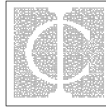

OFFICE OF REGULATION REVIEW

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Insurance and Superannuation Commission (ISC) Discussion Papers On Derivatives

The Office of Regulation Review (ORR) — located within the Industry Commission — provides advice on the Commonwealth Government's regulation review policy: it reviews new regulations; and monitors the progress and participates in programs for the reform of existing regulations. The ORR also advises Cabinet on regulatory proposals affecting business, liaises with departments and agencies in the development of regulations, and comments publicly on regulatory issues.

The ORR functions include advising agencies on the use of the Cabinet endorsed 'Guidelines for Regulatory Impact Statements' (RIS) (Attached). Whilst RIS guidelines have to date applied only when agencies seek Cabinet approval for new or amended regulations, it is anticipated that their essential elements will apply more broadly in the future. For example, the Legislative Instruments Bill currently before Parliament provides for similar tests which agencies must apply to a wide range of legislation including subordinate regulation. Such guidelines and tests also provide a useful indication of 'best practice' for all public sector organisations seeking to introduce new or amended regulations.

The ORR endorses the approach taken by the Insurance and Superannuation Commission (ISC) in three Discussion Papers — released on 27 March 1995 — dealing with the regulation of derivatives for superannuation; life insurance; and general insurance. The analysis undertaken by the ISC in these three papers conforms — in broad terms — to the approach outlined in the RIS guidelines.

Whilst the ORR agrees with the overall conclusions in the three ISC Discussion Papers, the following comments provide analysis and

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suggestions regarding specific ISC proposals for the regulation of derivatives.

Costs and benefits of regulation

The thrust of the Commonwealth Government's regulatory guidelines are that, for regulatory intervention to be justified, there should be a clear net gain to society. In addition, when assessing the various approaches to regulation, the benefits and costs of each option need to be identified and compared, to assist decision makers in choosing the best regulatory option.

The rationale of the ISC for deciding upon preferred regulation outcomes would be enhanced by analysing — in a little more detail — the benefits and costs of the various options discussed.

The ORR recognises that, in practice, many of the costs and benefits of each option for the regulation of derivatives might not be amenable to quantitative measurement. Nevertheless, a listing of a qualitative nature — if systematic and comprehensive — may be sufficient to gain an appreciation of the relative costs and benefits of each alternative.

Consistency of the proposals with other rules and regulations

As a general principle, there should be consistency between the approach taken by the ISC to the regulation of derivatives with the approach adopted by other regulators of the financial system, such as the Australian Securities Commission (ASC) and the Reserve Bank of Australia (RBA).

The three ISC Discussion Papers identify the approach adopted by some Australian regulators to the regulation of derivatives. But, they do not compare in a systematic manner their proposals with the approach adopted by other regulators.

Review of regulations

Another aspect of good regulation making is that it should include a process for monitoring and/or amending regulations where, for example, regulations impose detrimental or unintended costs. Methods of achieving this goal can include an expiry date (ie. inserting a sunset clause) or a comprehensive review, perhaps 3 or 5 years after a regulation is implemented or amended.

Exclusion of use of speculative derivatives by superannuation funds

Paragraph 5. (i) of the ISC proposal relating to superannuation on page 6 states: 'In particular, the risk management practices should effectively exclude the intentional use of derivatives for speculative purposes.'

This proposal would allow superannuation funds to invest in derivatives for non-speculative purposes, such as reducing the level of risk resulting from

investments in physical assets such as shares and property. However, it would prevent superannuation funds from investing in speculative derivatives, which could include:

- **highly leveraged derivatives, where exposure in a market is larger than the funds held to back that exposure; and**
- **high risk derivatives with no leverage and within the risk/return ratio of the investment strategy of a prudent fund manager.**

The ISC Discussion Papers do not explain why more stringent regulations should apply to superannuation funds, compared to life insurance and general insurance providers.

In addition, it should be recognised that effectively excluding superannuation funds from investing in 'speculative' derivatives with no leverage, may reduce the total risk exposure of a fund. However, it may also result in a reduction in the risk adjusted rate of return of that fund.

Derivatives can also be cheaper to transact. For example, an investment manager could buy a diversified portfolio of shares, paying brokerage and stamp duty of each transaction, and allocate staff resources to acquire and maintain this diversified portfolio. Alternatively, a derivative could be purchased which would replicate such a holding, but at a smaller cost. Therefore, excluding use of speculative derivatives could also result in higher transaction costs for superannuation funds.

In summary, a prohibition on the use of speculative derivatives could be too wide, covering both use of highly leveraged derivatives — which arguably should be restricted — and high risk/return derivatives with no leverage, where there seems to be a lesser case for prohibition.

This aspect of the ISC draft proposal could deny superannuation funds full access to:

- **a large and growing area of financial instruments;**
- **the larger profits to be made from properly judged risky investments in derivatives for speculative purposes; and**
- **the benefit of risk reduction from a fully diversified portfolio of investments which includes using derivatives for speculative purposes.**

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The contact officer in relation to these comments is Dr. Stephen Rimmer whose telephone number is 264 5897.

Paul Coghlan
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31 May 1995