to spread through a range of other intermediaries over time. As a matter of principle, the Committee has reservations about the view that all users of EFTS should be afforded the same level of protection irrespective of which intermediaries provide EFTS services. Nevertheless, consistent with the support expressed elsewhere in this Report for a functional approach to regulation and competitive neutrality, **regulation of the provision of EFTS services should be consistent for all intermediaries.**¹⁷ (Some associated issues are discussed in Chapter 23.)

22.37 The question of responsibility for the setting down of the rights and obligations of suppliers and users of EFTS is of some concern to the Committee. The development of EFTS in Australia would be severely inhibited if separate legislation were developed to deal with problems on an ad hoc basis by each state without regard to interstate consistency or the Commonwealth Government's responsibilities in respect of the banking system.

22.38 Whether protection should be an adjunct to national co-operative consumer credit legislation would depend on agreement among the States and the Commonwealth to the development of such legislation. However, it should be recognised that, while EFTS may be associated with the provision of credit, it will increasingly extend to other financial services. Other alternatives which bear close consideration include appropriate provisions in the Bills of Exchange Act or a separate Electronic Funds Transfer Act as in the United States.

22.39 So far as the second issue identified earlier is concerned, the Committee believes that, while there may be a need to prescribe the broad rights and obligations of providers and users of EFTS, regulation should not impede the efficient development of EFTS.

¹⁵ Law Reform Commission, Research Paper No. 9, *Privacy — Credit Records*, January 1980.

¹⁶ Bankcard, which might be viewed as a device permitting access to EFTS in the future, is subject to the NSW Consumer Credit Bill and certain provisions of the corresponding Bill in Victoria. See also paragraph 22.41.

¹⁷ In the USA legislation regulates all financial intermediaries that offer EFT services to consumers, and extends to all types of electronic 'banking' services. In Canada, the Act establishing the Canadian Payments Association sets out the rights and obligations of users of the payments system, extending regulation to a wider range of intermediaries than banks.

22.40 While overseas research and the experience of the United States and Canada on this issue provide a useful starting point for possible legislation, Australia's financial system and the development of EFTS will inevitably require specific and unique solutions.

22.41 One particular instance where it is believed the approach to regulation adopted in the United States is desirable is the issue of unsolicited 'access devices'. In Australia, s.63A of the Trade Practices Act prohibits the sending of unsolicited credit cards; this prohibition was imposed after complaints about the marketing of Bankcard. The Committee believes this provision may be unduly restrictive in that it adversely affects the ability of intermediaries to issue credit cards to as wide a market as banks.

22.42 A preferable approach is that adopted in the US where, to ensure that an institution that is entering the EFTS market is not seriously disadvantaged relative to existing participants, unsolicited access devices may be issued subject to:

- compliance with requirements regarding disclosure of terms and conditions governing the use of the device; and
- safeguards regarding validation so as to ensure that the card cannot be used to initiate transfers to or from a customer's account except on request and after verification of the customer's identity.

22.43 Other issues which will need to be examined in any comprehensive review of EFTS, and the rights of the various parties, include the following:

- the protection of users in the event of error, system malfunction or theft (e.g. limitation on the potential liability of consumers);
- the protection of individual privacy; and
- the minimum records that should be kept by intermediaries.

22.44 It is evident that considerable work remains to be undertaken before a decision can be reached as to the need for legislation to protect users of EFTS and the form this might take. **The Committee therefore suggests that the Government should set up a task force with the States and Territories, the providers of EFTS services and related consumer groups to examine the need for legislation to protect users of EFTS. This examination should include a critical assessment of section 63A of the Trade Practices Act.**

(c) Insolvent Consumer Debtors

22.45 The Law Reform Commission has made recommendations to reform Australia's insolvency laws.¹⁸ Its main recommendation is to establish a program for the regular payment of debts by non-business debtors concurrently with the establishment of a government-sponsored debt counselling service and the reform of existing judgment debt recovery processes. The LRC suggested that the debt repayment program should provide for an extension of time for the payment of debts and for the reduction of debts where full payment is not expected.¹⁹

22.46 The Committee has no firm views on the full implications of the LRC's suggestions. It should be recognised, however, that any arrangements which delay

¹⁸ The Law Reform Commission, Report No. 6, *Insolvency: The Regular Payment of Debts*, 1977.

¹⁹ Subsequent to certain counselling procedures, creditors would be notified by mail of the proposed scheme. At least half of the creditors in number and amount would have to agree to the scheme to bind all creditors, who would then be restricted from taking further recovery action.

or reduce the payment of debts effectively increase the cost of finance to others, as lenders have to make sufficient returns on their assets to cover the cost of their borrowings and provide an acceptable profit margin. Consistent with this and with its approach in other areas, however, the Committee would record that:

- before a government-sponsored debt counselling service is introduced it should be established that existing debt counselling arrangements operated by the consumer finance industry and other private organisations are inadequate — with or without modification;
- the role played by existing legislation in impeding private initiatives to assist those borrowers who have become insolvent might first require re-examination. For example, it has been claimed that loan documentation requirements impede the ability of credit providers to restructure the loan repayments of insolvent debtors;
- methods of government intervention should be subjected to tests of cost effectiveness.

(d) Class Actions

22.47 Concern has been expressed about the possible impact of the introduction of 'class actions' on financial intermediaries in Australia.²⁰ The Committee also received the Law Reform Commission's discussion paper which concluded that there was a need in Australia for such a procedure.²¹

22.48 So far as the financial system is concerned, it has been suggested that class actions could expose financial intermediaries to extensive damages for 'technical' breaches of credit legislation, e.g. a failure to comply with print size in loan documentation.

22.49 Consideration of the merits and disadvantages of class actions in general falls outside the scope of this Inquiry. However the Committee warns that class actions could have a serious effect on the cost and availability of consumer finance.

²⁰ Class actions permit the claims of a number of persons to be determined in one action and damages awarded in respect of each member of the 'class'.

²¹ 'Access to the Courts — II Class Actions', Law Reform Commission, Discussion Paper No. 11, June 1979.

PARTICIPATION IN THE FINANCIAL SYSTEM

17.1 The range of financial institutions which might reasonably participate in the

provision of domestic payments is wide and includes:

Ch. 23 Participation in the Domestic Payments System

Ch. 24 Domestic Entry to Financial Intermediation

Ch. 25 Non-resident Participation in Australian Financial Intermediation

• entry to banking and the payments system

• the structure and efficiency of the payments system

The main content of the chapters is also a review of the current situation

and the likely future developments.

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