AFMA

AUSTRALIAN FINANCIAL MARKETS ASSOCIATION

Submission to the Financial System Inquiry Interim Report

26 August 2014

About AFMA

AFMA is the industry association for participants in Australia's securities and OTC financial markets. The Association's Objectives cover policy advocacy, promoting the development of efficient and competitive financial markets, industry self-regulation in addition to promoting high professional standards education and data services.

AFMA has over 130 members, including Australian and international banks, all of the leading stockbrokers, securities companies, state government treasury corporations, fund managers, traders in electricity and other specialised markets and industry service providers.

AFMA represents Members' interests in dealings with governments and regulatory authorities on issues that affect the business of members and the capital markets generally.

Promoting Market Efficiency

Market Governance

AFMA's key mandate is to promote best practice in financial markets so they can continue to maximise their contribution to the economic health of Australia. We achieve this by promoting effective self-regulation of the OTC markets through efficient and ethical market practices, conventions and standard documentation.

Financial Operations

AFMA's market governance role is complemented by the development of widely-accepted industry standards for transactional processing. This ensures that operational aspects of financial transactions, in particular confirmation, settlement, reconciliation and risk management processes are globally-recognised best practice.

Promoting Market Integrity

AFMA recognises the importance of efficient regulation to inspire investor confidence in our markets, and in this regard plays a leading role in providing industry input to government and regulators on public policy matters relevant to the financial markets. We seek to ensure that government regulation of the financial sector is firm enough to inspire investor confidence yet flexible enough to allow the markets to grow to their full potential. Official regulation is under-pinned by AFMA's conventions and other standards which promote best practice.

Promoting Market Professionalism

AFMA encourages high standards of professional conduct in financial markets by delivering professional development and accreditation programs to improve individual expertise in OTC and exchange-traded markets. AFMA accords accreditation, recognised by the markets regulator ASIC, to individuals who achieve the required levels of competence. AFMA provides training and accreditation for the staff of members engaged in the OTC markets and is a Registered Training Organisation.

Market Data and Documentation

AFMA administers and publishes the key BBSW benchmark rate and provides daily market data and documentation for OTC transactions to international standards. Further information is available at www.afma.com.au

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1. EXECUTIVE SUMMARY

Format of our submission

In this submission, AFMA has made comments about issues raised in the Financial System Inquiry (the Inquiry) Interim Report July 2014 (the Interim Report) that are significant in the context of the ongoing development of the Australian financial markets. Our comments relate to those areas that are core business for AFMA members or which fundamentally affect that core business. This submission includes further recommendations where we think we can make a useful contribution. These are summarised below. AFMA has not responded to all of the issues raised in the Interim Report.

Key points

AFMA's initial submission to the Inquiry in March 2014 (available at our website www.afma.com.au) was based on three core propositions:

- A strong economic performance by Australia is reliant on well-functioning wholesale banking and financial markets;
- Well-functioning wholesale banking and financial markets depend in part on good regulation, which is the outcome of a capable regulator implementing an objective and well-substantiated government policy position; and
- The financial system requires regulatory and tax policy settings that support its development, including by fostering innovation by industry participants – but we are not yet on the optimal pathway to achieve this.

These core propositions continue to guide our comments to the Inquiry in this submission.

AFMA's initial submission also said that there has not been a clear strategic sense in recent years of how the Government wishes to see the financial system develop and what policies it will prioritise to achieve its objectives in this respect. We also said that the Inquiry's outcome should provide a basis for the Government to work with industry to prepare a strategic plan for the long term development of the financial services sector in Australia in a way that balances innovation, competition, stability, consumer protection and revenue-raising.

The Inquiry's Interim Report is a useful and informative reference for gauging the state of the financial system, and the sentiment of the participants in the sector (be they industry participants, regulators or users of financial services). The Interim Report also articulates issues that are currently topical. There are a range of matters identified in the Interim report that go to the current structure, regulation and usability of the financial system that are all worthy of further consideration.

A strong, resilient and vibrant financial system is a major underpinning for the continuation of Australia's economic prosperity, and consequently, the wellbeing of society.

Financial markets are an integrated part of the chain of production in the national economy. They are not separate from the rest of the economy; rather there is a tight interdependency.

AFMA would therefore urge the Inquiry, as it moves towards the completion of its final report, to also give significant focus to issues that are currently impacting, and will impact in the future, the ongoing development and competiveness of Australia's financial system, particularly in the Asian region, but also globally.

Areas such as:

1. Taxation, in the form of direct tax measures, but also other tax-like measures such as cost recovery;
2. Effective and efficient regulatory and legal structures that are appropriate for the Australian context and help to build our economy (rather than burgeoning regulatory and legal requirements);
3. Conditions conducive to establishing and maintaining financial services business in Australia (particularly given the significant contribution of the financial services sector to GNP and employment);
4. Australia's comparative advantage in terms of our relationships with key regional neighbours and trading partners; and
5. The export of Australia's recognised centres of expertise in financial services

must be subject to a clear strategic approach by Government that is aimed at ensuring the ongoing growth and development of the financial system, both domestically and internationally, in the years to come.

AFMA considers it is vitally important that Government policy making, and decision making by Government agencies, does not have the effect of inadvertently driving business activity out of Australia. The architecture of the financial system should, within the reasonable bounds of efficiency, make Australia a more attractive place to do business, rather than a less attractive proposition.

Commentary on the Interim Report and summary of AFMA's recommendations

The Interim report sets out principles for the Financial System, which are:

- Efficient allocation of resources and risks;
- Stability and reliability;
- Being fair and efficient.

The Interim report suggests that our financial markets achieve these outcomes in terms of meeting the needs of Australians and performed well throughout the GFC period. Looking at the available evidence, AFMA agrees with this judgement – for instance:

- A steady reduction in transaction costs on financial markets (spreads and charges) – for example, spreads in the institutional market for interest rate swaps, which are a product commonly used by financial entities and corporates for hedging, have declined by about 40% since the time of the Wallis financial system inquiry;

- An active equity capital raising market – for example, capital raising on ASX in the GFC was around 7% of GDP (permanent financing equivalent to over 40% value of credit approvals for large loans in those years).

Similarly, in the over the counter markets, customer transactions are a large part of the market and have been growing in proportion; for instance, non-banks accounted for over one third and two thirds of the interest rate swap and government bond markets, respectively, in 2012-13.

That said, it has not all been plain sailing since the GFC – indeed, there have been difficult periods for those in the financial markets.

For example, trading in cash equities fell sharply in both real and nominal terms following the GFC and has not recovered since. Market velocity fell from 107% in 2008-09 to 78% in 2013-14[1]; meanwhile, the regulatory burden and associated costs have been rising markedly; for instance, cost recovery for market supervision now costing the industry approximately $20 million per annum was introduced in 2010.

Some problems have been specific to particular markets. For example, policy uncertainty in the lead up to the elimination of the carbon tax curtailed hedging though electricity derivatives contacts and greatly restricted market volumes. This experience illustrates the importance of policy certainty for the effective performance of markets.

Moreover, the cost of implementing regulatory change is high and has the effect of increasing financial intermediation costs through both banks and financial markets. This is a factor that has been openly acknowledged by central banks.

Looking to the future, financial markets must continue to evolve if they are to meet the changing needs of Australian business, governments and households. For instance:

- Demographic change will affect the size and pattern of superannuation savings; and
- Closing the infrastructure financing gap will require innovative funding solutions.

Hence, there are challenges that the Inquiry must address to improve the vibrancy of our financial markets. This is important because the forces of economic and regulatory change are expected to shift the balance of the financial system more towards market based financing in the future.

The Inquiry could also contribute to future economic and financial sector development by pointing to important limitations of financial sector regulation. It cannot address the economic and financial impact of sustained large fiscal deficits, as experienced by some European countries. Nor can it prevent the pressures arising from domestic or global macro imbalances, such as those that instrumental in causing the GFC.[2] However, regulation that creates a resilient financial system is an important component of measures to contain the impact of such external pressures.

[1] Market velocity is total value transacted divided by average market capitalisation.

[2] Dr Adrian Blundell-Wignall, "The crisis: causes, consequences and lessons for the future. The international perspective", ASIC Sumer School 2009

This does not diminish the importance of financial regulation. While sound fiscal and macroeconomic policies provide the basis for an effective financial system, financial regulation is an essential response to the endogenous risks in the financial system.

The International context is more important than ever

As we look to the future, economic growth and development in the Asian region drives a need for greater regional financial market integration, offers new funding sources and provides the opportunity for financial services exports.

Australia must be well placed to take advantage of this and it is welcome that the Inquiry has recognised these issues.

Equally importantly, the regulation of our financial markets are now subject to global standards to a much greater degree. This is evident through traditional channels like the Basle prudential framework but now also through the work of the Financial Stability Board and IOSCO.

This aspect is also recognised appropriately in the Inquiry’s Interim Report.

Government policy settings

Government policy settings will be a key influence on financial market development. This includes the approach that is adopted in relation to regulation, taxation and promoting development of the sector.

Regulation

The financial sector needs policies that are designed and then implemented to serve the national the economy in a cost-effective and efficient way. Good regulation supports the natural discipline of the market process, which is the driver of the efficient allocation of capital.[3]

AFMA agrees with the observation by the Inquiry that Australia’s current regulatory model has served us well. The right framework is in place and regulators have generally performed well.

Going forward, we need to both protect the quality of our regulatory system and improve its performance. In doing this, we need to start at the beginning by ensuring that the right policies are put into place.

Parliament needs to maintain its policy-making authority and ensure that it has access to highly capable and objective policy advice to understand the implications of the laws they are making.

This requires an intellectually strong and well-resourced policy making capability in the Department of Treasury. In addition, Treasury is best placed to assess and advise government on the conflict in

[3] As market conditions become difficult from time to time, there can be calls to limit practices like short selling and the use of credit derivatives to temper the price signals they provide. These facilities improve market efficiency by enhancing price discovery and promoting liquidity, amongst other things and can be delivered in conjunction with regulation to contain any associated risk to an orderly market.

policy objectives that can sometimes occur. Treasury must be adequately resourced to do this and the Inquiry should seek assurance about this.

The administrative role of regulators is separate to the policy-making role of Treasury and government. This distinction is necessary both for good policy development and the effective administration of policy measures. This delineation should not be compromised either by design or by default through differences in the resourcing of the various participants in the policy and regulatory process.

Regulators should be appropriately resourced for their functions, and have clearly defined roles and expectations placed on them within the terms of the Government's policy. The revival of Statements of Expectation, which are mentioned in the Interim Report, are a welcome development in this regard. In addition, AFMA believes there is merit in further considering an Inspector General of Regulation to review a regulator's systems and procedures for administering legislation. This model has worked well in the taxation area.

Industry's role in financial markets and the regulatory process

Industry involvement in the regulatory process, including through self-regulation in appropriate cases, should form part of the future regulatory fabric of the Australian financial system.

Adopted in a flexible and innovative manner, this approach has the capacity to improve market efficiency, give better regulatory outcomes and reduce the cost of regulation.

For instance, industry bodies can develop best practice for financial market participants in relation to matters like conduct and risk management, which the regulators can then incorporate into their assessments of licensees. Done in the right way, this combines a dynamic and deep understanding of contemporary business models and practices with the formal authority of the regulators.

Where appropriate, this supports the regulatory objective of fair and efficient markets. AFMA has provided best practice guidance to the market on the conduct of market soundings that illustrates the potential here.

Tax settings and future reform

In AFMA's view, the taxation system has too great an influence on the financial system for it not to be subject to firm recommendations in the Inquiry's final report.

The efficiency and effectiveness of financial markets are adversely impacted by aspects of our tax system.

For example, interest withholding tax reform is recognised as a mechanism to improve competition in the financial system but it has been deferred, delayed and eventually dropped as a policy reform in recent years. However, Australia must remain an attractive destination for mobile capital, and offer diversified funding options to Australian based financial institutions and businesses.

Another related example is the significant progress towards implementation of the G20 objective for central clearing in OTC derivatives, while there is no apparent progress towards the elimination of uncertainty in relation to withholding tax that conflicts with this regulatory objective.

AFMA believes that it is important to the future development of the financial system for the Inquiry to recommend to the Government that it should:

1. Strike a balance between taxation and regulation policy that attaches a high priority to the future development of the financial system; and
2. Adopt a coordinated, whole of government approach to policy implementation by its various agencies.

Corporate bond market

The Interim Report has correctly identified that a deeper and more liquid corporate bond market would provide diversification benefits to both issuers and investors.

Australia has an established domestic bond market, but a range of regulatory and tax factors have limited its development, which are described in more detail in AFMA's initial submission to the Inquiry, and in this submission.

At a fundamental level, the goal of developing the bond market will require collaboration by all stakeholders – Government and the industry have a responsibility here in working towards measures to address the inter-related objectives of improving:

- Issuer access**:** making it less onerous to raise funds via the Australian bond market;
- Investor access**:** retail investors have adequate better access and greater choice;
- Investor skills and knowledge: ensuring that investors have the necessary skills and knowledge to understand the importance of utilising corporate bonds in their portfolio, particularly in the context of an aging population; and
- Tax treatment: more neutral treatment of fixed income products vis-a-vis other investment products.

Consumer outcomes and conduct regulation

Product disclosure

If investors want choice in the management of their financial affairs, there must be a disclosure regime that supports informed decision making. AFMA is supportive of measures that help investors access all of the information they need about a product, and to understand that information. This might include things such as:

- Comparative disclosure or mechanisms to enable investors and their advisers to compare products;
- The use of technology to model performance scenarios;
- Disclosure about a reasonable band of return for a class of products.

There is no clear evidence to suggest that the equity capital raising regime is not working effectively.

We have made some observations about access to equity capital markets in section 3.4.

Financial advice

AFMA strongly supports the introduction of a clearly articulated, compulsory framework to raise professional standards and competency in the financial services industry. Financial advisers should be raised to the standard of a 'trusted adviser'. There is some way to go in the industry to achieve this outcome.

Global regulation

The financial sector, and financial markets in particular, are now to a much greater degree dependent on international regulatory standards, developed by bodies like IOSCO and the Basle Committee on Banking Supervision.

It is essential to the Australian national interest that our regulators:

- are well placed to contribute to the development of global standards; and
- have the capability and confidence to make judgements on the way in which these standards should be applied in the Australian context.

International standards will generally be appropriate for the Australian financial system, and adoption is a key element of our efforts to integrate globally. However, there will be situations where the timing or form of adoption of an international standard in Australia would make a material difference to the economic cost and effectiveness of our financial system – this applies to matters well beyond bank capital issues that have been the subject of recent public commentary. Our decision making process in respect of banking and financial markets must place greatest weight on the right outcome for the Australian economy.

Therefore, it is also important to test the relevance and applicability of global standards to Australian markets through thoughtful and thorough consultation.

The Inquiry also makes reference to the vexing problem of extraterritoriality of regulation. The Inquiry could highlight to the Government its agreement with the importance of the G20 in providing a systemic, outcomes-based approach to this issue. The Treasurer noted in February the role of the G20 in managing spillovers between countries as they strengthen their financial policy frameworks. He stated that G20 countries should agree to recognise and accept each other's regulatory regimes where they achieve equivalent outcomes, noting that countries should be given the appropriate flexibility in how obligations are met.

Competitiveness of Australia

The regulatory system is one aspect of Australia's international competitiveness but there are others.

Cost recovery is a rapidly growing impost on the sector and there is no apparent consistency of policy or logic across the various levies and charges. This is in part because the objective of cost recovery is some cases more fiscal and short term in nature than it is to promote effective financial sector regulation in a principled and disciplined way.

The Inquiry could contribute to the future development of our financial system by recommending to the Government a clear policy on cost recovery for regulation that is driven by a focus on the beneficiaries of regulation, and on the actual regulatory risks posed by different business models.

Bearing in mind that governments, the broader public and investors are the key beneficiaries of financial regulation, the Inquiry should recommend the following principles to the Government:

1. The sole objective of a cost recovery mechanism should be better regulatory outcomes – cost recovery should not be implemented unless there is a clear positive link between the associated cost recovery mechanism and the core objectives of regulation;
2. A cost recovery mechanism should not be adopted unless the associated moral hazard can be controlled and effective accountability mechanism are put into place – moral hazard arises because neither the regulator nor the Government have to pay for the utilisation of resources by the regulator, so there is no effective discipline or constraint to support regulatory efficiency;
3. A cost recovery mechanism should apply in a fair manner and have a neutral effect on competition, including the provision of technology and innovative products and services, within the financial system;
4. Cost recovery should be applied on a consistent basis across the financial sector and take account of benefits that flow to governments, its agencies and the community including higher tax revenues and improved national security;
5. Judgement about the utility of costs recovery within these terms should be made solely in accordance with the circumstances of the Australian financial system and economy; not by reference to the situation in overseas financial systems.

Lastly, the Johnson report on Australia as a Financial Centre is almost 5 years old now, and many of its recommendations have not been acted on in a meaningful way.

The ingenuity and capability of Australian financial markets, the quality of our regulatory and legal systems and the economic development of Asia presents a great opportunity to grow our financial services exports and related income and employment.

However, Australian governments have yet to deliver a convincing message to global institutions that we are willing to compete – that we will do whatever is necessary to fully leverage off our competitive strengths in a regional context. This commitment is necessary to build confidence in business to locate their operations in Australia.

2. COMPETITION AND CONTESTABILITY

2.1 Interim Report Observation: Regulatory capital requirements

The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral. Banks that use internal ratings-based (IRB) risk weights have lower risk weights for mortgage lending than smaller authorised deposit-taking institutions (ADIs) that use standardised risk weights, giving the IRB banks a cost advantage.

Policy options identified in the interim report:

- No change to current arrangements.
- Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation, increase minimum IRB risk weights, introduce a tiered system of standardised risk weights, lower standardised risk weights for mortgages or allow smaller ADIs to adopt IRB modelling for mortgages only.
- Provide direct Government support to the RMBS market, or allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio.

AFMA comments

The main area of competitive disadvantage appears to be in the residential mortgage arena, where the five current IRB-accredited banks are reported to have a 23 basis point cost advantage over other ADIs using the standardised approach.

However, it is unlikely that increased risk weights for IRB-accredited banks will serve the residential mortgage consumer. While it levels the playing field amongst lenders, it does not result in what competition is meant to produce – namely, lower borrowing costs for the consumer.

The remaining options identified in the Interim Report have the potential to provide a lower cost basis for the unaccredited banks, however should embody as a core principle the expectation that an unaccredited bank applying for relief will embark on a course of action designed to acquire IRB accreditation status.

Absent this principle, any subsequent change in policy which resulted in the revocation of relief would place upward pressure on the rates paid on impacted floating rate mortgages, thereby increasing risk sensitivity, irrespective of whether market conditions warrant it. Furthermore, deliberations on this issue should not lose sight of two factors:

1. From 2016 onwards, the four major Australian banks will also be subject to a 'higher loss absorbency' (HLA) capital requirement, as part of the framework for domestic systemically important banks (D-SIBs); and
2. Financial stability requires that banks do not unduly increase their risk appetite or relax lending standards, given the potential for speculative activity in a low interest rate/rising house price environment.

3. FUNDING AUSTRALIA'S ECONOMIC ACTIVITY

3.1 Interim Report Observation: Funding from overseas

Ongoing access to foreign funding has enabled Australia to sustain higher growth than otherwise would have been the case. The risks associated with Australia's use of foreign funding can be mitigated by having a prudent supervisory and regulatory regime and sound public sector finances.

Policy options identified in the Interim report:

- No change to current arrangements.
- Facilitate development of a small and medium-sized enterprise finance database to reduce information asymmetries between lenders and borrowers.

AFMA comments

AFMA generally agrees with the observation, both in terms of:

- supporting ongoing access to foreign funding as a fundamental tenet of Australia's financial architecture; and
- a prudent regulatory system and a strong Government balance sheet can assist in mitigating the risks associated with reliance on foreign funding (particularly rollover risk) by ensuring that Australia remains an attractive destination for mobile capital.

However, AFMA believes that the Inquiry should, in its final report, specifically highlight the factors that increase the cost of funds for Australian borrowers in terms of both debt and equity investment. These include, but are not limited to, measures that exist within Australia's taxation system that are, from a policy perspective, inconsistent with the attraction of foreign debt and equity investment. In a number of areas we urge the Inquiry to make recommendations on some of the more important measures as they pertain to tax, rather than mere referral to the Tax Reform White Paper.

AFMA notes the increasing pool of capital from superannuation savings may mean, over time, that reliance on foreign investment is reduced. This should not, of itself, alter the regulatory and taxation settings that relate to foreign capital, which should be considered through the lens of promoting efficient flows and mitigating the costs associated with foreign investment, which ultimately will result in increased costs for Australian enterprises.

The Johnson Report

AFMA cites the views expressed by the Australian Financial Centre Forum in its report "*Australia as a Financial Centre: Building On Our Strengths*" (**the Johnson Report**) which noted the cogent reasons for persistent current account deficits being prevalent in Australia and the necessary reliance on foreign capital. In broad terms, the Johnson Report concluded that the regulatory settings were appropriate in terms of balancing the risks of relying on foreign capital against ensuring that Australia remains an attractive destination for such capital. The report's recommendations in this regard extend only to enhancing understanding of Australia's regulatory settings through an integrated portal (such as a website) and enhanced co-ordination by regulators.

More importantly, the Johnson Report made two crucial recommendations in respect of the taxation settings that stymie cross border flows and foreign investment. Noting that "(m)aintaining a strong and competitive foreign bank and broader foreign financial institution presence is desirable," the Johnson Report highlighted the benefits that accrue from providing efficient access to offshore savings pools, which in addition to the necessary reliance on foreign capital given persistent current account deficits also enhances international engagement of the financial sector. In this light, the recommendations of the Johnson Report were:

- to remove withholding tax on interest paid on foreign-raised funding by Australian banks, on interest paid to foreign banks by Australian branches and on foreign institutions' related party borrowing; and
- to remove the LIBOR Cap on deductibility of interest paid on parent-branch funding.

The basis for the recommendation with respect to interest withholding tax was clearly articulated by Johnson as follows:

> "*The continuing application of interest withholding tax on financial institutions' borrowing offshore sits uneasily with the Government's desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres, which increasingly do not charge interest withholding tax on such transactions*."

The Johnson Report also noted the somewhat fragmented approach to the imposition of interest withholding tax on interest paid by a financial institution offshore, with exemptions in place for publicly offered debt ("section 128F"), interest paid by an offshore banking unit, and interest paid to an unrelated financial institution resident in a jurisdiction where the Double Taxation Treaty included an exemption. The Johnson Report also acknowledged that where interest withholding tax is imposed, it is generally borne economically by the borrower, as the lender will insist on being "grossed-up" for the amount withheld.

This issue was recently examined by the Australian Centre of Financial Studies, who noted:

> "*Despite the strength of Australian banks, international deposits are only around $120 billion or 6% of all liabilities. The imposition of interest withholding tax on the retail deposits of non-residents has potentially resulted in the lower utilization of international deposits by Australian banks, not only resulting in a less diversified funding base for the banks, but also potentially increasing the cost of capital. Furthermore, the imposition of withholding taxes on non-resident deposits may impact the ability of international banks to compete in Australia, negatively impacting competition in the Australian banking sector. There is a need therefore to remove withholding tax on non-resident deposits, as recommended by both the Johnson Report (2009) and the Henry Tax review (2010)*." [4]

[4] Ralston and Jenkinson, *International Linkages: Financial Markets and Technology*, 2014, p8.

On the LIBOR Cap, the Johnson Report opined that it was a policy that was contrary to ensuring access by Australian institutions to foreign funding sources, particularly in times of financial stress (such as those exhibited in the Global Financial Crisis). Furthermore, any tax avoidance concerns could be adequately addressed through existing transfer pricing mechanisms (which AFMA notes have been strengthened in the past 12 months through the enactment of the new Division 815 into the *Income Tax Assessment Act 1997)*.

Government responses to Johnson

Notwithstanding the strong recommendations of the Johnson Report, neither the abolition of interest withholding tax for financial institutions nor the LIBOR Cap has proceeded. Of more concern, there is no commitment from the Government to implement either Johnson recommendation.

The response from the former Government to the Johnson Report initially set out a timeframe for the phase-down and ultimate abolition of interest withholding tax for financial institutions. However, as set out in a media release from the now Treasurer and the then Shadow Minister for Finance, Deregulation and Debt Reduction on 28 August 2013, the phasing-down of interest withholding tax on financial institutions has been discontinued.

The LIBOR Cap has not been the subject of a Government statement regarding policy intent. The Government response to the Johnson Report merely requested Treasury to review the cap, which has not been completed. It is noted that the Board of Taxation, in its report on the Taxation of Permanent Establishments, was asked to provide comments regarding the appropriateness of the LIBOR Cap and while this report was delivered to Government in April 2013, it has not been released to the public, nor has the Government issued any response in relation to the LIBOR Cap.

Functionally separate entity approach to taxation of permanent establishments

In the intervening period between the publication of the Johnson Report and the Financial System Inquiry, a further taxation issue has arisen that has created inefficiencies in terms of attracting foreign capital to Australia. This relates to the failure of Australia to adopt global best practice (as endorsed by the OECD) in terms of taxing branches as functionally separate enterprises. This approach to branch taxation was endorsed by the OECD in 2010 and has been adopted by many of Australia's leading trading and investment partners.

In AFMA's view, taxing branches in a manner consistent with separate entities is consistent with the principles of tax neutrality, promotes diversity in the financial system, and enhances the competitiveness of the system through promoting certainty and alignment with international standards. This is particularly important for bank branches, which are common conduits to facilitate the inflows of capital from offshore into Australia.

In practice, adoption of the functionally separate enterprise approach to branch taxation will require amendments to the domestic taxation legislation that permits interpretation of Australia's network of Double Taxation Treaties in a manner that enshrines such an approach.

This issue was the subject of the Board of Taxation review into the Taxation of Permanent Establishments. As noted above, while this report was delivered to Government in April 2013, it has not been released to the public and the Government has not issued any response.

Adopting a coherent approach to regulatory reform

In the post-GFC environment, the Inquiry would be aware of a significant number of reforms being driven by the G-20 to enhance the transparency of OTC derivative transactions, including the drive for such transactions to be centrally cleared where systemically important. As acknowledged in the Interim Report, this has highlighted an inherent flaw in the structure of Australia's taxation system as it strives to attract foreign capital, namely the imposition of interest withholding tax on interest paid to a central clearing party outside of Australia.

This is an unintended consequence of the implementation of the G-20 commitments and has had a significantly adverse impact on the Australian derivatives market, vastly in excess of any revenue arising to the Government. In its joint-submission to Treasury on this issue in 2013, AFMA, the Australian Bankers Association and the Financial Services Council estimated that due to the imposition of Australian withholding tax on interest paid to central clearing parties, the percentage of Australian derivatives transactions that could be lost to overseas jurisdictions could be in the magnitude of 20-25%. Such a reduction would be enduring.

More generally, the fact that this anomaly has not been rectified evidences a failure by the Government to adopt a coherent approach to mitigating unintended consequences arising from regulatory reform, especially where the unintended consequence is perceived as being revenue accretive for Government over the forward estimates period.

AFMA recommendation

In terms of ensuring optimal settings for financing Australia's future, including the continued reliance on foreign capital, AFMA submits that the Inquiry needs to make recommendations on the two existing policy settings that provide significant impediments to the free flow of capital – namely, interest withholding tax and the LIBOR cap.

AFMA notes the approach adopted by the Inquiry is merely to refer these issues to the Tax Reform White Paper, to be conducted in 2015. Given AFMA's understanding as to the breadth of the White Paper's Terms of Reference, we are concerned that mere reference to the White Paper will not ensure that these issues are given the prominence they deserve in the White Paper process. Accordingly, we request that the Inquiry make recommendations to the White Paper process with respect to interest withholding tax and the LIBOR Cap in a manner consistent with the Johnson Report.

We further request that the Inquiry make a specific recommendation to exempt interest paid to or by a central clearing party from interest withholding tax.

In addition, we request the Inquiry to urge the Government to release the Board of Taxation Report into the Taxation of Permanent Establishments, concomitantly with a recommendation for the

Government to endorse the functionally separate entity approach to the taxation of branches and the enshrinement of the approach in the Australian taxation legislation.

In our view, these recommendations would be consistent with the Inquiry's Terms of Reference, which enable the Inquiry to make observations that inform the White Paper, as opposed to merely referring issues to the White Paper.

3.2 Interim Report Observation: Corporate bond market

Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Allow listed issuers (already subject to continuous disclosure requirements) to issue 'vanilla' bonds directly to retail investors without the need for a prospectus.
- Review the size and scale of corporate 'vanilla' bond offerings that can be made without a prospectus where the offering is limited to 20 people in 12 months up to a value of $2 million, or for offers of up to $10 million with an offer information statement.

AFMA comments

As the Interim Report has correctly identified, "a deeper and more liquid corporate bond market would provide diversification benefits to both issuers and investors". In our initial submission, AFMA noted that in order to achieve this ultimate goal, it is important for all stakeholders to work together in a consultative and collaborative manner towards solutions that achieve three main inter-related objectives:

- Issuer access: To ensure that it is no more onerous for corporate borrowers to raise funds via the Australian corporate bond markets, both wholesale and retail, than other sources, including the Australian equity market, bank financing and offshore debt markets;
- Investor access: To ensure that investors, particularly retail, have adequate access to, and greater choice in, corporate bond markets; and
- Investor skills and knowledge: To ensure that investors, both wholesale and retail, have the necessary skills and knowledge to recognise the importance and benefits of corporate bonds in their portfolio, particularly in the context of an aging population.

With respect to issuer access, AFMA put forward a suggestion in our initial submission that the continuous disclosure regime within the ASX should be utilised with respect to retail corporate bonds. This would make it less burdensome for issuers to raise funds via the retail corporate bond market than is currently the case, whilst ensuring that consumer protections are maintained. AFMA's suggestion is essentially similar to the second option proposed by the Inquiry above (ie. allow listed issuers (already subject to continuous disclosure requirements) to issue 'vanilla bonds' directly to retail investors without the need for a prospectus). Consequently, AFMA supports the further exploration of this policy option with appropriate consultation.

Other alternatives

While the policy options presented above work towards achieving the first objective of issuer access, AFMA believes that there are other policy options that are worth exploring that could work toward satisfying the second objective of investor access.

In this regard, the reforms currently before Parliament which allow for simple corporate bonds to be traded using corporate bond depository interests go some way towards achieving this objective. Further reforms, including broadening the definition of "simple" in this legislation, would assist in providing improved retail investor access.

Furthermore, and as noted in our initial submission, there are other policy options which could be explored to increase the range of issuers and product types in the market. For example, Government initiatives to support bond issuance in the infrastructure sector would not only increase the range of borrowers that investors could access, but also achieve other policy goals.

The support of social benefit bonds, whose return is based on the achievement of agreed social outcomes, is another option that could be pursued.

The third objective of improving investor skills and knowledge is also important for the development of the corporate bond market. In this regard, other policy options could be considered here, as discussed in our initial submission. These include Government involvement in the discussion about appropriate asset allocation weighting in superannuation funds, efforts to educate retail investors on the benefits of corporate bonds, and reviewing the regulations around credit ratings for retail corporate bonds (see below).

The Interim Report has correctly made the observation that "Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development." While the policy options canvassed in the Interim Report go some way towards addressing some of the regulatory factors, there appear to be few or no policy options presented to address taxation factors.

AFMA notes the approach adopted by the Inquiry in the Interim Report in relation to taxation matters, which is to list in Appendix 2 the issues that should be considered by the Tax White Paper.

However, given our expectation as to the breadth of the Terms of Reference for the Tax White Paper, we are concerned that a mere articulation of the broader tax factors that have, in the Inquiry's view, hindered the growth of the corporate bond market may not provide sufficient impetus to ensure that the issue is considered fully.

AFMA recommendation

To that end, AFMA would encourage the Inquiry to make a specific recommendation to the Tax White Paper to standardise the taxation treatment of returns from different asset classes, which will assist in removing the existing taxation bias against corporate bonds.

3.3 Other issues

The Inquiry seeks further information on a number of other issues related to the corporate bond market (see questions in italics), which we have addressed below.

Q. As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives?

As noted in our initial submission, as Australia's demographic continues to show a shift towards an aging population, there has never been more of a need for less volatile investment returns to complement investment portfolios. All other things being equal, it would be expected that as a greater share of the population enters retirement, demand for fixed income products would increase.

However, from a wholesale investor perspective, it is arguable that there is already currently a perennial underweighting in the fixed income asset class which is not conducive to an increase in fixed income product demand. Consequently, it is not obvious whether demand for fixed income will increase as the population ages further.

Regulation or other incentives could be explored to assist in increasing the demand for fixed income. As suggested previously, Government involvement in the discussion about asset allocation weighting, such as via recommending or publishing appropriate asset allocation weightings for various age-based scenarios, is something that could be considered to assist in increasing fixed income demand.

Also, from a retail investor perspective, it can be argued that fixed income has not loomed large in investment portfolios, regardless of the age of the investor. As suggested previously, financial education may well be a large part of the issue here, and further efforts on the part of industry and Government in this regard should be explored.

Q. Could enhanced transparency of transactions improve liquidity in the over-the-counter Australian corporate bond market, including its attractiveness to retail investors? What commercial or regulatory impediments are there to the potential development of improved transparency in the over-the-counter corporate bond market?

The Interim Report suggests that "since the corporate bond market in Australia is largely over-the-counter and lacks transparency, retail investors are effectively precluded from investing directly in these bonds." While this statement is essentially correct, it is not correct to infer that a lack of transparency is a reason for retail investors being precluded from investing. This is largely a regulatory issue, as choice and access for retail investors is limited.

That said, increased transparency of information with respect to any market has the capacity to generate additional interest from investors hitherto not associated with that market. It is arguable whether this would improve liquidity in the wholesale over-the-counter bond market itself, as transparency of information does not appear to be a concern to wholesale investors. Consequently, we do not see any commercial or regulatory impediments in the wholesale market.

However, increased transparency of information may increase the attractiveness of fixed income products to retail investors. At the very least, increased transparency would improve retail investor education and decision making. For example, it is arguable that few retail investors have the credit assessment skills to determine value in the market. At this time, most of the major credit rating agencies providing services in Australia have elected not to hold an Australian Financial Services Licence that enables them to provide credit ratings on retail products. It is understood that this is due, at least in part, to the more onerous obligations that apply to a license of this type, including the obligation to be a member of an external dispute resolution scheme. As suggested in our initial submission, these licensing requirements are a regulatory impediment which could be reviewed.

Q. Could alternative credit ratings schemes develop in Australia and would this help improve the appetite for bonds, particularly those of growing medium-sized enterprises? Could alternative standards of creditworthiness develop in Australia? What are the barriers to such developments, and what policy adjustments would assist such developments?

AFMA has no specific view on this question, but please refer the response above with respect to our suggestion on credit rating schemes.

3.4 Access to equity capital markets

Policy options identified in the Interim Report:

- No change to current arrangements.
- Review the size and scale of offerings that can be made without a prospectus where the offering is limited to 20 people in 12 months up to a value of $2 million, or for offers of up to $10 million with an offer information statement.
- Introduce additional protections for investors in relation to use of private placements and non-renounceable rights issues.

The Inquiry also seeks further information on the following areas:

- Is there a need to introduce differentiated markets to allow greater access to equity markets by smaller companies?
- Should other capital-raising requirements be modified to reduce dilution effects? Would this affect the capacity of corporates to raise funds, particularly under conditions of market stress?

AFMA comments

Approximately 70% of ASX listed companies (by number) have a market capitalization of less than $100 million. Of these, 44% have a market capitalisation of less than $20 million.[5] A significant proportion of these smaller companies operate in the resources sector. The equity raising considerations faced by these smaller listed companies can differ from their larger counterparts in a number of important respects.

The registers of smaller companies often have lower levels of institutional ownership. Many have one or more large individual shareholders, often the founder(s) of the business or member(s) of the senior

[5] ASX Limited "Capital Raising in Australia: Experiences and Lessons from the Global Financial Crisis", 29 January 2010

management team. The immediate implication of this is that the shareholder base may be capital constrained and/or lack the sophistication or desire to provide equity capital during periods of market turmoil, or to support complex capital projects.

As smaller companies grow, they will usually seek to introduce more sophisticated institutional-type investors with access to significant pools of capital onto their register. This is commonly achieved through a placement structure, and is therefore limited by the 15% placement capacity rule.

This constraint prompted the ASX to introduce the concept of "enhanced placement capacity" in late 2012, under which listed companies with a market cap of $300 million or less and who are not in the S&P/ASX300 Index may seek shareholder approval by special resolution at its AGM to place up to an additional 10% of its issued share capital (ie. up to 25%) in a 12 month period. The issue price of shares issued under the enhanced placement capacity must not be at a discount greater than 25% of the volume-weighted average price (VWAP) of the stock for the 15 trading days before the issue date.

Supporting smaller companies through these kinds of mechanisms is appropriate.

A single market structure, involving common reporting and governance requirements, supports the development of the equity capital market on the whole. A single market approach also means that as smaller companies grow into larger companies they already understand and are actively adhering to the requirements expected by regulators and market participants. This in turn promotes investor confidence.

AFMA supports modified capital raising rules which recognize and the issues unique to smaller companies seeking to raise capital.

AFMA also supports all listed companies (small and large) trading together in a single market to:

- leverage the best-practice currently required of all listed companies; and
- promote investor confidence and encourage an active and sustainable investor following.

Access for retail investors to new equity offers

The use of private placements and non-renounceable rights issues

The Australian regulatory regime affords Australian companies a range of potential offer structures that can be used to raise equity capital. The capital raising regime in Australia compares favourably against other developed economy regimes in terms of sophistication and flexibility. For example, the ability to conduct rights issues on an accelerated basis supports both the availability of capital and the terms on which it can be raised.

This regulatory sophistication contributed significantly to the ability of Australian corporates to achieve de-gearing objectives as credit availability tightened up through the global financial crisis ("GFC"). During 2009, over half of all ASX listed companies, and circa 80% of the S&P/ASX 200 index (consisting of the larger listed companies), raised equity. Equity issuance by existing listed Australian companies raised $98.6bn in 2009, 58% above the previous record year of 2007.[6]

The Board of a company seeking to raise equity has the flexibility to determine the appropriate offer structure as it exercise its fiduciary duty to make decisions that are in the best interests of the company as a whole. In determining the appropriate offer structure a company's Board will have regard to a range of factors including:

- the amount to be raised;
- shareholder participation;
- issue pricing;
- the need for an underwritten transaction;
- legal considerations including capacity to issue new shares;
- timetable issues;
- share register composition;
- documentation requirements;
- any related party matters; and
- costs.

AFMA considers that it is appropriate for:

- the regulatory framework to provide Australian companies with structural flexibility in relation to how they raise equity capital; and
- the decision on the optimal offer structure to be determined by the Board having regard to its fiduciary duties, rather than be dictated explicitly by regulation.

Dilution of retail investors is always a relevant and important (but not always the only) consideration for a company's Board when considering the appropriate offer structure for an equity raising. The obligation is on the Board to weigh up these considerations and implement an offer structure which allows them to satisfy their fiduciary duties.

The Interim Report focuses on two particular offer structures - private placements and non-renounceable rights issues. Australian companies have elected to raise equity under these offer structures for various reasons, which we outline below.

1. Private placements

Private placements, which are often coupled with a Share Purchase Plan ("SPP"), typically offer companies the following advantages over a rights issue:

- Market risk period – a placement structure allows a raising to be conducted on the shortest possible timetable, often after market close or under a one day trading halt. This short market risk period may be particularly important during periods of heightened market volatility and

[6] Ibid

investor uncertainty – for example, placements played an essential role in allowing Australian companies to raise equity on an underwritten basis during the GFC;

- Pricing - tighter issue pricing and low cost to execute relative to other offer structures, resulting in the new equity being raised at an overall lower cost of capital;
- Access to funds - funds settle and are available to the company within three business days;
- New investors - provides a mechanism for bringing new targeted shareholders onto the register where the Board has such a strategic objective; and
- Documentation –the issuer relies on the continuous disclosure regime and the use of cleansing notices to affirm that there is no material information that has not already been disclosed to the market.

Advancements in register analytics mean that most existing institutional shareholders can be identified prior to launch and offered participation (subject to legal restrictions). In many cases, shareholders are given priority allocations in private placements, such that they have an opportunity to at least maintain their pro rata shareholding in the company. In addition, there are several mechanisms for accessing retail shareholders through the raising structure, including:

- Inclusion of an SPP, which often provides the overwhelming majority of retail shareholders with an opportunity to increase (rather than dilute) their shareholding interest in the company. A 15% placement conducted concurrently with an SPP permitting up to $15,000, by definition, is non-dilutionary to all participants other than those who own greater than $100,000 worth of shares in the company. SPPs are commonly conducted alongside placements – since the start of 2013 more than half of the material size placements conducted (>$100m) have been accompanied by an SPP; and

- Inviting targeted retail brokers into the placement, being those whose sophisticated retail client base includes a significant number of existing shareholders in the company. This strategy increases the number of sophisticated retail shareholders that have an opportunity to participate in the raising.

AFMA considers that the current placement capacity restrictions under ASX Listing Rule 7.1 are appropriate. There may be merit in considering further enhancements to the SPP rules, including further increasing the maximum application per shareholder amount beyond the current $15,000 limit.

2. Non-renounceable rights issues

Rights issues, whether non-renounceable or renounceable, have the advantage of providing a pro-rata offer to all eligible shareholders. However, they involve a longer period of market risk (circa 3 weeks) which typically impacts:

- The ability to obtain underwriting for the transaction to provide the company with certainty;
- The issue pricing achievable – typically a wider discount than a placement, resulting in a higher cost of equity to the company; and

- The transaction costs involved - in the context of an underwritten rights issue, the value of the put option embedded in the underwriting agreement (in effect the premium paid by the company in the form of an underwriting fee) increases as the market risk period increases, and is therefore typically greater for a rights issue than for a placement.

The primary disadvantage of a non-renounceable structure relates to shareholders who are unable or unwilling to participate in the raising. These shareholders receive no value for their entitlement under a non-renounceable structure, whereas under a renounceable rights structure they may, depending on market appetite for the entitlements. Non-renounceable rights issues typically offer companies the following advantages over renounceable rights issue structures:

- Depending on various factors including the nature of the shareholder register, prevailing market conditions and the facts relating to the equity raising, full underwriting may not be achievable on a renounceable rights issue or it may be achievable but at a significantly larger pricing discount relative to a non-renounceable rights issue. There is more limited retail sub-underwriting appetite for renounceable structures from market participants. This dynamic is driven by the fact that, under a renounceable rights issue, the underwriter (and sub-underwriters) only have financial downside on any shortfall shares – if there is value in the shortfall shares it is not captured by the underwriter (or sub-underwriters);

- Renounceable rights issues are more complex and costly to implement as there is a need to reconcile the entire register between registered holders and underlying beneficial shareholders to the last share. This process is not well understood by the market and requires the engagement of a dedicated analytics firm who must complete the reconciliation before the ASX trading halt is lifted; and

- Accelerated renounceable rights issues require an additional day of trading halt compared to an accelerated non-renounceable structure (usually 3 days versus 2 days).

AFMA considers the current regulatory framework in relation to entitlement structures is consistent with the approach of providing boards with flexibility and a range of alternatives to consider when determining the optimal equity capital raising offer structure.

There are various shareholder protections that exist under the current framework that AFMA considers to be appropriate, for example:

- limits such as the maximum 1:1 offer ratio under a non-renounceable structure; and

- the requirement to appoint a nominee to sell the rights of ineligible shareholders under a renounceable structure and have those proceeds remitted to renouncing shareholders.

4. STABILITY AND THE PRUDENTIAL FRAMEWORK

4.1 Interim Report Observation: Too big to fail and moral hazard

During the GFC, significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big-to-fail. These perceptions can be reduced in Australia by making it more credible to resolve these institutions with Government support.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Increase the ability to impose losses on creditors of a financial institution in the event of its failure.
- Strengthen regulators' resolution powers for financial institutions, and invest more in pre-planning and pre-positioning for financial failure.
- Further increase capital requirements on the financial institutions considered to be systemically important domestically.
- Ring-fence critical bank functions, such as retail activities.

AFMA comments

Having in place a well-developed failure resolution regime to deal with insolvency and administrative forms of insolvency management, which reduce to a manageable level the damage to the economy caused by any financial firm's failure, is a fundamental component of financial sector regulation. It is a crucial contributor to confidence in the system.

The alternative is the moral hazard of allowing a financial firm to believe that its failure would be dangerous to the financial system and that it would therefore likely receive significant Government assistance when its solvency is suddenly threatened.

The GFC demonstrated that idiosyncratic or system-wide shocks may undermine the viability of ADIs and other financial institution in any jurisdiction, notwithstanding the presence of sophisticated regulatory and supervisory frameworks designed to promote their resilience.

This was particularly so in cases where banks were so large and interconnected that their failure had potential to cause significant dislocation in the financial system, thus undermining the effective functioning of the economy. The notion of too-big-to fail (TBTF) following from the Lehman Brothers failure in 2008 arose out of that bank's systemic role in the financial markets. In a sense, it was not a case of 'too-big', but 'too-interconnected'.

The emphasis of reforms carried out under the G-20 agenda, particularly in relation to derivatives markets and complex products, has been to address network connectivity risk to the system. It is hoped that better information feedback to regulators through data collection on transactions and the concentration of risk into central nodes through the promotion of central clearing will help to address the 'too connected to fail' problem.

One factor which contributed to failures during the GFC was that owners and creditors expected that Governments would have no option but to rescue banks getting into difficulties. In Europe expectations of rescue were fulfilled and public funds were used on an unprecedented scale. This may have protected financial stability in the short term but it also put public finances under considerable strain.

Where publicly funded bail-outs occurred, it was on an assessment that the costs, in terms of the wider impact on society, would have been greater still had individual banks been allowed to fail. These costs arise because of the reliance that individuals and companies have on the financial services provided by banks, in going about their daily lives and business.

Bank rescues served to shield shareholders, bondholders and other creditors from the costs they would have faced had banks gone into liquidation, reinforcing the view that some carry an implicit Government guarantee. Even in Australia, where there was no failure, developments in international wholesale funding markets were restricting the ability of financial institutions both here and overseas to access funding, with potentially serious implications for liquidity and lending activity.

Prior to the GFC, in 2005 a comprehensive review of Australia’s failure and crisis management arrangements by the Council of Financial Regulators resulted in recommendations that the Government introduce a limited mechanism to provide depositors and general insurance policyholders with access to their funds on a timely basis. The Council’s views were that the lengthy nature of the wind-up process for a failed institution could create financial hardship for households and businesses if they could not access their funds in the meantime. If that occurred, the Government would be under pressure to make an ad hoc response, as was demonstrated by the failure of the general insurer HIH in 2001.

This lead the Government in October 2008 to announce temporary arrangements (known as the Financial Claims Scheme) to enable the provision of a guarantee for the deposits and wholesale funding of Australian deposit-taking institutions. The Government guarantee arrangements were designed to promote financial system stability in Australia, by supporting confidence and assisting authorised deposit-taking institutions (ADIs) to continue to access funding at a time of considerable turbulence. They were also designed to ensure that Australian institutions are not placed at a disadvantage compared to their international competitors that could access similar Government guarantees on their wholesale funding.

It should be borne in mid that the Financial Claims Scheme (FCS) was designed as a minimalist scheme, to complement depositor preference. As part of its focus on retail depositors, the FCS cap considered before the financial crisis was in the range of $20,000 to $50,000. This was thought to strike an appropriate balance between protecting retail depositors and avoiding excessive moral hazard.

Today, the legacy of this action is permanent cap of $250,000 per person per institution on deposits guaranteed under the FCS. The descriptive wording of this measure as a ‘deposit guarantee’ encourages in the public mind the mis-perception that there is a broad implicit guarantee that a big bank would not be allowed to fail. It is difficult to fully address the moral hazard problem that such policy responses produce.

The FCS is a form of deposit insurance. It aims to provide depositors with confidence that their funds are safe even in crisis situations. This is intended to maintain confidence in the banking system and reduce the potential for damaging runs. In the event that an ADI does fail, economic disruption would be minimised by providing rapid access to funds.

The FCS is designed as a 'paybox' scheme, the sole purpose of which is to reimburse depositors in a failed Australian ADI. The FCS payout relies on ex-post funding. If an ADI fails, the Government will provide funds to depositors through APRA. The Government would then recover funds through a priority claim on the assets of the insolvent ADI in the liquidation process. If the assets were insufficient to meet the Government's claim, the Government could levy the ADI industry to meet the shortfall.

The FCS supplements Australia's main existing depositor protection arrangement, which is depositor preference. This gives depositors a prior claim on the assets of an ADI that has become insolvent.

Pre-funded claims schemes face a number of challenges in the Australian context. A primary problem is how to accumulate adequate pre-funded resources. The priority claim the Government has on the failed ADI's assets creates a different environment to jurisdictions with pre-funded resolution arrangements or insurance schemes. Depositor preference is an important factor in the approach to resolution arrangements in Australia.

Australian depositors have a priority claim on the assets of a failed ADI ahead of other unsecured creditors, after the Government has been reimbursed for any amounts paid under, and expenses incurred in relation to, the FCS, rather than a deposit insurance scheme which is favoured in many other jurisdictions.

The failed ADI's remaining assets in Australia must be used to repay any deposits in Australia above the FCS cap before they can be used to repay other unsecured creditors. To further support depositors' interests, ADIs are required to hold sufficient assets in Australia at all times to meet their Australian deposit liabilities.

AFMA would agree with the proposition that the most effective way to address the moral hazard issue is to have in place well developed arrangements for dealing speedily and efficiently with financial claims and failure resolution. Liquidity losses to depositors can occur when access to their deposit accounts is delayed or their accounts are frozen. These actions transform demand deposits involuntarily into longer-term time deposits or bonds. Liquidity losses also result when credit lines cannot be relied upon or drawn down to meet business needs. Loss of liquidity thus impairs the efficient operation of the payments system.

When regulators close a bank legally, they often also effectively close it physically, at least partially, until funds are recovered from the sale of assets to start paying depositors on their claims. In many countries the lack of access to deposits and credit lines is more feared than actual losses to depositors and generates as great, if not greater, adverse externalities. The more likely depositors are to receive their funds promptly, the less likely they are to engage in runs.

As we have noted the threat of ad hoc politically driven bail-outs should be designed out of the system as far as possible. For this reason the simple approach of a 'bail-in' has gained policy support in many jurisdictions.

In the event of failure, bail-in converts debt into equity. It uses internal capital rather than taxpayer dollars to absorb losses and recapitalise the firm. Bail-in speeds up resolution dramatically. It is generally recognised that approaches which rely on lengthy contractual negotiations do not work in the real world. Key elements of resolution arrangements need to be executed over a weekend so that markets can function on the Monday. Bail-in preserves critical functions to avoid excessive contagion to financial markets or the real economy. It avoids wholesale liquidation, which can impair critical payment functions, and which can be hugely destructive in a major crisis.

APRA has broad resolution options available to it that could enable it to create a bridge bank and recapitalise a failed ADI. AFMA supported the enhancement of APRA's ability to deal with bank failure in 2012 in response to the Government's consultation paper on 'Strengthening APRA's Crisis Management Powers'. In doing so we followed three guiding principles, which are still applicable:

- Respect for the group structure when resolving a financial institution failure, and recognition of home resolution authority actions for Australian entities of international firms;
- Leaving creditors no worse off than under insolvency;
- Ensuring consistent treatment of transactional claims relating to derivatives and other financial instruments, including appropriate respect for netting and collateral rights, subject to safeguards to avoid destruction of value.

An important policy objective in this context is to promote the integration of Australian crisis management responses to cross-border events within a globally consistent regime.

The Financial Stability Board's (FSB) *'Key Attributes of Effective Resolution Regimes*' (Key Attributes) provide the framework for a global regime, and they encourage alignment of recovery and resolution practice and regulation across the G-20 jurisdictions.

While the focus of the Key Attributes is on global systemically important financial institutions (SIFIs), the Government's proposals in the 'Strengthening APRA's Crisis Management Powers' consultation paper recognise that most of the Key Attributes can have wider application to SIFIs and other financial institutions and should provide the benchmark for the Australian resolution framework for prudentially supervised financial institutions. This is an important area for further policy work to be carried out, as the application of the Key Attributes in the Australian environment to a wider set of financial institutions does have some practical consequences they need to be carefully thought through and reconciled with existing regulatory settings.

The FSB's general guidance on recovery planning and stress testing, in particular the emphasis on an ADI itself being responsible for the design of recovery options, is sensible. Indeed, even with increasing degrees of interaction with APRA, up to the point that non-viability is declared, a failing firm's management needs to be making the decisions about how to run their business in the interests of all of the ADI's stakeholders.

The Australian resolution regime does need to take account of resolution actions of home authorities where branches of foreign banks are concerned, and separate resolution proceedings should not be initiated unless that is consistent with the overall resolution strategy for the group.

One of the most important lessons from the last financial crisis was that regulatory bodies around the world should co-operate to ensure that they agree on plans to resolve firms, and do not act solely in their domestic interest, to the detriment of other countries and the global financial system.

Cross-border banking has expanded rapidly over the last decade. Many large banks now rely upon a global network of branches and subsidiaries, with centralised funding that is distributed within the financial group under a global strategic plan. The activities of these groups have expanded beyond traditional deposit-taking and lending to include a range of non-bank financial activities, such as securities broking and asset management.

In addition to these 'universal' banks, the international space is now dominated by G-SIFIs that operate across borders, in multiple currencies and time zones. While international financial groups operate globally, the frameworks for addressing their distress and failure are local and apply to distinct parts of the group rather than to the group as a whole.

By allowing financial institutions under their supervision to establish presences in a range of jurisdictions, home authorities expose themselves to the reality that the legal frameworks for facilitating cross border finance in stable periods are typically more effective than the cross-border resolution arrangements that are available in times of distress.

The FSB's Key Attributes address this challenge. They aim for a harmonisation of resolution regimes across markets. While the institution-specific co-operation agreements among regulators that are contemplated by the Key Attributes are helpful, effort needs to be made to align legislation with FSB principles.

4.2 Interim Report Observation: Macro-prudential powers

A number of jurisdictions have implemented new macro-prudential toolkits to assist with managing systemic risks. The effectiveness of these for a country like Australia is not yet well established, and there are significant practical difficulties in using such tools.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Establish a mechanism, such as designation by the relevant Minister on advice from the Reserve Bank of Australia (RBA) or the Council of Financial Regulators (CFR), to adjust the prudential perimeter to apply heightened regulatory and supervisory intensity to institutions or activities that pose systemic risks.
- Introduce specific macro-prudential policy tools.

AFMA comments

Various commentators have noted that there are good reasons for Australia not to follow other countries in making greater use of counter-cyclical, macro-prudential policy instruments. Kirchner observes that policy makers have yet to establish how greater counter-cyclical use of quantitative controls over the supply and demand for credit, based in part on macroeconomic conditions, can be effectively reconciled with a more deregulated financial system in which financial market prices now play the dominant role in allocating capital.[7]

The Inquiry should be very cautious about recommending the introduction of any specific macro-prudential policy tools in the absence of a concluded view about the benefits of such tools, and in the absence of a clearly articulated need to implement these kinds of mechanisms in Australia.

As articulated by the FSB, the defining elements of macro-prudential policy are:

- the objective - limiting systemic or system-wide financial risk;
- the scope of analysis - the financial system as a whole and its interactions with the real economy; and
- a set of powers and instruments and their governance - prudential tools and those specifically assigned to macro-prudential authorities.

According to the FSB, macro-prudential policy is a complement to micro-prudential policy and it interacts with other types of public policy that have an impact on financial stability. No matter how different policy mandates are structured, addressing financial stability and systemic risk is a common responsibility. Many policies could and should influence financial stability and systemic risk, but not all such policies should be considered macro-prudential.

However, a 2011 report published by the Bank for International Settlements and prepared in collaboration with the FSB and the IMF, said that while there was no widely agreed and comprehensive theoretical framework for an optimal macro-prudential toolkit, it identified three main categories for such tools- those that address threats to financial stability arising from excessive credit expansion and asset price booms; those that address key amplification mechanisms of systemic risk linked to leverage and maturity mismatches; and those that mitigate structural vulnerabilities in the system and limit systemic spill overs in times of stress.[8]

The report noted that the instruments most commonly employed to address threats from excessive credit expansion included time-varying capital requirements, ceilings on credit or credit growth, caps on loan-to-value ratio and debt service-to-income ratio and a minimum margin and reserve requirement. It says that while flexibility for a more tailored and targeted approach was self-evident, there are also limitations, and that the higher administrative costs may be more susceptible to circumvention and, if taken too far, could inadvertently result in intrusive credit allocation.

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[7] Dr Stephen Kirchner, "*Australia mustn't jump the gun on macro-prudential policy*" Business Spectator 25 July 2014

[8] Bank for International Settlements, Financial Stability Board and International Monetary Fund Joint Report *Macroprudential policy tools and frameworks – Progress Report to G20,* October 2011

The report said limits on maturity mismatches and caps on foreign currency lending were key to address systemic risks, while additional loss absorbency measures and resolution requirements for systemically important financial institutions were among the most conventional tools to mitigate structural vulnerabilities and limit spill overs from stress.

An important caveat in the report was that most countries had calibrated the instruments based on discretion and judgment rather than rules.

> *"While rules have merits – they can help to overcome policy inertia, enhance accountability, and create greater certainty for the industry – designing them may be difficult, especially when multiple instruments are being used in combination. This is why rules are often complemented with discretion."*

The result is that there is not obvious guide to what tools might be placed in the toolkit.

AFMA recommendation

AFMA does not have a recommendation for particular tools, but considers that adoption of a conceptual framework for evaluating appropriate tools is needed as a starting point.

Identifying the rights tools for macro-prudential policy requires a model linking the final objective with the tools needed to get there. Analytical work carried out by the Bank of England and de Nederlandsche Bank with others, has produced a four-step plan to provide a simple framework for thinking about this issue.

The process begins with defining the final objective of macro-prudential policy. In the next step, the kind of risks that pose the main threat to the objective are identified. In step three, specific problems that may be causing the different types of risk are identified in some detail. In the fourth and final step, the tools that could counteract the specific problems are identified.

The Interim Report notes that stress tests have been one of the early tools identified as part of the toolkit to evaluate banking systems. Evaluating resistance to shocks that can affect normal functioning is considered of high importance and at the root of the main objectives of macro-prudential policy. The guiding principle in the application of stress tests is that these exercises, considered as a diagnosis tool, must help to evaluate and formulate regulatory and supervisory policies with the aim of enhancing the soundness of the banking sector and the efficiency of financial intermediation. This is intended to improve the overall allocation of scarce resources in the economy, with the resulting positive impact on the health of the financial system.

In general, the main objective of top-down stress tests is to evaluate the loss absorption capacity of a system under scrutiny. These stress tests aim to identify vulnerabilities while assessing and evaluating the loss-absorption capacity of a given banking system when these vulnerabilities crystallise and become real shocks.

Consequently, macro-prudential stress tests should be regarded as a supplementary tool for supervisory activity, which provide firm and certain criteria to take proactive and reactive measures to cope with the impact of a pre-defined shock to the system.

In particular, a top-down stress test aims to provide an order of magnitude estimate of capital needs. This is achieved by adding up ADI by ADI results based on a general model of the banking sector, rather than on specific information and models at the individual bank level, which is the aim of a bottom-up stress test conducted by banks for their own internal purposes.

4.3 Interim Report Observation: Implementation of international prudential frameworks

Australia has implemented some aspects of global prudential frameworks earlier than a number of jurisdictions. It has also used national discretion in defining capital ratios. When combined with other aspects of the prudential framework and calculated on a consistent basis, Australian banks' capital ratios (common equity tier 1) are around the middle of the range relative to other countries. However, differences such as those in definitions of capital do limit international comparability.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Maintain the current calibration of Australia's prudential framework.
- Calibrate Australia's prudential framework, in aggregate, to be more conservative than the global median. This does not mean that all individual aspects of the framework need to be more conservative.
- Develop public reporting of regulator-endorsed internationally harmonised capital ratios with the specific objective of improving transparency.
- Adopt an approach to calculating prudential ratios with a minimum of national discretion and calibrate system safety through the setting of headline requirements.

AFMA comments

As the Inquiry has identified, APRA has applied stronger definitions of capital and floors for loss given default estimates for residential mortgages. These variances from the base line can result in Australian banks appearing less well capitalised than their global peers. This is particularly relevant given the current dependence of the Australian banking industry on foreign funding from the global capital markets.

It is seldom the case that a one-size-fits-all calibration is applied across jurisdictions, rather that the global prudential standard will serve as the base line against which discretion is applied in order to compensate for nuances which otherwise place one jurisdiction at either a competitive disadvantage to others, or in a worse-case scenario - fully unable to comply with the global standard.

This was the case with the application of the Basel III Liquidity Coverage Ratio (LCR), where it was clear that Australia did not have the required stock of high quality liquid assets (HQLA) in order for ADIs to satisfy the standard. In response to this problem, the Reserve Bank of Australia facilitated the provision of a committed liquidity facility (CLF) as part of Australia's implementation of the Basel III liquidity reforms, thereby ensuring that participating authorised deposit-taking institutions (ADIs) have enough access to liquidity to respond to an acute stress scenario, as specified under the liquidity standard.

This was clearly an instance where national discretion was required in order to harmonise Australia's standards with the global median, and represented a pragmatic rather than conservative approach to a complex problem.

AFMA recommendation

AFMA believes that Australia's best interests are served by the continued and targeted application of national discretion when defining capital ratios, and that this discretion should demonstrate a pragmatic approach rather than one that is generally more conservative than the global median.

Given:

- Australian banks' ongoing dependence on foreign funding; and
- local regulatory concerns that any course of action would reduce its national discretion leading to rules less suited to Australia's particular circumstance

the development of national reporting of regulator-endorsed internationally harmonised capital ratios specifically designed to improve transparency and facilitate the official measurement of these ratios relative to contemporaries in other jurisdictions appears to offer the best compromise and approach to a complex issue. This will serve to ensure that the Australian financial system can be readily compared and interpreted, and can therefore continue to attract foreign investment as required by the banking community.

5. CONSUMER OUTCOMES AND CONDUCT REGULATION

5.1 Interim Report Observation: Current disclosure obligations

The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.
- Remove disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery.
- Subject product issuers to a range of product design requirements, such as targeted regulation of product features and distribution requirements to promote provision of suitable products to consumers.
- Provide the Australian Securities and Investments Commission (ASIC) with additional product intervention powers and product banning powers.
- Consider a move towards more default products with simple features and fee structures.

The Inquiry seeks further information on the following areas:

- Do similar issues in relation to the PDS disclosure regime apply to prospectuses, and is there a need to review prospectus requirements?
- What evidence is there on the effectiveness of financial literacy strategies in enhancing consumer confidence and decision making at particular points in time, and in achieving increasing literacy over the long term?

AFMA comments

A view is often expressed that disclosure documents are defence documents, and that they are too long, and overly complex. However, the current form and content of disclosure documents is driven by the regime in the Corporations Act, the regulatory guidance issued by ASIC (which, in some cases, has required more information than is stipulated in the Act to be provided in disclosure documents) and by what is considered to be market best practice in terms of the level and standard of disclosure. ASIC has a significant influence on this aspect through its stop order and supplementary disclosure powers. Issuers tend to adjust their documentation in response to events where ASIC has intervened or required additional disclosure to be made.

A combination of factors affect the overall usability of disclosure documents, including the issuer behaviour that is driven by the disclosure regime, the quality of financial advice provided in connection with financial products and disclosure documents, the level of consumer literacy and ability to understand information about financial products but also more generally information about the process of investing and the outcomes of an investment decision.

It is more likely to be a combination of these factors that have resulted in many of the poor outcomes for investors that have been documented in recent years, rather than only issues related to the quality of disclosure or the content and presentation of disclosure documents.

AFMA recommendation

The financial product regime in Australia does not ban or restrict access to particular types of products for retail consumers. Even the distinction in the Corporations Act between retail and non-retail (wholesale) consumers relates to the value of the investment or the net worth of the person (ie. the investor), and not the attributes or the risk profile of any particular product.

Very few, if any, financial products available to retail investors have guarantees about performance or return of capital, except for basic banking products and some forms of general insurance.

The performance of a product cannot be guaranteed because market and economic conditions and other extraneous factors are outside the control of a product issuer.

In the absence of guarantees about performance, if a product "fails" there are likely to be one or more of the following factors in play:

- The product was poorly designed and therefore, unlikely to perform in the manner anticipated;
- The disclosure was inadequate;
- The product was not appropriate for the investor given their personal circumstances (including their age, risk appetite and so on);
- The investor did not understand the product or the disclosure about the product;
- The investor did not receive appropriate advice; and/or
- The adviser did not understand the product or the disclosure about the product.

A fundamental question for policy-makers in considering the design of the product disclosure regime is how much risk should investors be allowed to take? The answer to this depends on the nature of the investor (ie. whether they are retail or wholesale), the size of the investment and the consequences of that investment failing.

The current regime operates on the basis that it is a matter for each investor to determine what their needs are and how much risk they are willing to accept. The purpose of the disclosure regime is to assist the investor in making those decisions on an informed basis.

Some of the policy options outlined in the Interim Report signal the possibility of a shift to a different regime – for example, additional product intervention powers and product banning powers for ASIC, or a move towards more default products.

AFMA would be concerned about additional powers that enabled ASIC, for instance, to seek to ban a product or a class of products based on subjective criteria determined by the regulator. There are sufficient existing powers in the Corporations Act under which ASIC may stop a product being offered (interim and final stop orders) or require additional information to be included in the disclosure about the product. ASIC also has powers to take action in relation to advertising, marketing and promotional material about a financial product.

In AFMA's view, if Australia was to consider moving to a model under which certain products are banned or have access restrictions placed on them (either in terms of the product itself, or the type of investor) then large scale reform of the Corporations Act would be required, including the principles that underpin the way the legislation operates. That is, decisions about banning products or restricting access would be merit-based, rather than principles-based.

Default-style products may have a place in the financial system and are possibly a good option in terms of reducing the overall cost of advice for consumers. For example, it is likely that default products would be offered through execution-only platforms, or scaled/limited advice arrangements. This may be suitable for some consumers. However, default products can only ever play a limited role as, by their nature, they are unlikely to be innovative or produce anything other than a standardised return.

The other policy options in the Interim Report appear to be aimed at enhancing the existing disclosure regime.

If investors want choice in the management of their financial affairs, there must be a disclosure regime that supports informed decision making. AFMA would be supportive of measures that help consumers access all of the information they need about a product and to understand that information. Some of these measures might include:

- Comparative disclosure or mechanisms to enable investors (and their advisers) to compare products. Product disclosure documents would need to include some standardised information to enable comparison to occur in a meaningful way;
- The further development by third parties of comparison tools or ratings systems to assist investors and their advisers to understand the key features of financial products, and how a particular product compares to other products in the same class. Any such tools or systems must be free from conflicts of interest. The Government should examine whether there are impediments to the further development of these types of services;
- Use of technology to allow an investor (and their adviser) to model product performance scenarios based on a range of variables. The model could red flag, for example, when an investor inputs a combination of variables that are not realistic, or outside the parameters of reasonable assumptions; and
- Disclosure requirements in relation to a reasonable band of return for a product. This is an area that continues to be problematic for consumers who are not equipped to know whether a suggested or indicative return is realistically achievable. If an investor wants to go outside that reasonable band or invest in riskier assets that offer a much higher rate of return, then those investments need to be either subject to very stringent regulatory controls on the one hand, or otherwise be caveat emptor and clearly flagged as such.

AFMA is not aware of any evidence to suggest that prospectus requirements in relation to equity capital raising need to be amended. The current regime for equity capital markets and initial public offerings works well, is generally well understood by the investing public, and should not be interfered with.

We have made other observations about access to equity capital markets in section 3.4 of this submission.

A note about AFMA's Principles Relating to Product Approval

AFMA's members who are product manufacturers have also been active in working to implement better practice in the design and distribution of new financial products. In October 2012, AFMA issued principles relating to product approval for retail structured financial products (the Principles).[9]

The Principles are intended to support the product development and distribution process within firms that issue retail structured financial products by clarifying the respective roles and responsibilities of the various parties involved in a manner that promotes the fair treatment of individual investors.

Some of the key elements of the Principles are that:

- New financial products should be subject to a robust internal approval process that requites objective review and appropriate senior management sign off before they are offered to retail investors; and
- The internal approval process and the associated procedures should be detailed in a Product Approval Policy;
- AFMA recommends that members have in place a documented product approval framework which:
  - Considers reputational risks in the product development and sign-off process, and has arrangements in place to identify and respond to reputational risk issues;
  - Has clear roles and responsibilities to demonstrate accountability for those involved in all aspects of the development and approval process;
  - Has clear criteria about what constitutes a new product, and when a streamlined approval process may be used (for example, where the firm has previously issued a very similar product), or has a framework where such decisions are overseen by people separate from the business unit that will issue the product;
  - Incorporates effective scrutiny and challenge;
  - Has an effective product suitability framework;
  - Manages any conflicts between the firm and the investor properly;
  - Takes account of changes in the external environment; and
  - Is subject to a robust review mechanism.
- Firms should ensure that the product approval process allows for review and challenge by the risk, compliance and control functions;
- Firms should review and update as appropriate the product approval process on a regular basis to ensure that it remains robust and fit for purpose;
- Firms should only offer a financial product that represents a genuine investment opportunity for investors, although it may still be subject to risks; and
- Product suitability for the targeted market segment should be considered by the product manager and senior management at the product design stage;
- The product should satisfy what is understood to be genuine client interests, and management of the offering should enhance the firm's relationship with its investors.

The Principles address the factors that issuers should consider in determining the suitability of a product for the target market.

Finally, the Principles set out a number of issues that product issuers should have regard to when entering into product distribution arrangements.

[9] See AFMA's website www.afma.com.au, under Codes & Practices.

5.2 Interim Report Observation: Financial advice

Affordable, quality financial advice can bring significant benefits for consumers. Improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Raise minimum education and competency standards for personal advice (including particular standards for more complex products or structures such as self-managed superannuation funds), and introduce a national examination for financial advisers providing personal advice**.**
- Introduce an enhanced public register of financial advisers (including employee advisers) which includes a record of each adviser's credentials and current status in the industry, managed either by Government or industry.
- Enhance the Australian Securities and Investments Commission's power to include banning individuals from managing a financial services business.
- Rename general advice as 'sales' or 'product information' and mandate that the term 'advice' can only be used in relation to personal advice.

AFMA recommendations

Professional standards and competency

AFMA strongly supports the introduction of a clearly articulated, compulsory framework to raise professional standards and competency in the financial services industry. Financial advisers should be raised to the standard of a "trusted adviser". There is some way to go in the industry to achieve this outcome.

The industry has been engaging with ASIC for some time about concerns with the existing training standards framework (referred to as the "RG 146" framework). We therefore welcome the intensified focus on this area through the Inquiry, the Parliamentary Joint Committee on Corporations and Financial Services inquiry which is currently open for submissions, and the Industry Working Group on Professional Standards of Financial Advisers (convened by the Assistant Treasurer).

For the reasons outlined in AFMA's initial submission to the Inquiry (see page 120 onwards of that submission), AFMA does not support consideration of the introduction of the possible components of a framework (for example, the national examination proposed by ASIC) in isolation from all the other components that are necessary to implement an effective professional standards and competency framework.

New education, qualifications, training and competency standards should be considered in a holistic way. Any new framework that is introduced should ensure that the regimes administered by ASIC and by the Tax Practitioners Board (relating to financial advisers who also provide a tax (financial) advice service) are co-ordinated.

AFMA supports the adoption of a model akin to those that are in place for other professions in Australia – for example, medical practitioners, legal practitioners and accountants. Components of this type of framework would likely include:

- Minimum educational qualifications in order to gain entry to the profession, or alternatively, a minimum number of years of experience to accommodate more mature financial advisers who may not hold tertiary qualifications. Over time however, it is highly likely all advisers will hold tertiary qualifications as a pre-requisite to employment in the financial services industry;
- The successful completion of an assessment that would be applicable across the industry regardless of the nature of the adviser or their employer, or the kind of advice business the employer/licensee operates. The assessment might include a core component plus additional modules that relate to the adviser's areas of specialisation;
- Additional assessments that must be successfully completed in order to become a more senior adviser, or advise on more specialist, niche or complex products (akin to a specialist medical practitioner, or an accredited specialist or a senior counsel in the legal practitioner context);
- Ongoing professional development and continuing education for the whole of the adviser's career in order to maintain the "accreditation" they have achieved;
- A strong focus on ethical behaviour and conduct, both at the adviser and the licensee level; and
- Effective and stringent monitoring and review of the framework to ensure it continues to deliver good outcomes for advisers and consumers.

It is important that the framework applies across the whole industry to ensure the universal lifting of standards.

AFMA is also of the view that advisers who give personal advice to non-retail customers who are not corporates or institutions (that is - holders of AFSLs, listed companies and Government bodies) should also be subject to the professional framework. The "wealth" (net assets, income and so on) of an investor is not always a good proxy for the level of sophistication of that investor, or their ability to understand information in relation to financial decision making. Advisers who advise these types of non-retail customers should be expected to be equally as competent and qualified as advisers who advise retail customers. In that sense, the professional framework should be designed with the needs of the customer in the forefront.

Register of financial advisers

The Inquiry is no doubt aware that the Government has convened an industry working group, in which AFMA is a participant, to make recommendations on the implementation of a register of financial advisers. The working group reported to the Government on 22 August 2014, and we understand a further announcement by the Government is imminent.

The working group is also tasked with examining the options for the introduction of a broad framework to improve the professional standards of financial advisers and is due to report to the Government on these issues later this year.

ASIC powers to ban individuals from managing a financial services business

In principle, AFMA has no objection to enhancement of ASIC's powers to include banning individuals from managing a financial services business, subject to the normal procedural fairness processes and natural justice.

Labelling of general advice

On balance, AFMA is of the view that general advice is currently adequately distinguished from person advice under the law. It may not always follow, though, that consumers fully understand the difference.

Equally, it is not always going to be appropriate to re-classify general advice as "sales" (there may not be selling of a product involved), "product information" (the information may be about market conditions, not a product) or one of a potential myriad of other categories. This runs the risk of being even more confusing for consumers. There is also the risk that information that should be categorised as advice will be branded as something other than advice.

In AFMA's view, better disclosure to investors about the scope of the advice they will receive, what the adviser is able to advise on, the approved product list of the licensee, and whether the licensee is associated with or is itself a product manufacturer will be of more assistance to consumers than re-labelling of general advice. The Future of Financial Advice (FOFA) reforms have made substantial changes in relation to these areas.

5.3 Independence

The Inquiry seeks further information on the following areas:

- Is there a case to more clearly distinguish between independent and aligned advisers, and what options exist for doing this?
- Would consumers be likely to understand the difference between aligned and independent advisers and, if so, to what extent would this be likely to factor into a consumer's decision to take the advice?
- Would consumers be likely to be sensitive to differences in the price of independent or aligned advice?

AFMA comments

The discussion about independent versus aligned or vertically integrated advice business needs to move away from focussing on ownership structures. Instead, the key issues to consider are whether an investor receives good quality advice and products that meet their investment needs.

Consumers who receive advice from an adviser who is part of an aligned or integrated structure are just as likely to receive good quality advice, even if this entails recommendations about products issued by an entity who is related to the adviser.

Provided that:

- the investor understands the relationship between the adviser and any product manufacturer to whom they are related;
- the advice and products meets the investor’s needs;
- the advice and the products do not cost any more than completely independent advice or unrelated products; and
- the advice and the products are not subject to conflicts of interest or conflicted remuneration,

then from an overall perspective, that investor should not be any worse off by dealing with an aligned adviser rather than a completely independent adviser.

The costs of operating a completely independent advice business will be different to the costs of an aligned business which might be subsidised by product manufacture. In some cases, an aligned advice business may be able to offer financial services to consumers on a lower cost base than an independent adviser. This is probably not well understood by consumers. There is a trade-off between offering financial services at a lower cost, and the likelihood that those consumers may be offered products that are issued by a product manufacturer related to the adviser.

AFMA recommendation

Industry needs to build on the reforms introduced under FOFA to ensure that consumers fully understand the nature of the adviser with whom they are dealing, and what that means in terms of the financial services that can be provided.

6. REGULATORY ARCHITECTURE

6.1 Interim Report Observation: Regulatory perimeter

The regulatory perimeters could be re-examined in a number of areas to ensure each is targeted appropriately and can capture emerging risks.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Introduce specific refinements to the existing perimeters, including:
  - Prudential regulation — consider the case for prudential versus conduct regulation of superannuation funds.
  - Retail payment systems — consider a simplified and/or graduated framework with clear and transparent thresholds.
  - Conduct regulation — consider the case to extend regulation to fund administrators and technology service providers of sufficient scale, and apply select market integrity rules to securities dealers.

AFMA comments

In AFMA's view, the regulatory system taken as a whole has grown considerably in complexity such that institutions need to be of a minimum scale in order to have the capacity to meet their regulatory and compliance obligations.

An important regulatory perimeter issue that needs to be addressed is the one between financial sector regulation and competition law. In a number of areas financial sector rules and policy are used as the primary means to control competition for financial market infrastructure and financial institutions. Examples of this are the moratorium on equities clearing and the four pillars policy in respect of major Australian banks. Financial sector regulation also raises significant barriers to entry.

The future development of the financial system, and wholesale banking and financial markets in particular, will be substantially driven by the response of industry participants to the competitive pressures they face in the market place. Because the financial system is one of the most highly regulated sectors of the economy, future policies adopted by the Government and the operation of the regulatory and tax regimes will necessarily also be significant factors in shaping the future design and operation of the financial system.

The great practical challenge for government is to intervene in markets only in situations where this is warranted by a market failure and this intervention will improve the outcome. Overcoming this challenge requires a disciplined process that enables an objective and clear sighted review and assessment of policy and regulatory proposals.

Competition in financial markets should work to the benefit of market participants and investors by delivering lower prices, innovation and better market access. Therefore, AFMA supports the provision of an open, competitive environment for market infrastructure where it is of benefit to market users, while giving the regulators the tools necessary to manage systemic risk.

Having regard to the above, the Government should work in conjunction with the industry to adopt a strategic approach to the ongoing viability of the broader financial services sector in Australia that balances the interests of innovation, competition, regulation and consumer protection, and revenue raising.

Since the Wallis Financial System Inquiry in 1997, Australia has followed a path of levelling the playing field across financial services providers and financial products to enable intra-sectoral competition following the principle of convergence. This proved to be quite effective and remains the cornerstone of competition policy in the Australian financial sector.

Regulatory oversight was reformed to allow for convergence both among financial services providers such as banks, smaller deposit takers, life insurance companies, superannuation funds and asset managers so that functionally equivalent types of products – whether called banking, insurance, or capital markets products - could be supervised under a coherent system and rules, and not be regulated differently depending on what type of financial institution provides the service.

The policy objective of the regime was to not just to increase competition, but also to avoid regulatory arbitrage and to reduce differences in the net overall regulatory burden of products. The increased creation of complex financial products that straddle various markets and institutions was seen as necessitating a common regulatory approach.

The soundness of this conceptual approach was demonstrated by the problems highlighted with diffuse US financial sector regulation which resulted in inadequate supervision of financial institutions like AIG.

The rapid evolution of financial market infrastructure around the globe, driven by a huge volume of financial regulation reform in many jurisdictions, and commercial competition driven by the reordering of global economic activity mean that careful attention needs to be paid to the broad policy framework for financial market infrastructure within its overall economic and competition context.

AFMA recommendation

AFMA has consistently supported the need for a holistic policy review of financial market infrastructure regulation, particularly with regard to clearing and settlement infrastructure, which integrates market integrity goals with consideration of competition issues and market efficiency. This is in order to produce a strategic policy framework that provides clearly articulated principles to guide law reform and government decisions affecting ownership and control of financial market infrastructure, in a way that provides long term consistency and predictability for the market.

Discussion of competition in the financial sector has traditionally focused on the effects of globalisation and the impact of foreign market entrants. Integration into globalised financial markets is now an established feature of the Australian economy and competition policy should fully factor this fact into the policy framework.

Attention now needs to be directed to the question of complexity. Complexity is increasing due to the changing nature of financial services provision and the intensity of regulation. Financial services industries are continuously changing, not just due to the removal of barriers and increased role of non-bank financial institutions, but also due to increased globalisation and technological progress, which are all affecting the degree and type of competition. Even in market segments where competition has been intense and benefits in terms in access and costs have been very favourable, such as wholesale and capital markets, new competition policy challenges are arising nationally and internationally. The consolidation of financial services industries, the emergence of large, global players, the large investments in information technology and brand names necessary to operate effectively and to gain scale, and the presence of large sunk costs make it difficult to assure full competition. The increased importance of networks is also affecting the nature and degree of competition.

Account needs to be given to the impact of the greatly increased level of regulatory intervention into financial market activities since 2008. The great increase in the intensity of regulation means that large scale organisations are more and more the only ones able to have the resources to meet requirements of financial sector regulation. Overtime this will have an impact on competition in our market for existing players and significantly raises barriers to entry.

6.2 Interim Report Observation: Independence and accountability

Australia generally has strong, well-regarded regulators, but some areas of possible improvement have been identified to increase independence and accountability.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Move Australian Securities and Investments Commission (ASIC) and Australian Prudential Regulatory Authority (APRA) to a more autonomous budget and funding process.
- Conduct periodic, legislated independent reviews of the performance and capability of regulators.
- Clarify the metrics for assessing regulatory performance.
- Enhance the role of Statements of Expectations and Statements of Intent.
- Replace the efficiency dividend with tailored budget accountability mechanisms.
- Improve the oversight processes of regulators.

AFMA recommendation

Existing arrangements provide regulators with the right degree of independence and autonomy. AFMA does not agree with the idea of moving APRA and ASIC to more autonomous funding without a complete re-think on the issues of cost recovery and ad hoc industry levies. In our first round submission AFMA highlighted the overall ad hoc nature of the cost recovery process across the financial system. The Government process for establishing and reviewing recoverable costs should fit within a coordinated economic policy framework that takes into account the economy-wide impact of multiple service charges.

Funding

Cost recovery is a rapidly growing impost on the sector and there is no apparent consistency of policy or logic across the various levies and charges. This is in part because the objective of cost recovery is some cases more fiscal and short term in nature than it is to promote effective financial sector regulation in a principled and disciplined way.

The Inquiry could contribute to the future development of our financial system by recommending to the Government a clear policy on cost recovery for regulation that is driven by a focus on the beneficiaries of regulation, and on the actual regulatory risks posed by different business models.

Bearing in mind that governments, the broader public and investors are the key beneficiaries of financial regulation, the Inquiry should recommend the following principles to the Government:

1. The sole objective of a cost recovery mechanism should be better regulatory outcomes – cost recovery should not be implemented unless there is a clear positive link between the associated cost recovery mechanism and the core objectives of regulation;
2. A cost recovery mechanism should not be adopted unless the associated moral hazard can be controlled and effective accountability mechanisms are put into place – moral hazard arises because neither the regulator nor the Government have to pay for the utilisation of resources by the regulator, so there is no effective discipline or constraint to support regulatory efficiency;
3. A cost recovery mechanism should have a neutral effect on competition, including the provision of technology and innovative products and services, within the financial system;
4. Cost recovery should be applied on a consistent basis across the financial sector and take account of benefits that flow to governments, including higher tax revenues and improved national security; and
5. Judgement about the utility of costs recovery within these terms should be made solely in accordance with the circumstances of the Australian financial system and economy, and not by reference to the situation in overseas financial systems.

Cost recovery measures should be subject to effective governance and accountability arrangements to ensure that administrative costs are reasonable and contained over the long term. Attention needs to be paid to the general policy concern that without effective checks and balances in the design of the system, the ability to cost recover can make it easier for agencies to justify inefficient practices, because by virtue of making no net call on the Government budget they do not face the same level of official scrutiny. The ability to raise revenue that is deemed to be partly sheltered from budgetary and Parliamentary scrutiny because of its dedicated sourcing and application reduces incentives to be cost effective.

In relation to the proposition that regulatory costs should be proportionately borne by those contributing to the need for regulation or benefiting from that regulation, this is one of the most problematic areas of the current cost recovery arrangements.

In relation to much of financial sector regulation it is market intermediaries, not the "beneficiaries" of the regulation, who bear much of the cost recovery burden. Too often, market intermediaries are seen as easy points for revenue collection and made to bear the burden of cost recovery revenue collection.

New Government costs and charges are an impost on business that affect how the competitive environment and the relative attractiveness of doing business in Australia, compared to other jurisdictions, are viewed. Most charges associated with Government activities, particularly those related to regulatory activities, are paid by firms rather than individuals. To the extent that they are then passed on to counterparties (including retail clients), increased prices or a reduction in the range of products or services available will result.

Independence, autonomy and oversight

The creation of separate regulatory agencies with a high degree of autonomy from governments has been a recommendation of institutions such as the IMF and is a point raised in FSAP assessments of the Australian financial system. These recommendations are prompted by the laudable desire to protect financial regulation from corrupting influences, cronyism and self-interested business and pressure group influences driving political interference. Consistency and objectivity are to be highly valued in the administration of regulation. Australia's financial sector regulators have an excellent track record and reputation in this regard. Proper systems of accountability are a key reputational factor.

In considering how accountability should be approached, the work of Quintyn and Taylor[10] is commended to you. They describe a set of principles to follow:

- Agency independence is never absolute. The executive branch—which, in a democracy, is accountable to voters— delegates power to the agency. The agency therefore needs to give an account of its activities and, if necessary, to take action to redress its shortcomings.
- Accountability is not synonymous with control. It entails a network of complementary and overlapping oversight mechanisms and control instruments under which no one actually controls the independent agency, yet the agency remains "under control."
- Accountability and independence are complementary. Accountability reinforces an agency's independence by giving its actions legitimacy. The agency builds its reputation by explaining to the public how it is pursuing its mandate and allowing the public to express their views about its policies. A regulatory agency with a good reputation is more likely to be trusted by the public and given the benefit of the doubt in controversial cases. And a good reputation also bolsters the agency's independence.

[10] Eva Hüpkes, Marc Quintyn, and Michael W. Taylor - IMF Working Paper 05/51, "The Accountability of Financial Sector Supervisors: Principles and Practice," www.imf.org/ external/pubs/ft/wp/2005/wp0551.pdf

Clarify metrics for assessing regulatory performance

While simple metrics, such as the number of enforcement actions provide attractive public reporting opportunities for regulators, one needs to be cautious and avoid placing too great a reliance on this as a measure of performance as it can result in misplaced incentives to regulators which can misdirect their efforts.

For example in relation to enforcement actions, Australia's corporations law has many provisions with high penalties deterring market misconduct which, if effectively administered through steadfast surveillance, should deter misconduct in the first place - leading to a low incidence of cases being detected and followed up. A low number of enforcement actions may actually demonstrate a vigilant and effective regulator.

It is typically more difficult to measure a market regulator's performance against its mandate than it is to measure the performance of a monetary authority, such as a central bank. A well-defined statutory objective against which the agency's performance can be measured is generally considered a key requirement for holding independent agencies accountable. For central banks this is, increasingly, price stability, and central bank performance can be readily measured against this stated objective.

For market regulators, the issues are more complicated on three counts: the regulator's goals may not be explicitly or clearly articulated in the law. Market regulators often face multiple objectives such as protecting investors and maintaining market integrity and these objectives are typically hard to measure.

6.3 Interim Report Observation: Regulator cooperation and coordination

During the GFC and beyond, Australia's regulatory coordination mechanisms have been strong, although there may be room to enhance transparency.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Consider increasing the role, transparency and external accountability mechanisms of the CFR:
  - Formalise the role of the CFR within statute;
  - Increase the CFR membership to include Australian Competition and Consumer Commission, Australian Transaction Reports and Analysis Centre and Australian Taxation Office;
  - Increase the reporting by the CFR.

AFMA comments

Functioning of CFR

In AFMA's first submission we agreed with the importance of the CFR as a forum for cooperation in financial sector regulation which brings the relevant parts of government together. AFMA believes this existing arrangement can be built upon to provide the forum for strategic policy coordination of the financial sector regulators.

We also pointed out the importance of coordination between financial sector regulators under a process that provides for coherent and integrated policy guidance to them. In conjunction with our emphasis on the importance of the distinction policy-making and creating law from the administration of law by a regulator and primacy role of the Treasury in policy-making, we suggested that the Inquiry should consider a recommendation to put the Treasury in a position to fulfil its core function to provide coherent and integrated policy guidance through chairmanship of CFR. This proposal was predicated on our other recommendation that Treasury needs sufficient resourcing to do policy properly and have an upgraded capability. We are concerned now that the policy capacity of the Treasury is being severely curtailed by cuts to its budget with consequent loss of experienced staff. As a consequence Treasury does not appear to have the ongoing capacity to provide adequate secretariat support and direction to CFR.

AFMA recommendation

The creation of a separate, independent secretariat for CFR we feel would demand additional government resourcing that would detract from more efficient use of resources in the policy area. In this context, we believe that continuance of the current arrangement under which the RBA chairs CFR and provides Secretariat support should continue. This recommendation is based on the belief that the RBA is best placed to provide the resources to give economy and system wide strategic direction to the work of the CFR.

We do not recommend that the processes of the CFR should be overly formalised. However, the public reporting approach it has adopted towards its work on OTC Derivatives Reform provides a sustainable and practical model to follow in relation to other areas of work it engages in. For example, the publication of market assessment reports and the holding of public forums alongside the maintenance of its website would be a good approach to follow.

Expansion of CFR membership

AFMA agrees with the proposal that the CFR membership should be expanded to include all financial sector regulators, including ACCC and AUSTRAC. Coordination of regulatory activities is an important part of improving the efficiency of regulation. Alongside this reason, bringing regulators together to think from a system wide perspective how their activities relate to economy and system wide policy objectives should be of benefit to the financial system.

6.4 Interim Report Observation: Regulator mandates

Regulators' mandates and powers are generally well defined and clear; however, more could be done to emphasise competition matters. In addition, ASIC has a broad mandate, and the civil and administrative penalties available to it are comparatively low in relation to comparable peers internationally.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Strengthen competition considerations through mechanisms other than amending the regulators' mandates.
- Refine the scope and breadth of ASIC's mandate.
- Review the penalty regime in the Corporations Act.

AFMA comments

In section 6.1, we noted that perimeter boundary for competition regulation needs a more fully developed strategic framework in which to work in order to delineate the objectives and roles of regulators between the ACCC with general competition policy and sector specific role of the other financial sector regulators.

It is the objective of the ACCC to promote competition. We suggest that the aim should be to pursue system efficiency rather than 'competition'. The ACCC is equipped and accustomed to dealing with many sectors and to applying the law in a way that reflects each of their special characteristics; competition law can already be interpreted sufficiently flexibly to take the special traits of the financial sector into account. The adoption of different standards is not required.

In considering the role of competition in the context of financial sector regulation it is relevant to consider features of financial markets that may justify different treatment compared to other sectors and the question of whether there are any special economic features of financial markets that would justify different treatment.

The balance between competition and stability is an important consideration, and the extent to which competition policy should be applied to the financial sector where systemic stability is important is an area that needs more thorough policy thinking.

This leads to the question of to what extent stability considerations should influence the design as well as the application of competition policy. The application of competition policy presupposes stable market conditions. Competition policy is meant to address the potential anticompetitive effects stemming from individual cases rather than from a generalised situation. Competition policy in the financial sector needs to take account of systemic risk and the need for decisive action in the event that APRA needs to step in to resolve a failing ADI.

6.5 Interim Report Observation: Talent management

To be able to perform their roles effectively in accordance with their legislative mandate, regulators need to be able to attract and retain suitably skilled and experienced staff.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Review mechanisms to attract and retain staff, including terms and conditions.

AFMA comments

AFMA supports well-resourced regulators with highly qualified and experienced staff.

AFMA would not agree with suggestions that regulators are staffed by public servants who have neither care nor regard for the work they do. In fact, employees with strong regulatory experience are highly sought after within industry. This interchange of personnel is valuable in the long run both for regulators and industry.

This issue is clearly linked to funding of regulators. However, it is debatable whether the same or a smaller number of more highly paid staff within a regulator would result in tangibly different regulatory outcomes.

In AFMA's view, the Government needs to ensure that regulators are adequately resourced with sufficient staff to perform their functions, rather than continuing to cut back resources with the expectation of the same or a higher work output. It is more likely this issue that has a greater impact on the ability of regulators to retain staff.

AFMA recommendation

Regulators should be adequately resourced with sufficient staff to perform their functions.

7. TECHNOLOGICAL OPPORTUNITIES AND RISKS

7.1 Interim Report Observation: Regulation in a digital environment

Technological innovation is a major driver of efficiency in the financial system and can benefit consumers. Government and regulators need to balance these benefits against the risks, as they seek to manage the flexibility of regulatory frameworks and the regulatory perimeter. Government is also well-positioned to facilitate innovation through coordinated action, regulatory flexibility and forward-looking mechanisms.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Amend regulation that specifies using certain technologies with the aim of becoming technology neutral. Amendments should enable electronic service delivery to become the default; however, they should include opt-out provisions to manage access needs for segments of the community.
- Adopt a principle of technology neutrality, for future regulation recognising the need for technology-specific regulation on an exceptions basis. Where technology-specific regulation is required, seek to be technology neutral within that class of technologies.
- Establish a central mechanism or body for monitoring and advising Government on technology and innovation. Consider, for example, a public-private sector collaborative body or changing the mandate of an existing body to include technology and innovation.
- Establish a whole-of-Government technology strategy to enable innovation.

AFMA comments

Technological innovation is one of the major influencers of change in the financial system in Australia. Innovation improves efficiency and competition, which benefits individual consumers, corporate and Government bodies.

The pace of technological change that effects business and markets occurs at a much faster rate than regulatory change. This is also true for segments of the community where it is difficult for them to absorb changes, and the implications of those changes. This may not mean that more regulation is needed, but rather, could include stronger and deeper collaboration and engagement with the industry via market wide bodies and associations to enhance visibility and understanding of change in a timely manner. Regulators should use market based forums to ensure they are able to balance the benefits of technological innovation with the challenges that change also brings, via non-traditional ways of doing business.

AFMA recommendation

A principles-based approach to technological change and sponsorship, rather than assigning regulation to specific pieces of technology, would be a more practical approach to market wide delivery and adoption. A technology-neutral approach will ensure that there is a broader application of the intent of the application of a change or rule in the first place, and will help to maintain relevance of that regulatory stance in the longer term.

It has been noted by a number of economic commentators that because of the fast pace of development of new products, a principles-based approach to regulation using broadly applicable concepts has been advocated in a number of submissions to the Inquiry. However, as alluded to in the Interim Report, regulation that is broad and general (taking as an example Chapter 7 of the Corporations Act and the concept of “financial product” used therein) tends to require extensive interpretation, a comprehensive exceptions regime and detailed guidance from regulators.

As innovation and technological change occurs at a faster pace than regulatory change, market participants, trade bodies and regulators must at the very least have insight into trends and events. The lag in the ability of regulators and the market to keep up with technological change does not mean that innovation and technological change should be stifled or controlled. The principles-based approach, along with continual engagement between market participants, Government bodies and regulators will ensure enough information is available so that informed decision-making can occur at all levels.

The key is to ensure that technological innovation is fostered and that it occurs transparently within the perimeters of the financial system, to enable choice and limit unnecessary risk, while ensuring that it can drive efficiencies and benefits to consumers.

Innovation supports and encourages new entrants to the market, which will drive competition and produce a more diverse product offering as well as helping to produce sharper, more competitive pricing for the consumer.

7.2 Interim Report Observation: Managing information

Access to growing amounts of customer information and new ways of using it have the potential to improve efficiency and competition, and present opportunities to empower consumers. However, evidence indicates these trends heighten privacy and data security risks.

Policy options identified in the Interim Report:

- Review and assess the new privacy requirements two years after implementation to consider whether the impacts appropriately balance financial system efficiency and privacy protections.
- Review record–keeping and privacy requirements that impact on cross-border information flows and explore options for improving cross-border mutual regulatory recognition in these areas.

- Implement mandatory data breach notifications to affected individuals and the Australian Government agency with relevant responsibility under privacy laws.
- Communicate to APRA continuing industry support for a principles-based approach to setting cloud computing requirements and the need to consider the benefits of the technology as well as the risks.

AFMA recommendation

A two year review period after implementation to consider the impacts of the new privacy requirements on the financial system would seem to be the right direction to ensure that the results of the changes are in line with expectations.

Importantly, there must be a review to ensure that the changes have not inadvertently stifled business growth - in particular, any impacts on those firms wishing to locate or establish themselves in Australia, where they have cross border business and dealings that require an open flow for their own internal use (as opposed to the open transfer of financial data between companies). Singapore is a good example of a location where there are strict data privacy rules, administered by the Monetary Authority of Singapore, to protect their local businesses and consumers, but where there is also close market engagement and monitoring to ensure adherence to regulatory requirements.

In their submissions to the Inquiry, many market participants have noted the desire by multiple bodies to access data, especially in the context of cross-border mutual regulatory recognition, and the costs that result from compliance with these requirements. Similarly, it has been suggested that there should be a more formal cost benefit analysis of mandatory requirements prior to implementation. Increased access to customer information, or data breach notifications may enhance efficiency and competition for the benefit of consumers, however there is merit in maximising effectiveness of changes via a rigorous analysis prior to implementation.

The benefits of cloud technology are understood within the financial services sector, but such technology places a firm's control over their information at arm's length and raises questions about accountability should there be a breach in security. This may be compounded where a service provider resides offshore.

7.3 Interim Report Observation: Security

The financial system's shift to an increasingly online environment heightens cyber security risks and the need to improve digital identity solutions. Government has the ability to facilitate industry coordination and innovation in these areas.

Policy options identified in the Interim Report:

1. Review and update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation and progress public–private sector collaboration.

2. Develop a national strategy for promoting trusted digital identities, in consultation with financial institutions and other stakeholders.

AFMA comments

In the context of increasing threats to cyber security, the Interim Report notes that new entrants with less sophisticated data security protections may sometimes represent the "weak link" in the chain for cyber-security purposes.

The development of "trusted digital identities" could be expected to improve security and efficiency as well as increasing confidence. Government could assist in developing a centralised system of trusted digital identities, or could facilitate the development of such identities by guiding commercial providers, for example by setting standards for inter-operability.

Any national strategy for promoting trusted digital identities should be developed in the context of global initiatives such as the debate surrounding Legal Entity Identifiers. These types of considered deliberations should also assist in minimising potential costs as noted in our response in section 7.2.

8. INTERNATIONAL INTEGRATION

8.1 Interim Report Observation: Impediments to financial integration

Although elements of Australia's financial system are internationally integrated, a number of potential impediments have been identified. Financial system developments in the region will require continuing Government engagement to facilitate integration with Asia.

The Inquiry seeks further information on the following areas:

- What are the potential impediments to integration, particularly their relative importance, and the benefits to the broader Australian economy that can be demonstrated if they were removed?
- Where is future Government engagement needed to facilitate integration with Asia?

AFMA comments

Australia has benefited significantly from economic integration with the rest of the world and financial markets have contributed significantly to this outcome. International capital markets and financial institutions play a vital role in funding our economy and financing business investment. In addition, market based pricing for foreign exchange and interest rates help the economy to absorb the effects of changing conditions in key trading and investment partners. The markets also provide a wide range of cost effective hedging and risk management facilities to business that need to manage the associated price volatility.

While international integration provides valuable diversification opportunities for funding and investment by Australian entities, the corollary of this is the risk of contagion, as events in other economies will have some impact on performance of the Australian financial system and economy.

By its very nature, the risk of contagion is not unique to Australia, so it's not surprising that global regulatory reform of the banking and financial markets industry has in part been directed to reduce this risk.[11] The effect is to weaken the connectivity between global banks and also between global markets and related infrastructure. These constraints introduce unavoidable business and market efficiency costs but the judgement has reasonably been made that the financial stability benefits will exceed these costs.

However, the implementation of national financial reform programs in jurisdictions such the US and EU have been conducted in a manner that has introduced avoidable costs and, thus, has reduced

[11] For example, one of the challenges is that most banks have significant cross-border operations to meet the needs of their business clients and this connection can be a conduit for contagion. Specific measure like the Basle liquidity reforms seek to address this risk require the local operations to maintain a minimum local pool of liquidity separate from the other parts of the parent bank. Thus, banks are limited in their capacity to manage liquidity on a centralised basis.

market efficiency and placed a brake on desirable integration of financial markets. For example, the International Swaps and Derivatives Association (ISDA) has published evidence that OTC markets have fragmented along geographical lines since the start of the swap execution facility (SEF) regime in the US in October 2013.[12]

More generally, there is a failure to develop and implement global standards consistently, or coordinate effectively, on the evolution of rules at the development stage, resulting in growing incoherence and conflict surrounding rights of access and the regulation of cross-border business. This is impeding the desirable integration of international markets.

The Cross-Border Regulation Forum (CBRF), which is a global industry group that AFMA co-chairs, is providing significant input into the work being undertaken by the IOSCO Task Force on cross-border regulation.[13] CBRF has written a Report that provides comprehensive practical examples of harmful disconnects between key national regulatory regimes and sets out specific recommendations for the development of common regulatory standards.[14]

The failure by the global governments to overcome these problems will have adverse implications for Australia, as a highly open economy with significant reliance and connectivity to foreign financial markets.

Australia is well placed through its leadership role in G 20 the active participation of our regulators in the key global regulatory forums to promote progress towards a more sensible and coherent approach to challenge of ensuring fully effective international integration. For example, upcoming G20 Finance Ministers meetings will consider the proposals of the Financial Stability Board to achieve greater financial market regulatory coordination. This approach would improve international integration without compromising Australian standards for financial stability and conduct.

There is also an Asian dimension to this issue that should be reflected in the Australian response. Consistent with their need for more sophisticated financial systems to support their economic growth and development, many Asian countries are deregulating and expanding their financial markets, which necessarily involves greater international integration. Australia has great common interest with Asian countries in ensuring that the global financial regulation reforms are appropriate to the region. Therefore, it is important that an Asian regional perspective be taken into account in the Financial Stability Board and with standard setters like the Basle Committee.

[12] Revisiting Cross-Border Fragmentation of Global OTC Derivatives: Mid-year 2014 Update, ISDA, 24 July 2014.

[13] The Cross-Border Regulation Forum was created by an international group of financial services trade associations, including AFMA, investment banks, brokerage houses, market infrastructure operators and consumers of financial services, to help improve and encourage the dialogue on international regulatory standards to engage at an industry level with the IOSCO Task Force.

[14] The Report is available at the following link - CBRF Report 28 May 2014.

AFMA recommendation

The Inquiry should recommend that the Government in its capacity as a G20 member should actively promote and support initiatives to achieve greater international coordination of financial market regulation.

The Inquiry should recommend that the Australian regulators Government Australian regulators should continue to be active participants in international standard setting bodies and use their influence to support measures that support the effective coordination of international regulation.

The Inquiry should recommend that the Australian Government and regulators should work in conjunction with relevant Asian counterparts to ensure that the regional view and the economic interests of the region are most effectively represented in global political and regulatory forums.

We note that the above analysis and recommendations are supplementary to those made in AFMA's first round submission to the Inquiry.

AFMA recommended in our first round submission that:

1. The Government should give a firm commitment that it will give a high priority to measures necessary to sustain an internationally competitive financial sector and communicate this, together with expectations and targets, to its relevant agencies.
2. A Treasury Minister should be given responsibility to champion Australia as a financial services centre, both within government and externally and to work with State counterparts to coordinate policies to promote Australia's financial sector.
3. The regulatory and tax recommendations in the Johnson Report should be implemented and other measures since sought by industry to improve Australia's competitiveness should be examined.

The Australian Government and the industry have a proven capacity to develop the policies required to build on the opportunities provided by Asian economic growth and development. However, we have not made this outcome a priority in the past and by falling short in our execution we have lost business to overseas locations.

The offshore banking unit (OBU) regime is a good example. Australia needs an effective regime to compete with centres like Singapore and Hong Kong. However, we still have not eliminated uncertainty about expense allocation, even though that issue was identified as needing to be resolved as far back as 1997. More recently, interest withholding tax reform was promised on a deferred basis in 2010, then put back for another year in 2011 and now the reform has been dropped.

This record of announcing good policy intentions but then failing to deliver has dented industry confidence in the depth of Australia's intent to compete in the export of financial services and its commitment to maintain a competitive regime in the long run. The Government has the capacity to change attitudes positively towards Australia's commitment to be an exporter of financial services. This must be done through a number of concrete steps that demonstrate its intention. First order of business in this context should be implementation of the Johnson Report reforms – the report was issued in 2009 but many of its recommendations have yet to be implemented.

International business is conducted within an integrated framework of trade, investment and taxation agreements. To take greatest advantage of the Asian opportunities, the Government will need to commit resources to ensuring that our international agreements and supporting relationships are contemporary and effective.

This involves a broad range of activities but, to illustrate their importance, some relevant current example of relevant matters:

- **Maintenance of tax treaties**
  (a) *Negotiating a tax treaty with Hong Kong* – Australia does not have a tax treaty with Hong Kong, despite extensive and growing commercial relations. Hong Kong has in recent times engaged in a concerted effort to expand its Treaty network, such that since 1 January 2010 the number of Treaties concluded has increased from 4 to 30, with a further 14 jurisdictions currently in negotiations. AFMA understands representatives from Hong Kong have approached Australian Government officials to commence negotiations on a Double Taxation Treaty but it is yet to materialise. This tax treaty would be an important step in enhancing the effectiveness of the Investment Manager regime, a key recommendation of the Johnson Report;
  (b) *Negotiating a tax treaty with Luxembourg* – in a similar vein, Australia has not yet commenced negotiations on a tax treaty with Luxembourg, notwithstanding regular overtures from Luxembourg government officials. A tax treaty would be similarly useful in the implementation of the Investment Manager regime, given the significant pool of funds that are held in Luxembourg;
  (c) *Updating the tax treaty with China* – The current treaty dos not effectively provide relief from Chinese capital gains tax in respect of the disposal of portfolio investments in Chinese companies. Renegotiation should place Australian investors on an equal footing vis-à-vis investors from other jurisdictions and is an important step in allowing access to the Chinese capital markets.

- **Maintenance of free trade agreements**
  Negotiating a free trade agreement (FTA) with China - Australia and China agreed in 2005 to commence negotiations on a Free Trade Agreement (FTA) on the basis that it could deliver significant economic benefits for both Australia and China. Negotiations are ongoing.

- **Building government and industry relationships**
  The Asian capital markets are becoming more integrated and forums like ASEAN and APEC are promoting this process. The overall objective for Australia should be to promote development of Australian financial markets through participation in the process of Asian financial market integration. Australia has played an active role in promoting the Asia-Pacific Financial Forum agreed to by the APEC finance ministers in Indonesia last September. Ongoing commitment by the Government at this level will build understandings and relationships that provide framework for the development of policy and regulatory positions to assist Asian financial market integration.

As a general comment, we would advocate closer integration between the negotiation and conclusion of free trade agreements and tax treaties. We have seen instances where the best intentions of free trade agreements have been frustrated by either the absence of a tax treaty, or a treaty that does not exhibit current international best practice. As noted above, a prime example would ne that to the extent a free trade agreement is concluded with China, there would still not be significant investment from Australia into the Chinese equity market due to the tax treaty not effectively relieving double tax on the disposal of Chinese securities.

8.2 Interim Report Observation: Cross border regulatory settings

Government efforts to promote Australia's policy interests on international standard setting bodies have been successful. Domestic regulatory processes could be improved to better consider international standards and foreign regulation, including processes for collaboration and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.

Policy options identified in the Interim Report:

- Improve domestic regulatory process to better consider international standards and foreign regulation — including processes for transparency and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.

AFMA comments

As we outlined in our first round submission, the financial sector, and financial markets in particular, are now to a much greater degree dependent on international regulatory standards, developed by bodies like IOSCO and the Basle Committee on Banking Supervision.

For an open economy like Australia's, global integration and the associated global standards is a given and we have to decide how to best use this situation. It is essential to the Australian national interest that our regulators are both:

- well placed to contribute to the development of global standards; and
- have the capability and confidence to make judgements on the way in which these standards should be applied in the Australian context.

We agree with the Interim Report's observation that are regulators play a constructive role in the international bodies and that this has benefited the Australian financial system and economy in some significant matters; the Committed Liquidity Facility and the treatment of margin on uncleared cross currency swaps come to mind.

International standards will generally be appropriate for the Australian financial system, and adoption is a key element of our efforts to integrate globally. However, there will be situations where the timing or form of adoption of an international standard in Australia would make a material difference to the economic cost and effectiveness of our financial system. The Inquiry process has generated debate about the optimal approach in respect of bank capital requirements. However, the issue pervasive across the financial system reaching into areas of regulation affecting things like financial market operations and financial benchmarks.

Our decision making process in respect of the adoption of international standards must place greatest weight on the right outcome for the Australian economy. These matters are not clear-cut but rather require careful consideration and judgment. Therefore, it is also important to test the relevance and applicability of global standards to Australian financial institutions and markets through a thorough consultation process.

Where such matters may have broader policy implications and impact across the financial system, then these matters should be considered by the Council of Financial regulators. For instance, the introduction of the Basle liquidity framework has significant implications for systemic stability and financial markets and is appropriate for such discussion (as we understand it has been).

8.3 Interim Report Observation: Coordination of financial integration

Coordination of Australia's international financial integration could be improved.

Policy options identified in the Interim Report:

- No change to current arrangements.
- Amend the role of an existing coordination body to promote accountability and provide economy-wide advice to Government about Australia's international financial integration.

AFMA comments

Regulatory coordination

The Council of Financial Regulators (CFR) is the coordinating body for Australia's main financial regulatory agencies and it has operated effectively. We have provided comments on potential improvements to CFR in Section 6.3 above; the current arrangement with RBA as Chair should continue and its membership should be expanded to include all financial sector regulators.

As mentioned above, CFR is the appropriate body to ensure that Australia's response to domestic and international regulatory changes are properly coordinated by domestic regulators. CIFR should enable the financial regulators to consider jointly developments in relation to global regulatory standards and the potential manner of their incorporation into the domestic regime.

CFR should incorporate the Government objectives in relation to the strategic development of the financial system and its international competitiveness into its work stream. However, CFR has a regulatory focus and it does not have the authority or capability to make the policy decisions necessary to achieve an internationally competitive sector.

Championing Australia's competitiveness

The Government is the only body with the authority to lead efforts to build and maintain an internationally competitive financial sector. The responsible Minister plays a key role in Government by pressing for priority to be accorded to financial system development and in championing the international competitiveness of Australia both in Australia and overseas. As part of this process, the Government should communicate this priority to its relevant regulatory agencies and ask them to act on it.

In this regard, it is relevant to observe that a government that has a demonstrated commitment to the development of the financial system is of itself an important component of Australia's competitiveness. Stakeholders in Australia and overseas look to the Government to provide an absolute commitment to maintain the policy and regulatory setting for an internationally competitive financial system, as only it has the authority to make decisions on and implement the policy measures required to deliver on such a commitment.

Industry input to Government strategy

AFMA's hope is that the Inquiry's final report will provide the government with a clear strategic framework through which it can manage its policy priorities to best support the further development of the financial system. Industry know-how and experience must be incorporated as inputs to the Government's development strategy for the financial system, if the strategy is to be well-designed and have any chance of being successful. The Government must be able to receive this industry input directly at Ministerial level and unfiltered through a bureaucratic process.

In this regard, we agree with the proposal from Mark Johnson and Geoff Weir to the Interim Report of the Inquiry, which advocated the formation of an appropriately resourced standing advisory body to liaise between the financial sector and policy advisers.

There is certainly scope and need for a well-credentialed advisory body that would include industry leaders. The body should have an independent and properly resourced secretariat to ensure that its work program is actively managed, with follow through on the agreed initiatives and actions. Industry participants would give of their time and experience freely and contribute in a material way to the work of the body. Matching this commitment, the Government should fund the secretariat; both to illustrate its real commitment to the policy and related process and to reflect the broad community benefits that would flow form success in this area. If the Government cannot commit to this level of input, then the substance of its commitment may be questioned. Moreover, many of the businesses that would be targeted under this strategy would not currently form part of the Australian industry.

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